



Napo Pharmaceuticals, Inc
("Napo" or "the Company")

RESULTS FOR THE YEAR ENDED 31 DECEMBER 2007

South San Francisco; 17 April 2008 – Napo Pharmaceuticals, Inc. (LSE: NAPL and NAPU) announces today its results for the year ended 31 December 2007.

Financial Highlights:

- Net loss attributable to common shareholders was US\$26.2 million, inclusive of US\$4.1 million of in-process R&D associated with the acquisition of IndUS Pharmaceuticals, Inc. and US\$1.9 million of non-cash stock based compensation
- Cash and cash equivalents and short-term investments of US\$7.2 million at 31 December 2007
- Approximately US\$11.1 million (gross) raised through the issuance of common stock (US\$9.6 million) and convertible notes (US\$1.5 million)

Napo has received a "going concern" opinion from its US auditors, BDO Seidman LLP. The opinion states that the Company has suffered recurring losses from operations and has a net capital deficiency that raise substantial doubt about its ability to continue as a going concern.

Management have plans to raise additional funds, which include: the out-license of certain rights to crofelemer including the indications of CRO-HIV, CRO-IBS, CRO-ID and CRO-PED in the United States and other western territories; as well as certain rights to NP-500, in exchange for a licensing fee(s). Such licensing fees may need to be supplemented with debt or equity issuances in order for Napo to have sufficient funds to complete the CRO-HIV Phase 3 clinical trial. If Napo is unable to attract such funding through a combination of licensing fees and equity or debt issuances, it may be forced to curtail sharply its operations including discontinuing the CRO-HIV trial.

Operational Highlights

- Commencement of pivotal Phase 3 CRO-HIV trial, which, subject to further funding, is now expected to complete in the first half of 2009.
- Strengthened intellectual property position
 - Notice of allowance in 2007 (issued in 2008) patent for "enteric formulations of proanthocyanidin polymer anti-diarrhoeal compositions" which expires in 2017

- Additions to Napo's pre-clinical and clinical pipeline, including:
 - in-license of a use patent and regulatory package for NP-500, a compound for the indication of insulin resistance and metabolic disease.
 - in-license of certain patents and technology relating to CFTR (cystic fibrosis transmembrane conductance regulator) inhibitors. The CFTR inhibitors have a mechanism of action similar to that of crofelemer which Napo and its partners are developing for indications including, diarrhoea associated with HIV/AIDS, infectious diarrhoea and paediatric diarrhoea.
 - acquisition of IndUS Pharmaceuticals, Inc. ("IndUS") through the issuance of US\$4.1 million of Napo common stock. IndUS is focused on the discovery and development of new NCEs from natural sources, based on Ayurvedic practice, with therapeutic activity in cancer, diabetes and infectious diseases. IndUS has 5 issued US patents in the oncology area.

- Appointment of Dr. Pravin Chaturvedi as Napo's President and Chief Scientific Officer

Post Period End Highlights

- US\$2.5 million raised through issuance of convertible debt and equity in March 2008
- Statistically significant Phase 2a trial for CRO-ID (crofelemer for the treatment of acute adult infectious diarrhoea) conducted by Napo's partner, Glenmark Pharmaceuticals Limited. The results were based on an observed case analysis. Further analysis is ongoing, as per the protocol and ITT analysis will be published as and when it is available.

CRO-HIV Trial

The CRO-HIV ADVENT trial is a multicenter US trial and enrolment into the trial is directed towards showing clinical benefit of the drug in the patients who have consistent significant watery diarrhoea, which is a subset of the larger number of HIV patients who meet the criteria of having chronic diarrhoea. The Company adopted this strict requirement of the study protocol to minimise the variability in the study results and increase the power of the study. Since commencement of enrolment, over 200 patients have presented with chronic diarrhoea for evaluation for study participation, however, less than 50% have met the strict criteria for watery diarrhoea for study enrolment. Accordingly, Napo now anticipates that the Stage I interim results will be available from the CRO-HIV trial in the second half of this year and that the final results and a NDA filing will occur in the first half of 2009; this is subject to further funding.

Lisa A. Conte, CEO of Napo Pharmaceuticals, Inc. commented: "We are pleased with what Napo was able to accomplish in 2007. We commenced the pivotal Phase 3 trial for CRO-HIV; we increased our pipeline through in-licensing activities; significantly strengthened our management team through the addition of Dr. Pravin Chaturvedi as President and CSO, and we recently announced successful results from Glenmark's Phase 2a trial for CRO-ID. Subject to further funding, we look forward to a successful

conclusion of the Phase 2 cholera trial in Q2 2008 and our CRO-HIV Phase 3 trial in the first half of 2009. Napo is investigating the regulatory pathway to file a NDA for treatment of acute infectious diarrhoea (CRO-ID) with crofelemer coincident with its ongoing Phase 3 program in chronic diarrhoea in people living with HIV/AIDS (CRO-HIV). We believe that the positive results of the Phase 2a CRO-ID trial coupled with the regulatory pathway for CRO-ID/CRO-HIV will be attractive to a partner.”

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About Napo Pharmaceuticals, Inc.

Napo Pharmaceuticals, Inc. focuses on the development and commercialisation of proprietary pharmaceuticals for the global marketplace in collaboration with local partners. Napo was founded in November 2001, and is based in California, USA with a subsidiary in Mumbai, India.

Napo's late-stage proprietary gastro-intestinal compound, crofelemer, is in various stages of clinical development for four distinct product indications, including a late-stage Phase 3 program:

- CRO-HIV for AIDS diarrhoea, Phase 3
- CRO-IBS for diarrhoea irritable bowel syndrome ("D-IBS"), Phase 2
- CRO-ID for acute infectious diarrhoea (including cholera), Phase 2
- CRO-PED for paediatric diarrhoea, Phase 1

The FDA has granted fast-track status to CRO-IBS and CRO-HIV.

CRO-HIV is being evaluated in a randomised, double-blind, parallel-group, placebo-controlled, two-stage, adaptive design study to assess the efficacy and safety of crofelemer at 125mg, 250 mg, and 500 mg oral doses twice daily ("po BID") for the treatment of chronic diarrhoea in people living with HIV/AIDS (the "ADVENT" trial). The ADVENT trial will be executed in two stages. Stage I represents a dose selection stage and Stage II a dose assessment stage. Four dose groups (placebo, 125 mg, 250 mg, and 500 mg) are being assessed in Stage I. When approximately 50 subjects per group complete the initial efficacy dosing period (28 days), an interim analysis will be conducted to select an optimal single dose of crofelemer for Stage II. Stage II will continue until an additional 75 subjects are randomised both to this dose of crofelemer

and the placebo, providing for 125 patients on placebo and 125 patients the selected crofelemer dose.

Crofelemer, a proprietary patented agent, is extracted from *Croton lechleri*, a medicinal plant which can be sustainably harvested from several countries in South America. Napo also plans to develop an early clinical stage product, NP-500, for the treatment of insulin resistant diseases of Type 2 diabetes and metabolic syndrome (Syndrome X; pre-diabetic syndrome). Napo also has a plant library of approximately 2,300 medicinal plants from tropical regions, and Napo has entered two screening relationships associated with this collection. Currently, products are based on the chemical and biological diversity derived from plants with medicinal properties, but future products may be in-licensed from other sources.

Napo has partnerships with Glenmark Pharmaceuticals Limited of India and AsiaPharm Group Ltd. of China. For more information please visit www.napopharma.com.

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This release contains certain statements, statistics and projections that are or may be forward-looking. These statements are based on the current expectations or beliefs of Napo's management and are subject to a number of factors and uncertainties (including the "Risk Factors" identified in Napo's Prospectus issued on 28 September 2007) and the outcome of these events may differ materially from those described in the forward-looking statements. The accuracy and completeness of all such statements, including, without limitation, statements regarding the future financial position, strategy, projected costs, plans and objectives for the management of future operations of Napo and its subsidiaries is not warranted or guaranteed. These statements typically contain words such as "intends", "expects", "anticipates", "estimates" and words of similar import. By their nature, forward looking statements involve risk and uncertainty because they relate to events and depend on circumstances that will occur in the future. Although Napo believes that the expectations reflected in such statements are reasonable, no assurance can be given that such expectations will prove to be correct. There are a number of factors, which may be beyond the control of Napo, which could cause actual results and developments to differ materially from those expressed or implied by such forward-looking statements. Other than as required by applicable law or the applicable rules of any exchange on which our securities may be listed, Napo has no intention or obligation to update forward-looking statements contained herein. You should not place

undue reliance on forward looking statements, which speak only as at the date of this announcement.

Chairman and Chief Executive's Statement

Napo had several milestones that the Company hoped to achieve in 2007. Below is a summary of the intended milestones and a brief comment on the current status.

- Launch of the CRO-HIV pivotal Phase 3 trial:
 - Napo initiated patient enrolment for the pivotal, Phase 3 CRO-HIV trial in 2007. This trial is currently on-going and the Company now anticipates, subject to further funding, the Stage I interim results will be available from the CRO-HIV trial in the second half of this year and that the final results and a NDA filing will occur in the first half of 2009.
- Completion of the CRO-ID Phase 2 Cholera Trial
 - This trial is ongoing. Napo is testing lower doses and different formulations in the continuation of the cholera trial (See May 21, 2007 press release – “Ethics Committee Approval Granted for Multiple-Dose Continuation of Phase 2 Clinical Trial of Crofelemer for Treatment of Secretary Diarrhoea Associated with Cholera Infection”). Napo anticipates results from the trial in Q2 2008.
- Clinical progress of CRO-IBS Phase 2b trial (conducted by Napo's former licensee – Trine Pharmaceuticals Inc (“Trine”))
 - On 11 February 2008 Napo announced Trine's disclosure to Napo of Trine's review of preliminary data of the Phase 2b study conducted by Trine for the treatment of diarrhoea-predominant irritable bowel syndrome (“D-IBS”) with crofelemer (“CRO-IBS”). Napo was informed by Trine that they have determined that: i) the primary clinical endpoint of pain was not achieved; and ii) that there were no drug related adverse events. Napo and Trine have mutually terminated the license of crofelemer to Trine (See “Partners” for more information.). The Company recently received the data package from the trial and is evaluating the data.
- Development and planning for NP-500 for insulin resistance and metabolic disease
 - Napo has designed the outline of a Phase 2 trial for NP-500 which will commence upon the selection of a development partner and appropriate regulatory submissions. In February 2007, Napo entered into an agreement for the in-license of a use patent and regulatory and other information regarding NP-500. The license will allow Napo to have access to the regulatory package filed with the United States Federal Drug Administration, and to access technology protected by a use patent in the United States.
- Clinical progress of Glenmark's acute infectious diarrhoea indication

- Glenmark initiated a Phase 2a trial for CRO-ID at the end of November 2007, the positive results of which were announced on 10 April 2008. The results were based on an observed case analysis. Further analysis is ongoing, as per the protocol and ITT analysis will be published as and when it is available.
- IP Development
 - In late 2007, a notice of allowance was posted on the United States Patent Office web site for Napo's patent application "enteric formulations of proanthocyanidin polymer antidiarrhoeal compositions". This patent was later issued in early 2008. This patent, in conjunction with Napo's existing IP, the CFTR technology licensed from UCSF plus the recently licensed patent from the University of Iowa regarding secretory diarrhoea strengthens our IP position with regard to crofelemer's mechanism of action.
 - Napo reached agreement with the University of Iowa Research Foundation to obtain the non exclusive, royalty free license of United States Patent No. 5,234,922, and titled Use of Sulfonylureas and Other Potassium Channel Regulators to Treat Secretory Diarrhoea, and in the inventions described and claimed therein.
 - With the acquisition of IndUS, the Company acquired the exclusive worldwide rights to novel PBD compounds for the treatment of various types of cancers. Five US patents covering several preclinical candidates in the cancer portfolio of Napo Pharmaceuticals (US Patent Nos. 6,362,331, 6,800,622, 6,683,073, 6,884,799 and 7,015,215) have been issued. The Directors believe that the strength of the issued patents in the US and Patent Co-Operation Treaty countries together with the associated intellectual property estate around these compounds provides a significant intellectual property position for the Company across this class of compounds, which may provide the basis for the global commercialisation success of these potential new anticancer drugs. The Company also acquired several plant extracts with preclinical activity in the fields of diabetes and infectious diseases.
- Plans/partnering for western territory paediatric development
 - With the termination of the license agreement with Trine, Napo is in discussions with potential partners to license crofelemer in western markets across all its indications.
- Progress on the development of a lower cost manufacturing process for crofelemer
 - Our manufacturing partner is working on process improvements for crofelemer that will reduce the cost of manufacturing active pharmaceutical ingredient ("API"). It is anticipated that such

improvements will begin to be utilised in the early years of commercial manufacturing.

- Pre-clinical pipeline development
 - We are pleased to have accomplished this goal through:
 - in-licensing a regulatory package and a use patent covering NP-500 – for insulin resistance and metabolic disease;
 - in-licensing of CFTR technology (similar mechanism of action to crofelemer) from the University of California; and
 - the acquisition of IndUS and its pre clinical indications in oncology, infectious disease and diabetes.

The Acquisition of IndUS Pharmaceuticals

In October the Company acquired IndUS Pharmaceuticals, Inc. based in the Boston area, Massachusetts and with operations in Hyderabad and Coimbatore, India. IndUS is focused on the discovery and development of new NCEs from natural sources based on Ayurvedic practice with therapeutic activity in cancer, diabetes and infectious diseases. IndUS Pharmaceuticals has a portfolio of several novel pyrrolo [2,1-c][1,4] benzodiazepine (PBD) dimers that show sequence selective DNA minor-groove binding and display potent *in vitro* antitumor activity. IndUS has 5 issued US patents on these compounds and some have corresponding foreign patent applications. Furthermore, IndUS has a library of plant extracts demonstrating preclinical activity in the diabetes and infectious disease areas. The CEO of IndUS, Dr. Pravin Chaturvedi became Napo's President and Chief Scientific Officer and has been a tremendous addition to Napo.

Crofelemer IP Rights and Strategy

The Company now retains all rights to crofelemer in North America, Japan and Western Europe under its intellectual property as a result of the mutual termination of the license agreement with Trine. In early 2008, Napo and Trine mutually agreed to terminate their license agreement for crofelemer after Napo was notified that Trine's review of preliminary data for the Phase 2b trial for crofelemer for a diarrhoea predominant irritable bowel syndrome ("D-IBS") did not meet its endpoint for pain. With the termination of the agreement with Trine, Napo is conducting further analysis of the clinical data from the D-IBS study.

The Directors believe that the retention of all rights to crofelemer provides an opportunity for new licensing activity around crofelemer, not only for CRO-HIV and CRO-IBS, but for the range of indications including CRO-ID. Accordingly, Napo is in discussions with several parties regarding the potential licensing and partnering of this important asset.

Board changes

On 20 April 2007, Sir William Young, Chairman and Dr. Gregory Stock joined Jack Van Hulst on the board of directors of Napo. On 12 June 2007, Thomas Van Dyck joined the board of directors. Four Non-executive Directors resigned on 20 April 2007.

Napo's goals for 2008:

Whilst we recognise that the Company requires further funds to continue its operations, and we are committed to raising these funds either through licensing fees and/or equity or debt issuance, we have set the following goals for 2008:

- Completion of Stage I of the CRO-HIV trial
- Initiation of Glenmark's CRO-ID trial Phase 2b trial
- Announce data from the cholera trial
- Out-license of western rights to cfofelemer across its various indications
- Anticipated partnering and clinical development of NP-500

Thank you for your support. We would also like to thank our Non-executive Directors for their tremendous input and support of Napo.

Sir William Young
Chairman of the Board

Lisa A. Conte
CEO

Finance Review

Summary of Results of Operations:

| | Years Ended 31 December | | |
|---|--------------------------------|--------------------|--------------------|
| | <u>2005</u> | <u>2006</u> | <u>2007</u> |
| Revenue | 8,973 | 1,238,444 | 303,297 |
| Operating expenses: | | | |
| Cost of revenue: | 37 | | |
| General & administrative (2) | 2,090,909 | 4,361,064 | 7,052,738 |
| Research & development (1) | 1,297,076 | 7,469,626 | 19,495,072 |
| Total operating expenses | 3,388,022 | 11,830,690 | 26,547,810 |
| Loss from operations | (3,379,049) | (10,592,246) | (26,244,513) |
| Other income, net | 65,200 | 181,165 | 32,481 |
| Interest (expense.) income, net | (22,758) | 340,447 | 685,388 |
| Net loss | (3,336,607) | (10,070,634) | (25,526,644) |
| Deemed dividends | | (3,942,007) | (637,500) |
| Net loss attributable to common shareholders | (3,336,607) | (14,012,641) | (26,164,144) |
| Non-cash stock based compensation expense included in operating expenses: | | | |
| Research & development (1) | 15,762 | 767,437 | 1,746,332 |
| General & administrative (2) | 31,949 | 239,559 | 197,578 |
| Basic and diluted net loss per common share US\$ | (\$82.42) | (\$0.83) | (\$0.59) |
| Basic and diluted net loss per common share (pounds) | (£42.09) | (£0.41) | (£0.29) |
| Shares used in basic and diluted net loss per common share calculation | 40,484 | 16,925,408 | 44,451,285 |

Comparison of Years Ended 31 December 2007 and 2006

Revenue. Revenue in the year ended 31 December 2007 was attributable to contract revenue of approximately US\$300,000 from a grant from the National Institutes of Health – National Institute of Allergy and Infectious Diseases associated with the development of a formulation of crofelemer for cholera; as compared to US\$1.2 million in the year ended 31 December 2006. The majority of revenue in 2006 was the result of a US\$1 million milestone payment from Trine, which in 2004 licensed crofelemer for the indication of diarrhoea-predominant IBS (CRO-IBS) worldwide. The milestone payment

was associated with Trine's initiation of a Phase 2b trial for CRO-IBS. Additionally, Napo received contract revenue of US\$238,000 associated with the development of a formulation of crofelemer for cholera.

General and Administrative Expenses. General and administrative expenses were US\$7.1 million in the year ended 31 December 2007 compared to US\$4.4 million in the year ended 31 December 2006. In 2007, corporate legal costs were approximately \$1.7 million, an increase of approximately US\$1.1 million from approximately US\$600,000 in 2006. The increase in corporate legal expenses was related to the full year effect of a public listing of Napo common stock, changes in Napo's board of directors, acquisition costs related to the merger with IndUS and in-licensing activity associated with NP-500 and the CFTR technology licensed from the University of California - San Francisco and other general legal costs. Patent costs also increased substantially in 2007 to approximately US\$400,000 from US\$100,000 in 2006 related to the development of new intellectual property. Other increases in 2007 in general and administrative expenses included increased salary costs of approximately \$400,000; higher travel costs which increased approximately US\$71,000; plus higher charges related to employee benefits of approximately US\$123,000, both as a result of increased company headcount and higher charges for insurance for health and life coverage. Other general and administrative expenses including communications, rent, professional services as well as other expense items, collectively increased approximately \$400,000. Included in general and administrative expenses were non-cash compensation charges of approximately US\$198,000 associated with the grant of incentive equity options compared to approximately \$240,000 in the year ended 31 December 2006

Research and Development. Research and development expenses were US\$19.5 million in the year ended 31 December 2007 compared to US\$7.5 million in the year ended 31 December 2006. The increase in research and development expenses is attributable to the preparation for and initiation of the CRO-HIV trial as well as US\$4.1 million in-process research and development costs related to the acquisition of IndUS. The trial related expenses include costs related to pharmaceutical manufacturing, formulation, packaging and third party contractors and consultants involved with administering the trial. Excluding personnel and compensation expenses, expenses for the CRO-HIV trial increased to approximately US\$7.0 million in 2007 from approximately US\$2.5 million in 2006. In 2007 there were personnel additions in the areas of clinical development, formulation, quality-control and manufacturing. Overall, salary compensation for research and development personnel increased approximately \$2.0 million in 2007. There were sixteen research and development personnel at the end of 2007 compared to thirteen at the end of 2006. Included in research and development expenses were approximately US\$1.7 million of non-cash charges associated with the grant of incentive equity options compared to US\$767,000 in 2006.

Other income, net. Other income in the year ended 31 December 2007 was US\$32,000 compared to US\$181,000 in the year ended 31 December 2006. Other income in 2006 included a gain on a settlement with a third party regarding damages to property held in storage of US\$172,000.

Net Interest. Net interest *income* in the year ended 31 December 2007 was US\$685,000 compared to net interest *income* of US\$340,000 in the year ended 31 December 2006. The interest income in 2007 was due to higher net cash balances for a full year compared to the year ended 31 December 2006.

Deemed dividends. In the year ended 31 December 2007, Napo incurred non-cash charges of US\$638,000 associated with deemed dividends on Optionally Convertible Preferred Shares held by an investor in India. In 2006, Napo incurred non-cash charges of approximately US\$3.9 million associated with the issuance of Series C Convertible Preferred Stock in the months prior to Napo's initial public offering.

Net loss attributable to common stockholders. The net loss attributable to common stockholders in the year ended 31 December 2007 was US\$26.2 million compared to US\$14.0 million at 31 December 2006 reflecting significant increases in research and development activity related to the CRO-HIV trial, the write-off of in-process R&D related to the acquisition of IndUS in October 2007 and higher levels of general and administrative expenses associated with increased operating activities and non cash compensation charges and deemed dividends.

Comparison of Years Ended 31 December 2006 and 2005

Revenue. Revenue in the year ended 31 December 2006 was approximately US\$1.2 million as compared to US\$9,000 in the year ended 31 December 2005. In 2006, Napo received a US\$1 million milestone payment from Trine, which in 2004 licensed crofelemer for the indication of diarrhoea-predominant IBS (CRO-IBS) worldwide. The milestone payment was associated with Trine's initiation of a Phase 2b trial for CRO-IBS. Additionally, Napo received a contract revenue of approximately US\$244,000 from a grant from the National Institutes of Health – National Institute of Allergy and Infectious Diseases associated with the development of a formulation of crofelemer for cholera. Milestone and contract revenue of approximately US\$1,244,000 was partially offset by the write off of another revenue item which reduced total revenue to approximately US\$1,238,000.

General and Administrative Expenses. General and administrative expenses were approximately US\$4.4 million in the year ended 31 December 2006 compared to US\$2.1 million in the year ended 31 December 2005. General and administrative expenses increased in the year ended 31 December 2006 as a result of higher employee headcount and higher compensation, employee recruiting activities as well as increased costs associated with Napo's public offering including travel, public relations and other legal costs. Included in general and administrative expenses were non-cash compensation charges of US\$240,000 associated with the grant of incentive equity options compared to \$32,000 in the year ended 31 December 2005.

Research and Development. Research and development expenses were approximately US\$7.5 million in the year ended 31 December 2006 compared to US\$1.3 million in the year ended 31 December 2005. Research and development expenses increased significantly in 2006 with the addition of additional employees and consultants in the areas of manufacturing and clinical development in preparation for the pivotal Phase 3 trial for CRO-HIV and the cholera trial which began in March 2006. In addition to personnel, there were higher costs associated with preparations for the manufacture of active pharmaceutical ingredient, formulation and related activities. Research and development employees increased to thirteen at the end of 2006 from four at the end of 2005. Included in research and development expenses were non-cash compensation charges of US\$767,000 associated with the grant of incentive equity options compared to US\$16,000 in the year ended 31 December 2005.

Other income, net. Other income in the year ended 31 December 2006 was approximately US\$181,000 compared to US\$65,200 in the year ended 31 December

2005. Other income in 2006 included a gain on a settlement with a third party regarding damages to property held in storage of US\$172,000, while the other income item of US\$65,000 in the year ended 31 December 2005 was due to an insurance recovery on damaged property.

Net Interest. Net interest *income* in the year ended 31 December 2006 was approximately US\$340,000 compared to net interest *expense* of US\$23,000 in the year ended 31 December 2005. The interest income in 2006 was due to higher net cash balances while the net interest expense in the year ended 31 December 2005 was associated with interest expense on US\$1.1 million series C convertible notes which converted to Series C Preferred Shares in July 2005.

Deemed dividends. In the year ended 31 December 2006, Napo incurred non-cash charges of approximately US\$3.9 million associated with the issuance of Series C Convertible Preferred Stock in the months prior to Napo's initial public offering.

Net loss attributable to common stockholders. The net loss attributable to common stockholders in the year ended 31 December 2006 was approximately US\$14.0 million compared to US\$3.3 million in the year ended 31 December 2005, reflecting significant increases in research and development activity and higher levels of general and administrative expenses associated with increased operating activities and as well as Napo's initial public offering and non cash compensation charges and deemed dividends.

Cash Flow and Liquidity

For the years ended 31 December 2007 and 2006, cash used in operating activities was US\$18.4 million US\$7.2 million, respectively, and cash used to purchase property and equipment was US\$389,000 and US\$481,000.

Net cash provided by sales of investments, offset by investment purchases was US\$13.2 million in 2007. Additionally US\$1.4 million was used to license a regulatory package for NP-500, for insulin resistance and metabolic disease. In 2006 net purchases of investments were US\$18.8 million.

Net cash provided by financing activities was US\$7.6 million in 2007 and US\$26.2 million in 2006.

Financing activities in 2007 included:

In December 2006 and January 2007, Napo issued 3,150,914 shares of common stock including 124,271 shares to advisors at 94.5 pence or US\$1.85 per share for gross proceeds of US\$5.6 million and received a conditional commitment for additional funds of US\$300,000.

In October 2007, Napo issued 2,844,584 shares of common stock at 70 pence (approximately US\$1.41 per share).

In December 2007 and January 2008 the Company entered into subscription agreements in connection with the issuance of US\$1,475,000 of 8% Convertible Notes due 2010 ("2007 Notes"). Of this amount, US\$975,000 was received in December 2007

and the remaining US\$500,000 was received in January 2008. These notes were subsequently amended in March 2008 to have a maturity date of 31 May 2009. The notes are 100% convertible at US\$0.55 per share, representing 2,665,896 common shares of Napo. Holders of the 2007 Notes also received warrants to purchase 1,332,948 shares of Napo common stock at US\$0.55 per share.

As of 31 December 2007 Napo had cash and cash equivalents plus short term investments of US\$7.2 million and no bank borrowings and with US\$975,000 of convertible debt. Cash and cash equivalents plus short term investments at the beginning of the year was US\$18.4 million.

There was no capitalised interest in either period.

Earnings Per Share and Dividends

The net loss per common share in the year ended 31 December 2007 was US\$0.59 per share or £0.29 compared to 31 December 2006 at US\$0.83 or £0.41 GBP. Napo does not plan to pay any dividends in the foreseeable future, if ever.

The closing market price of the Company's shares at the end of the financial year in 2007 was 46.5 pence (31 December 2007); and the range of market prices during the year was between 46.5 pence and 96 pence.

Credit Risk

Napo holds significant cash balances which are invested on a short-term basis. These deposits and other financial instruments give rise to credit risk on amounts due from counterparties. Credit risk is managed by limiting the aggregate amount and duration of the exposure to any one counterparty by reference to its credit rating. Counterparties are chosen based on yield, availability of funds, credit rating and quality of service.

The maximum maturity of the portfolio may not exceed 36 months with the average maturity not to exceed 18 months. Eligible investment includes US treasury securities, asset-backed securities with a minimum rating of AAA, and A-1 rated money market instruments.

Subsequent Event

In March 2008, Napo entered into note and warrant purchase agreements for the issuance of convertible promissory notes that bear interest at a rate of 3.2 per cent for a total of US\$2,250,000 ("2008 Notes"). Up to 25 per cent of the principal amount of the 2008 Notes are convertible into shares of Napo common stock at a price of 27.9 pence per share. If the maximum conversion takes place, the Company would issue 1,016,655 shares of Napo common stock. The remaining 75 per cent of the 2008 Notes are repayable in cash on 31 July 2008. Holders of the 2008 Notes were also issued warrants to purchase 3,049,965 common shares of Napo common stock exercisable at any time from 31 July 2008 until 3 March 2013 at the conversion price of 27.9 pence per share.

In March 2008, coincident with the 2008 Notes Napo issued 600,000 shares of common stock to an investor at 25 pence per share.

Consolidated Balance Sheets

| | 2007 \$ | 2006 \$ |
|--|--------------------------|--------------------------|
| Assets | | |
| Cash and cash equivalents | 1,502,006 | 920,704 |
| Short-term investments | 5,736,971 | 18,803,881 |
| Stock subscriptions receivable | — | 599,998 |
| Prepaid expenses and deposits | 193,650 | 36,856 |
| Accounts receivable | 160,925 | — |
| Other current assets | 583,611 | 221,712 |
| Total current assets | <u>8,177,163</u> | <u>20,583,151</u> |
| Property and equipment, net | 588,941 | 425,961 |
| Prepaid license fee | 1,369,565 | — |
| Deposits | 79,888 | — |
| Patent, net | 83,329 | 111,109 |
| Total Assets | <u><u>10,298,886</u></u> | <u><u>21,120,221</u></u> |
| Liabilities and Stockholders' Equity (Deficit) | | |
| Accounts payable | 2,732,917 | 414,060 |
| Accrued compensation | 492,069 | 535,415 |
| Other current liabilities | 697,791 | 1,350,206 |
| Total current liabilities | <u>3,922,777</u> | <u>2,299,681</u> |
| Convertible notes payable | 975,000 | — |
| Total Liabilities | 4,897,777 | 2,299,681 |
| Convertible redeemable preference shares | | |
| (Optionally convertible, redeemable preference shares, 1 Indian Rupee par value, 3,886,555 and 3,529,412 shares authorized, issued and outstanding at 31 December 2007 and 2006, respectively, aggregate liquidation preference of US\$6,848,330 and US\$5,710,830 at 31 December 2007 and 2006, respectively) | 6,848,330 | 5,710,830 |
| Commitments and Contingencies (Note 4) | | |
| Stockholders' Equity (Deficit) | | |
| Common stock: \$0.0001 par value, 90,000,000 shares authorised; 49,215,080 and 39,910,222 shares issued and outstanding at 31 December 2007 and 2006, respectively | 4,931 | 3,991 |
| Common stock subscribed | — | 49 |
| Stock subscriptions receivable | — | (300,000) |
| Accumulated other comprehensive income (loss) | 12,954 | (7,658) |
| Additional paid-in capital | 47,661,518 | 36,328,335 |
| Deficit accumulated during the development stage | (49,079,151) | (22,915,007) |
| Treasury stock, at cost, 125,614 shares at 31 December 2007 | (47,473) | — |
| Total Stockholders' Equity (Deficit) | <u>(1,447,221)</u> | <u>13,109,710</u> |
| Total Liabilities and Stockholders' Equity (Deficit) | <u><u>10,298,886</u></u> | <u><u>21,120,221</u></u> |

See summary of accounting policies and notes to consolidated financial statements.

Consolidated Statements of Operations

| | Year Ended 31 December | | | Period from Inception (15 November 2001) through 31 December 2007 |
|--|------------------------|--------------|-------------|---|
| | 2007 \$ | 2006 \$ | 2005 \$ | 2007 \$ |
| Revenue | 303,297 | 1,238,444 | 8,973 | 2,865,135 |
| Operating expenses: | | | | |
| Cost of revenue | — | — | 37 | 194,601 |
| General and administrative expense(1) | 7,052,738 | 4,361,064 | 2,090,909 | 16,781,093 |
| Research and development expense(2) | 19,495,072 | 7,469,626 | 1,297,076 | 31,267,215 |
| Total operating expenses | 26,547,810 | 11,830,690 | 3,388,022 | 48,242,909 |
| Loss from operations | (26,244,513) | (10,592,246) | (3,379,049) | (45,377,774) |
| Gain from insurance recovery | — | 172,051 | — | — |
| Interest (expense) income, net | 685,388 | 340,447 | (22,758) | 771,335 |
| Other income, net | 32,481 | 9,114 | 65,200 | 106,795 |
| Net loss | (25,526,644) | (10,070,634) | (3,336,607) | (44,499,644) |
| Deemed dividends | (637,500) | (3,942,007) | — | (4,579,507) |
| Net loss attributable to common stockholders | (26,164,144) | (14,012,641) | (3,336,607) | (49,079,151) |
| Basic and diluted net loss per common share (USD) | (0.59) | (0.83) | (82.42) | |
| Basic and diluted net loss per common share (pounds) | (0.29) | (0.41) | (42.09) | |
| Shares used in basic and diluted net loss per common share calculation | 44,451,285 | 16,925,408 | 40,484 | |
| Included in operating expenses is noncash stock-based compensation as follows: | | | | |
| (1) General and administrative expense | 197,578 | 239,559 | 31,949 | 659,481 |
| (2) Research and development expense | 1,746,332 | 767,437 | 15,762 | 2,619,064 |

See summary of accounting policies and notes to consolidated financial statements.

Statement of Stockholder's Equity, Optionally Convertible Redeemable Preference Shares ("OCRPS") and Accumulated Other Comprehensive Income

| | OCRPS | | Common Stock | | Common Stock Subscribed | | Stock Subscriptions | Paid-in | Series A Preferred Stock | | Series B Preferred Stock | | Series C Preferred Stock | | Accumulated | Accumulated Other Comprehensive | Stockholders' |
|---|--------|--------|--------------|--------|----------------------------|--------|------------------------|-----------|-----------------------------|-----------|-----------------------------|--------|-----------------------------|-------------|-------------|---------------------------------------|---------------|
| | Shares | Amount | Shares | Amount | Shares | Amount | Receivable | Capital | Shares | Amount | Shares | Amount | Shares | Amount | Deficit | Income | Equity |
| | | \$ | | \$ | | \$ | \$ | \$ | | \$ | | \$ | | \$ | \$ | \$ | \$ |
| Issuance of common stock in December 2001 for cash | | | 9,378 | 1 | | | | 277 | | | | | | | | | 278 |
| Issuance of Series A preferred stock at \$0.2998 per share in December 2001 for cash | | | | | | | | | 750,000 | 225,000 | | | | | | | 225,000 |
| Issuance of Series A preferred stock to pay predecessor expenses at \$0.2998 per share in December 2001, net issuance costs of \$10,150 | | | | | | | | 1,932,341 | 569,169 | | | | | | | | 569,169 |
| Issuance of common stock warrants for services in May and June 2002 | | | | | | | | 2,503 | | | | | | | | | 2,503 |
| Issuance of series A warrants for services in June 2002 | | | | | | | | | | 3,002 | | | | | | | 3,002 |
| Issuance of common stock for cash at \$0.03 per share throughout 2002 | | | 11,106 | 1 | | | | 336 | | | | | | | | | 337 |
| Issuance of Series A preferred stock at \$0.2998 per share in June 2002, net issuance costs of \$3,543 | | | | | | | | | 3,176,009 | 962,164 | | | | | | | 962,164 |
| Compensation recognized under incentive stock option plans | | | | | | | | 31,602 | | | | | | | | | 31,602 |
| Net loss from inception through 31 December 2002 | | | | | | | | | | | | | | (1,845,358) | | | (1,845,358) |
| Balances at 31 December 2002 | | | 20,484 | 2 | | | | 34,718 | 5,858,350 | 1,759,335 | | | | | (1,845,358) | | (51,303) |
| Compensation recognized under incentive stock option plans | | | | | | | | 67,667 | | | | | | | | | 67,667 |
| Net loss | | | | | | | | | | | | | | (1,972,121) | | | (1,972,121) |
| Balances at 31 December 2003 | | | 20,484 | 2 | | | | 102,385 | 5,858,350 | 1,759,335 | | | | | (3,817,479) | | (1,955,757) |

See summary of accounting policies and notes to financial statements.

(Continued)

| | OCRPS | | Common Stock | | Common Stock Subscribed | | Stock Subscriptions | Paid-in | Series A Preferred Stock | | Series B Preferred Stock | | Series C Preferred Stock | | Accumulated | Accumulated Other Comprehensive | Stockholders' |
|--|--------|--------|--------------|--------|----------------------------|--------|------------------------|---------|-----------------------------|-----------|-----------------------------|-----------|-----------------------------|-----------|-------------|---------------------------------------|---------------|
| | Shares | Amount | Shares | Amount | Shares | Amount | Receivable | Capital | Shares | Amount | Shares | Amount | Shares | Amount | Deficit | Income | Equity |
| | | \$ | | \$ | | \$ | \$ | \$ | | \$ | | \$ | | \$ | \$ | \$ | \$ |
| Balances at 31 December 2003 | | | 20,484 | 2 | | | | 102,385 | 5,858,350 | 1,759,335 | | | | | (3,817,479) | | (1,955,757) |
| Issuance of common stock in exchange for services in March 2004 | | | 20,000 | 2 | | | | 600 | | | | | | | | | 602 |
| Issuance of common stock warrants in exchange for services in March and April 2004 | | | | | | | | 4,117 | | | | | | | | | 4,117 |
| Issuance of Series B preferred stock at \$0.50 per share in March through September 2004, including conversion of short-term notes payable | | | | | | | | | | 6,999,233 | 3,459,001 | | | | | | 3,459,001 |
| Issuance of common stock warrants with preferred stock in March 2004 | | | | | | | | 115,585 | | | | | | | | | 115,585 |
| Compensation recognized under incentive stock option plans | | | | | | | | 54,851 | | | | | | | | | 54,851 |
| Net loss | | | | | | | | | | | | | | | (1,748,280) | | (1,748,280) |
| Balances at 31 December 2004 | | | 40,484 | 4 | | | | 277,538 | 5,858,350 | 1,759,335 | 6,999,233 | 3,459,001 | | | (5,565,759) | | (69,881) |
| Issuance of common stock warrants in exchange for services in February and September 2005 | | | | | | | | 5,705 | | | | | | | | | 5,705 |
| Issuance of Series C preferred stock from July through December 2005 at \$0.85 per share, net of issuance costs of \$24,185 | | | | | | | | | | | | 5,260,017 | 4,451,029 | | | | 4,451,029 |
| Compensation recognized under incentive stock option plans | | | | | | | | 42,006 | | | | | | | | | 42,006 |
| Net loss | | | | | | | | | | | | | | | (3,336,607) | | (3,336,607) |
| Balances at 31 December 2005 | | | 40,484 | 4 | | | | 325,249 | 5,858,350 | 1,759,335 | 6,999,233 | 3,459,001 | 5,260,017 | 4,451,029 | (8,902,366) | | 1,092,252 |

See summary of accounting policies and notes to financial statements.

(Continued)

| | OCRPS | | Common Stock | | Common Stock Subscribed | | Stock Subscriptions | Paid-in | Series A Preferred Stock | | Series B Preferred Stock | | Series C Preferred Stock | | Accumulated | Accumulated Other Comprehensive | Stockholders' |
|---|-----------|-----------|--------------|--------|-------------------------|--------|---------------------|------------|--------------------------|-------------|--------------------------|-------------|--------------------------|-------------|--------------|---------------------------------|---------------|
| | Shares | Amount | Shares | Amount | Shares | Amount | Receivable | Capital | Shares | Amount | Shares | Amount | Shares | Amount | Deficit | Income | Equity |
| | | \$ | | \$ | | \$ | \$ | \$ | | \$ | | \$ | | \$ | \$ | \$ | \$ |
| Balances at 31 December 2005 | | | 40,484 | 4 | | | | 325,249 | 5,858,350 | 1,759,335 | 6,999,233 | 3,459,001 | 5,260,017 | 4,451,029 | (8,902,366) | | 1,092,252 |
| Issuance of Series C preferred stock in January through April 2006 net of issuance costs | | | | | | | | | | | | | 3,135,291 | 2,654,110 | | | 2,654,110 |
| Conversion of preferred stock into common stock on initial public offering | | | 21,352,958 | 2,135 | | | | 13,582,517 | (5,958,417) | (1,789,335) | (6,999,233) | (3,459,001) | (8,395,308) | (8,336,316) | | | |
| Issuance of common stock in connection with option exercises | | | 1,247,090 | 124 | | | | 38,039 | | | | | | | | | 38,163 |
| Issuance of common and preferred stock upon warrant exercises | | | 2,569,036 | 257 | | | | 1,315,761 | 100,067 | 30,000 | | | | | | | 1,346,018 |
| Compensation recognized under incentive stock option plans | | | | | | | | 981,060 | | | | | | | | | 981,060 |
| Issuance of OCRPS, net of issuance costs of \$141,979 | 3,529,412 | 2,858,021 | | | | | | | | | | | | | | | |
| Deemed dividend on OCRPS | | 2,294,118 | | | | | | | | | | | | | (2,294,118) | | (2,294,118) |
| Accretion of OCRPS | | 416,712 | | | | | | | | | | | | | (416,712) | | (416,712) |
| Recognition of issuance costs on issuance of OCRPS | | 141,979 | | | | | | (141,979) | | | | | | | | | (141,979) |
| Preferred stock deemed dividend | | | | | | | | | | | | | 1,231,177 | (1,231,177) | | | |
| Issuance of common stock in December 2006 for cash, net of issuance costs of \$139,981 | | | 400,606 | 41 | | | | 368,989 | | | | | | | | | 369,030 |
| Issuance of common stock for cash in connection with initial public offering in July 2006, net of issuance costs of \$2,216,707 | | | 14,300,048 | 1,430 | | | | 18,932,814 | | | | | | | | | 18,934,244 |
| Common stock issuable for cash | | | | | 324,727 | 32 | | 599,966 | | | | | | | | | 599,998 |
| Common stock issuable under subscription agreements | | | | | 170,482 | 17 | (300,000) | 299,983 | | | | | | | | | |
| Issuance of warrants in September 2006 | | | | | | | | 25,936 | | | | | | | | | 25,936 |
| Unrealized loss on investments | | | | | | | | | | | | | | | | (7,658) | (7,658) |
| Net loss | | | | | | | | | | | | | | | (10,070,634) | | (10,070,634) |
| Comprehensive loss | | | | | | | | | | | | | | | | | (10,078,292) |
| Balances at 31 December 2006 | 3,529,412 | 5,710,830 | 39,910,222 | 3,991 | 495,209 | 49 | (300,000) | 36,328,335 | | | | | | | (22,915,007) | (7,658) | 13,109,710 |

See summary of accounting policies and notes to financial statements

(Continued)

| | OCRPS | | Common Stock | | Common Stock Subscribed | | Treasury Stock | | Stock Subscriptions | Paid-in | Accumulated | Accumulated Other Comprehensive | Stockholders' |
|---|-----------|-----------|--------------|-----------|-------------------------|-----------|----------------|-----------|---------------------|------------|--------------|---------------------------------|---------------|
| | Shares | Amount \$ | Shares | Amount \$ | Shares | Amount \$ | Shares | Amount \$ | Receivable \$ | Capital \$ | Deficit | Income \$ | Equity \$ |
| Balances at 31 December 2006 | 3,529,412 | 5,710,830 | 39,910,222 | 3,991 | 495,209 | 49 | | | (300,000) | 36,328,335 | (22,915,007) | (7,658) | 13,109,710 |
| Common stock issued under subscription agreements in January 2007 | | | 495,209 | 49 | (495,209) | (49) | | | 300,000 | | | | 300,000 |
| Issuance of common stock in connection with option exercises | | | 672,000 | 67 | | | 25,614 | (47,463) | | 48,589 | | | 1,193 |
| Issuance of common stock for cash in January and October 2007, net of issuance costs of \$2,888,996 | | | 4,921,475 | 492 | | | | | | 5,240,975 | | | 5,241,467 |
| Issuance of common stock in connection with acquisition in October 2007 | | | 2,906,193 | 291 | | | | | | 4,099,709 | | | 4,100,000 |
| Issuance costs paid with common stock in January and October 2007 | | | 409,981 | 41 | | | | | | | | | 41 |
| Common stock repurchased in July 2007 | | | (100,000) | | | | 100,000 | (10) | | | | | (10) |
| Compensation recognized under incentive stock option plans | | | | | | | | | | 1,943,910 | | | 1,943,910 |
| Issuance of OCRPS in October 2007 | 357,143 | 500,000 | | | | | | | | | | | |
| Accretion of OCRPS | | 637,500 | | | | | | | | | (637,500) | | (637,500) |
| Unrealized gain on investments | | | | | | | | | | | | 20,612 | 20,612 |
| Net loss | | | | | | | | | | | (25,526,644) | | (25,526,644) |
| Comprehensive loss | | | | | | | | | | | | | (25,506,032) |
| Balances at 31 December 2007 | 3,886,555 | 6,848,330 | 49,215,080 | 4,931 | | | 125,614 | (47,473) | | 47,661,518 | (49,079,151) | 12,954 | (1,447,221) |

See summary of accounting policies and notes to financial statements

Consolidated Statements of Operations

| | Year Ended 31 December | | | Period from Inception (15 November 2001) through |
|--|------------------------|---------------------|--------------------|---|
| | 2007 \$ | 2006 \$ | 2005 \$ | 2007 \$ |
| Operating Activities | | | | |
| Net loss | (25,526,644) | (10,070,634) | (3,336,607) | (44,499,644) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | | | |
| Depreciation and amortization | 253,814 | 134,445 | 49,130 | 531,095 |
| In-process research and development purchased with common stock | 4,092,758 | — | — | 4,092,758 |
| Stock based compensation expense | 1,943,910 | 1,006,996 | 47,711 | 3,278,545 |
| Issuance of preferred stock to pay predecessor expenses | — | — | — | 569,169 |
| Changes in assets and liabilities: | | | | |
| Prepaid expenses and deposits | (236,682) | 7,457 | 8,358 | (273,538) |
| Accounts receivable | (160,925) | — | — | (160,925) |
| Other current assets | (286,822) | (154,140) | (19,708) | (508,544) |
| Accounts payable | 2,318,857 | 278,613 | 4,466 | 2,732,917 |
| Accrued compensation | (43,346) | 280,116 | (187,657) | 492,069 |
| Other current liabilities | (723,818) | 1,346,574 | 32,322 | 626,388 |
| Total Cash Used in Operating Activities | (18,368,898) | (7,170,573) | (3,401,985) | (33,119,710) |
| Investing Activities | | | | |
| Purchase of property and equipment | (389,014) | (480,761) | (37,863) | (952,764) |
| Purchase of short-term investments | (4,249,290) | (27,715,339) | — | (31,964,629) |
| Sale of short-term investments | 17,340,380 | 8,903,800 | — | 26,244,180 |
| Prepaid license fee | (1,369,565) | — | — | (1,369,565) |
| Purchase of patent | — | — | — | (250,600) |
| Total Cash Provided by (Used in) Investing Activities | 11,332,511 | (19,292,300) | (37,863) | (8,293,378) |
| Financing Activities | | | | |
| Proceeds from issuance of common stock on initial public offering | — | 18,934,244 | — | 18,934,244 |
| Proceeds from issuance of convertible redeemable preference shares, net | 500,000 | 2,858,021 | — | 3,358,021 |
| Proceeds from issuance of convertible notes payable | 975,000 | — | — | 3,431,000 |
| Proceeds from exercise of preferred and common stock warrants | — | 1,346,018 | — | 1,346,018 |
| Sale of preferred stock for cash | — | 2,654,110 | 4,250,806 | 9,295,304 |
| Sale of common stock for cash, net of issuance costs | 5,241,508 | 369,030 | — | 5,611,153 |
| Proceeds from stock option exercises | 1,183 | 38,163 | — | 39,356 |
| Proceeds from issuance of common stock under subscription | 899,998 | — | — | 899,998 |
| Total Cash Provided by Financing Activities | 7,617,689 | 26,199,586 | 4,250,806 | 42,915,094 |
| Net increase (decrease) in cash | 581,302 | (263,287) | 810,958 | 1,502,006 |
| Cash and cash equivalents, beginning of period | 920,704 | 1,183,991 | 373,033 | — |
| Cash and Cash Equivalents, end of period | 1,502,006 | 920,704 | 1,183,991 | 1,502,006 |

| | Year Ended 31 December | | | Period from Inception (15 November 2001) through 2007 |
|--|------------------------|------------|------------|---|
| | 2007 \$ | 2006 \$ | 2005 \$ | 2007 \$ |
| Supplemental Schedule of Non-Cash Investing and Financing Activities: | | | | |
| Conversion of preferred stock in connection with initial public offering | — | 13,584,652 | — | 13,584,652 |
| Issuance of common stock in connection with acquisition | 4,100,000 | — | — | 4,100,000 |
| Deemed dividend on optionally convertible redeemable preference shares | — | 2,294,118 | — | 2,294,118 |
| Accretion of optionally convertible redeemable preference shares | 637,500 | 416,712 | — | 1,054,212 |
| Deemed dividend on preferred stock | — | 1,231,177 | — | 1,231,177 |
| Issuance of common stock under subscription agreements | — | 900,000 | — | 900,000 |
| Issuance of preferred stock as repayment of short-term notes | — | — | 170,000 | 2,456,000 |
| Interest paid with preferred stock | — | — | 30,224 | 73,840 |

See summary of accounting policies and notes to consolidated financial statements.

SUMMARY OF ACCOUNTING POLICIES AND NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Organisation, Business and Basis of Presentation

Napo Pharmaceuticals, Inc. ("Napo" or "the Company ") was incorporated on 15 November 2001 in Delaware and is focused on licensing, developing and commercialising proprietary specialty pharmaceuticals for the global marketplace in collaboration with development partners. Napo is currently developing its proprietary product, crofelemer, for gastrointestinal indications such as diarrhoea-predominant Irritable Bowel Syndrome (D-IBS), chronic diarrhoea in people living with HIV/AIDS (AIDS diarrhoea), pediatric diarrhoea and acute infectious diarrhoea. The Company operates in one segment.

The Company is considered to be in the development stage as, since inception, its activities have consisted primarily of acquiring the rights to crofelemer, raising capital, attracting employees, establishing facilities, performing research and development, entering into agreements with other entities for the development and commercialisation rights to crofelemer and the analysis of its collection of plant samples for bioactive molecules which could result in potential new drug candidates. Revenue received from inception to date includes initial license payments and miscellaneous sales of non-core product obtained through the purchase of certain Shaman Pharmaceutical, Inc. assets also discussed below.

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States and include the accounts of the Company and its wholly owned subsidiaries. All significant inter-company balances and transactions have been eliminated in consolidation.

Liquidity

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. At 31 December 2007, Napo had an accumulated deficit of approximately US\$49.1 million and expects to incur substantial losses over the next several years while it continues in the development stage. The Company's operations are subject to certain risks and uncertainties frequently encountered by companies in the early stages of operations, particularly in the evolving market for small biotech and specialty pharmaceuticals companies. Such risks and uncertainties include, but are not limited to, timing and uncertainty of achieving milestones in clinical trials and in obtaining approvals by the Food and Drug Administration (the "FDA") and regulatory agencies in other countries, not only by the Company, but by its licensees as well. The ability to generate revenues in the future will depend substantially on the timing and success of reaching development milestones and in obtaining regulatory approvals and market acceptance of the Company's products, assuming the FDA, and similar regulatory authorities in other countries, approves new drug applications.

The Company plans to meet its future capital requirements and to complete its clinical studies to obtain the necessary FDA approvals requires substantial amounts of additional sources of funding. Management has plans to raise additional funds, which include: (a) pursuing a partnership in relation to the development and marketing of crofelemer and NP 500 in Asia; (b) seeking additional funding strategies including debt and

further equity issuances; and (c) seeking fundraising and/or collaboration associated with the CFTR inhibitor mechanism.

There is no assurance that the Company will be successful in obtaining a partnership or sufficient funding on acceptable terms, if at all. If Napo is unable to secure additional funding and, shareholders, if required, do not approve such financing, Napo would have to curtail certain expenditures which it considers necessary for optimizing the probability of success of Napo's clinical development programs, including delaying the CRO-HIV clinical trial which would have a material adverse effect on the Company's operations. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires the Company's management to make judgments, assumptions and estimates that affect the amounts reported in its consolidated financial statements and the accompanying notes. Actual results could differ materially from those estimates. Significant estimates include, but are not limited to, valuation of stock based compensation and deferred tax assets, and impairment of long lived assets and intangible assets.

Concentration of Credit Risk and Cash and Cash Equivalents

The financial instruments that potentially subject the Company to a concentration of credit risk are cash equivalents and short-term investments. The counterparty to the agreement relating to the Company's investment securities is a financial institution of high credit standing. The Company considers all highly liquid instruments with an original maturity of three months or less to be cash equivalents. Cash is placed with a high-credit quality financial institution. Cash is generally in excess of FDIC insurance limits. Napo is exposed to credit risk in the event of default by the financial institution holding the cash to the extent of the amount recorded on the balance sheet. The carrying value of cash and cash equivalents approximates estimated market value at 31 December 2007.

Short-Term Investments

All short-term investments are classified as available-for-sale and therefore carried at estimated fair value based on quoted market prices. All investments are highly liquid (can be liquidated in less than one month) with a ready market. The Company views its available-for-sale portfolio as available for use in its current operations. Accordingly, all investments are classified as short-term, even though the stated maturity date may be one year or more beyond the current balance sheet date. Available-for-sale securities are stated at estimated fair value based upon the quoted market price of the securities. Unrealized gains and losses on such securities are reported as a separate component of stockholders' equity. Realized gains and losses on available-for-sale securities are included in interest income/expense. The cost of securities sold is based on the specific identification method. Interest and dividends on securities classified as available-for-sale are included in interest income.

The following table summarizes the maturities of the Company's investments at 31 December 2007 (US\$):

| | Amortized Cost | Gross Unrealized Losses | Fair Value |
|------------------|------------------|----------------------------|------------------|
| Less than 1 year | 3,654,181 | (13,610) | 3,667,791 |
| Due 1-2 years | 594,836 | 656 | 594,180 |
| Due in 2025 | 375,000 | — | 375,000 |
| Due in 2028 | 1,000,000 | — | 1,000,000 |
| Due in 2040 | 100,000 | — | 100,000 |
| Total | <u>5,724,017</u> | <u>(12,954)</u> | <u>5,736,971</u> |

Intangible

Asset

In accordance with the provisions of Statement of Financial Accounting Standards (“SFAS”) No. 142, *Goodwill and Intangible Assets*, the Company performs an annual impairment test for the intangible asset. If the carrying amount is in excess of the fair value, an impairment loss will be recorded. No impairment has been recorded through the date of these financial statements.

The purchased intangible asset represents a composition of matter patent on crofelemer. A composition of matter patent affords patent protection on the novel chemical structure of crofelemer, previously undescribed in the scientific literature. The purchased intangible asset is carried at cost, net of accumulated amortization and is amortized over its remaining estimated useful life of nine years; being the remaining legal patent life without extensions.

Property and Equipment

Property and equipment are stated at cost, less accumulated depreciation. Depreciation is calculated using the straight-line method over the estimated useful lives of the assets; generally three years.

Impairment of Long-Lived Assets

In accordance with the provisions of SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, the Company reviews long-lived assets, including property and equipment, for impairment whenever events or changes in business circumstances indicate that the carrying amount of the assets may not be fully recoverable. Under SFAS No. 144, an impairment loss would be recognised when estimated undiscounted future cash flows expected to result from the use of the asset and its eventual disposition are less than its carrying amount. Impairment, if any, is assessed using discounted cash flows or other appropriate measures of fair value. Through 31 December 2007, there have been no such losses.

Foreign Currency Translation

Napo translates the assets and liabilities of its foreign subsidiaries to US\$ at the rates of exchange in effect at the end of the period. Expenses are translated using rates of exchange in effect during the period.

Research and Development Expenses

Research and development expenses consist of expenses incurred in performing research and development activities including related salaries, clinical trial and related drug product costs, contract services and other

outside service expenses. Research and development expenses are charged to operating expense in the period incurred.

Napo is currently conducting a phase III trial for crofelemer for the indication of chronic diarrhoea associated with HIV/AIDS.

Napo is also currently conducting a trial for crofelemer for the indication of cholera. This trial is being conducted at the International Center for Diarrhoeal Disease in Bangladesh. Approximately 134 patients have been treated since March 2006.

Income Taxes

Napo uses the liability method for income taxes as required by SFAS No. 109, *Accounting for Income Taxes*. Under this method, deferred tax assets and liabilities are determined based on differences between financial reporting and tax reporting bases of assets and liabilities and are measured using enacted tax rates and laws that are expected to be in effect when the differences are expected to reverse. Currently there is no provision for income taxes as the Company has incurred net losses since inception. To date, Napo has no history of earnings. Therefore, net deferred tax assets are reduced by a valuation allowance to the extent that realization of the related deferred tax asset is not assured. The Company has recorded a valuation allowance for the full amount of its calculated deferred tax assets.

In June 2006, the Financial Accounting Standards Board issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109. This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition of tax benefits, classification on the balance sheet, interest and penalties, accounting in interim periods, disclosure, and transition.

Basic and Diluted Net Loss Per Common Share

Basic net loss per common share is computed by dividing net loss by the weighted-average number of common shares outstanding during the period. The computation of basic net loss per share for all periods presented is derived from the information on the face of the statements of operations, and there are no reconciling items in either the numerator or denominator.

Diluted net loss per common share is computed as though all potential common shares that are dilutive were outstanding during the year, using the treasury stock method for the purposes of calculating the weighted-average number of dilutive common shares outstanding during the period. Potential dilutive common shares consist of shares issuable upon exercise of stock options and warrants. The Company has excluded 7,419,422, 8,724,630 and 7,633,306 shares from the diluted net loss calculation for the years ended 31 December 2007, 2006 and 2005, respectively, because their inclusion would have been anti-dilutive.

Revenue Recognition

Napo has a federal government research grant which provides for the reimbursement of qualified expenses for research and development related to a cholera study, as defined under the terms of the grant agreement. Revenue under this grant agreement is recognized when the related qualified research expenses are incurred. Grant reimbursements are received on a quarterly or monthly basis and are subject to the issuing agency's right of audit. During the years ended 31 December 2007 and 2006, the Company recognized US\$303,297 and US\$243,850, respectively, of revenue under this grant.

Milestone payments under research, partnering, or licensing agreements are recognized as revenue upon the achievement of mutually agreed upon milestones, provided that (i) the milestone event is substantive and its achievement is not reasonably assured at the inception of the agreement, and (ii) there are no performance obligations associated with the milestone payment.

Stock-Based Compensation

Effective 1 January 2002, Napo adopted the preferable fair value recognition provisions of SFAS No. 123, *Stock-Based Compensation*. In December 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 123(R), *Share-Based Payment*, which is a revision of SFAS No. 123. SFAS 123(R) supercedes Accounting Principles Board ("APB") Opinion No. 25, *Accounting for Stock Issued to Employees*, and amends SFAS No. 95, *Statement of Cash Flows*. SFAS 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values at the date of grant and to record that cost as compensation expense over the period during which the employee is required to perform service in exchange for the award (generally over the vesting period of the award). Excess tax benefits, as defined by SFAS 123(R), will be recognized as an addition to additional paid-in capital. The Company adopted SFAS 123(R) with application since inception.

The Company has calculated stock-based compensation expense using the Black-Scholes option valuation model and included the portion of share-based payment awards that is ultimately expected to vest during future periods. Historically, there have been relatively few forfeitures. At this time, no significant additional forfeitures are expected in the foreseeable future. However, in the event that there are forfeitures, estimates will be revised to reflect actual experience. Stock-based compensation expense is recognized on a straight-line basis.

Recent Accounting Pronouncements

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities - an Amendment of FASB Statement 133*. Statement No. 161 enhances required disclosures regarding derivatives and hedging activities, including enhanced disclosures regarding how: (a) an entity uses derivative instruments; (b) derivative instruments and related hedged items are accounted for under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*; and (c) derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. Specifically, SFAS No. 161 requires disclosure of the objectives for using derivative instruments be disclosed in terms of underlying risk and accounting designation, disclosure of the fair values of derivative instruments and their gains and losses in a tabular format, disclosure of information about credit-risk-related contingent features and a cross-reference from the derivative footnote to other footnotes in which derivative-

related information is disclosed. FASB No. 161 is effective for fiscal years and interim periods beginning after 15 November 2008.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* ("SFAS No. 141R"). SFAS No. 141R establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any noncontrolling interest in the acquiree and the goodwill acquired. SFAS No. 141R also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. SFAS No. 141R is effective as of the beginning of an entity's fiscal year that begins after 15 December 2008, and will be adopted by the Company in the first half of 2009. Napo does not believe that the adoption of SFAS 141R will have material impact on its consolidated results of operations and financial condition.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements - An Amendment of ARB No. 51*. Statement No. 160 establishes new accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. Specifically, this statement requires the recognition of a noncontrolling interest (minority interest) as equity in the consolidated financial statements and separate from the parent's equity. The amount of net income attributable to the noncontrolling interest will be included in consolidated net income on the face of the income statement. Statement No. 160 clarifies that changes in a parent's ownership interest in a subsidiary that do not result in deconsolidation are equity transactions if the parent retains its controlling financial interest. In addition, this statement requires that a parent recognize a gain or loss in net income when a subsidiary is deconsolidated. Such gain or loss will be measured using the fair value of the noncontrolling equity investment on the deconsolidation date. Statement No. 160 also includes expanded disclosure requirements regarding the interests of the parent and its noncontrolling interest. Statement No. 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after 15 December 2008.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*. SFAS No. 159 expands the use of fair value accounting but does not affect existing standards which require assets or liabilities to be carried at fair value. The objective of SFAS No. 159 is to improve financial reporting by providing companies with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. Under SFAS No. 159, a company may elect to use fair value to measure eligible items at specified election dates and report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. Eligible items include but are not limited to, accounts and loans receivable, available-for-sale and held-to-maturity securities, equity method investments, accounts payable, guarantees, issued debt and firm commitments. If elected, SFAS No. 159 is effective beginning 1 January 2008. The Company is currently assessing whether fair value accounting is appropriate for any of its eligible items and the impact, if any, it will have on its results of operations and financial position.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* ("SFAS No. 157"). SFAS No. 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. The provisions of SFAS No. 157 were originally effective for the fiscal year beginning 1 January 2008. The FASB has deferred the implementation of SFAS No. 157 by one year and it will be effective for the fiscal year beginning 1 January 2009. The Company is currently evaluating the impact of the provisions of SFAS No. 157 on its financial position, results of operations and cash flows and does not believe the impact of the adoption will be material.

Notes to the Consolidated Financial Statements

1. License and Other Agreements

Revenue from the License or Assignment of Intellectual Property Rights

The Company recognises revenue from the license or assignment of intellectual property rights to third parties, including development milestone payments associated with such agreements if the funds have been received, the rights to the property have been delivered, and the Company has no further obligations under the agreements in accordance with the date(s) when the payment has been received or collection is assured. In June 2004, the Company recognized US\$950,000 of license revenue from the grant of a license to Trine Pharmaceuticals, Inc. for the worldwide development and commercialization rights to Crofelemer for the indication of D-IBS.

Royalty Revenue

In May and June 2005, the Company entered into licensing agreements with AsiaPharm Group Ltd, based in the Peoples Republic of China and Glenmark Pharmaceuticals Limited, based in Mumbai, India, for the license of Crofelemer for the indications of AIDS-related diarrhoea, acute infectious diarrhoea and pediatric diarrhoea in their respective territories. AsiaPharm Group, through its subsidiary, AsiaPharm Investments Ltd., invested in Napo Series C preferred stock as did Glenmark Pharmaceuticals. No royalty revenue has been recognized from these licenses to date.

2. Property and Equipment

Property and equipment consists of the following (US\$):

| | 31 December | |
|-------------------------------|-----------------------|-----------------------|
| | 2007 | 2006 |
| Lab equipment | 780,026 | 513,186 |
| Office equipment | 62,963 | 49,265 |
| Construction in progress | 92,447 | — |
| Software | 16,029 | — |
| Furniture and fixtures | 1,299 | 1,299 |
| | <u>952,764</u> | <u>563,750</u> |
| Less accumulated depreciation | (363,823) | (137,789) |
| Property and equipment, net | <u><u>588,941</u></u> | <u><u>425,961</u></u> |

3. Leases

The Company entered into a lease agreement in June 2007 for office space under a noncancelable operating lease, expiring in December 2007. Previous to June 2007, this same space was leased on a month-to-month basis. Rent expense under this operating lease for the years ended 31 December 2007, 2006 and 2005 amounted to US\$262,000, US\$189,000 and US\$162,000, respectively.

The Company has also entered into two separate noncancelable lease agreements for new office space, commencing 1 April 2007. The first lease expires on 31 March 2010 and the second lease, beginning on 1 April 2010, expires on 31 March 2014. These two leases relate to the same property, the first being a sub-lease and the second being a primary lease with the ultimate landlord. For the second lease, the Company may be required to provide a letter of credit to the landlord for US\$385,000 as additional security for Napo's performance under the lease. This letter of credit has not yet been provided by the Company. Rent expense under these operating leases amounted to US\$307,000 during the year ended 31 December 2007.

Future minimum lease payments under these noncancelable leases at 31 December 2007 are as follows:

| | |
|------------|--------------------|
| 2008 | \$199,497 |
| 2009 | 225,771 |
| 2010 | 483,054 |
| 2011 | 581,404 |
| 2012 | 599,157 |
| Thereafter | <u>772,247</u> |
| | <u>\$2,861,130</u> |

4. Commitments and Contingencies

General

On 14 November 2007, certain members of Napo management and all members of the Company's board of directors were granted the right to receive an aggregate of 1,100,000 shares of the common stock of the Company upon the occurrence of certain criteria, including a 250% increase in the value of Napo common stock from its price at the time of the grant. If the criteria are not met within two years from the date of grant, the right to receive the shares will expire. If the criteria are met within two years from the date of grant, these shares will be issued to the recipients and will be fully vested at that time. The exercise price for these shares is US\$1.40.

The Company has at-will employment agreements with certain of its employees that provide severance payments, including healthcare benefits to be paid in the event of a change of control of Napo, defined in the agreements as a transaction where more than 50% of the total combined voting power of its outstanding securities changes ownership, whereby pursuant to a change of control any of the following occur: (i) the employment of these employees is not maintained; (ii) their compensation is changed; (iii) their job title is changed; or (iv) the geographic location of their workplace is changed.

The severance payments vary in length from 6 months to 12 months of the employee's then current level of compensation, including healthcare benefits, as set by the board of directors. As of 31

December 2007, the cost of such severance would equal approximately US\$1.2 million.

The Company's has two licensing agreements which contain provisions whereby Napo has agreed to indemnify and hold harmless its licensees from claims or damages arising from the licensing arrangements. In one agreement, the indemnification relates to any losses arising out of or resulting from any third-party claims made or suits brought against the licensee which arise or result from the breach of certain representation made by the Company, infringement of unrelated third party intellectual property rights, the Company's negligence or will misconduct in performance of the agreement, any personal injury or death associated with clinical trials, and any product recall or product liability claims, if the cause of action is based upon a defect in the Company's licensed intellectual property. In the second agreement, the indemnification relates to losses arising out of or resulting from the Company's failure to comply with applicable laws, defend the licensee from allegations of infringement of unrelated third party intellectual property rights, and the Company's failure to perform under the agreement to generally accepted industry standards.

The Company is subject to various legal proceedings and disputes that arise in the normal course of business. These matters include employee claims. The Company does not know whether it will prevail in these matters nor can it assure that any remedy could be reached on viable terms, if at all. Based on currently available information, the Company believes that it has meritorious defenses to these actions and should an unfavorable outcome arise, there can be no assurance such outcome would not have material adverse effect on its future results of operations, liquidity or financial position.

Trine Pharmaceuticals, Inc.

In June 2004, the Company entered into an agreement with Trine Pharmaceuticals, Inc. ("Trine") regarding certain development responsibilities and commercialization rights of crofelemer, including worldwide development and commercialization rights for IBS and HIV. In accordance with this agreement, Trine made a US\$1,000,000 cash milestone payment in 2006. This amount has been recorded as revenue in these consolidated financial statements.

In February 2008, as part of a mutual termination, full commercial rights of crofelemer previously licensed to Trine Pharmaceuticals, Inc. have reverted to Napo. As part of the termination, Napo has agreed to pay US\$500,000 and US\$750,000 CRO-HIV success milestone payments to Trine based on the first and second to occur, respectively, of the following milestones: (1) The Company's filing of an NDA for CRO-HIV, (2) the Company's receipt of FDA approval to commercialize crofelemer for CRO-HIV, (3) the Company's execution of an agreement granting rights to develop and/or commercialize crofelemer for CRO-HIV, and (4) a change in control of the Company. There are no additional future obligations to Trine.

License Agreement with Michael Tempesta

The Company has entered into a license agreement dated 16 October 2002 with Michael Tempesta. This agreement settled disputes between Shaman Pharmaceuticals, Inc. ("Shaman"), the Company's

predecessor, and Dr. Tempesta relating to previous license arrangements between Shaman or the Company and Dr. Tempesta. The agreement provides for the payment of a royalty to Dr. Tempesta of between 2 *per cent* and 4 *per cent* of net sales of products containing Crofelemer or any derivative thereof obtained from any species of the Croton plant. "Product" for the purposes of calculating royalties is defined as all products for the treatment, maintenance or improvement of human health which are prescription medicines, botanicals, dietary supplements sold for the treatment of diarrhoea, Irritable Bowel Syndrome ("IBS") or herpes. This excludes cosmetic products, non-medicinal agricultural products and products for non-human animal health. To date, no payments have been made under this perpetual license agreement.

Healing Forest Conservancy

The Company has entered into a perpetual agreement with the Healing Forest Conservancy ("HFC") pursuant to which the Company has issued to HFC 30,000 common shares in Napo at a purchase price of \$0.0001 each and has agreed to pay 2 *per cent* of the net profit derived from the sale of all of its products to HFC once Napo has achieved net profits after tax over a consecutive period of 6 months. The aim of Napo's arrangement with HFC is, amongst other things, (i) to promote the conservation of the biological diversity of tropical forests, particularly medicinal plants (ii) to promote the survival of cultural diversity of tropical forest peoples, and in particular, their traditional knowledge of medicinal plants, (iii) to develop and implement a process to return financial benefits from net profits made on certain products to collaborating countries and cultural groups, (iv) to promote initiatives addressing total community health for developing and emerging communities; and (v) to lead efforts to encourage sustainable global communication and participation from other organizations, including corporate, non-governmental organizations, governmental agencies, and others.

5. Convertible Notes Payable

In December 2007, the Company issued convertible notes payable for US\$975,000 (the "2007 Notes"). These notes are for a term of three years and bear interest at 8% until the notes are paid or converted into common stock. The notes may not be converted before an equity financing of \$10 million or more or 1 July 2008, whichever is earlier. Only the principal is convertible. Interest will be paid in cash. If the Company enters into an equity fundraising in excess of US\$10 million prior to 1 July 2008, the notes are convertible into common stock at the same price as the investors in the financing. If no equity financing occurs prior to 1 July 2008, the notes will be convertible into common stock at the ten day average price as traded on the London Stock Exchange. The conversion price cannot be less than US\$0.38 per share. It has been determined that the conversion feature embedded in the 2007 Notes should not be bifurcated and the host instrument is classified as a liability at 31 December 2007.

6. Stockholders' Equity (Deficit)

| Initial | Public | Offering |
|----------------|---------------|-----------------|
|----------------|---------------|-----------------|

On 31 July 2006, upon the initial public offering of its common stock on the Main Market of the London Stock Exchange, Napo issued 14,300,048 shares of common stock at an offering price of US\$1.54 per share. At that time all Series A, B and C Convertible Preferred Stock automatically converted into 21,352,958 shares of common stock. Cash proceeds from the sale, net of underwriters' discount and offering expenses, totalled US\$18.9 million. Total shares of Napo common stock outstanding immediately subsequent to the IPO were 39,536,282.

Common Stock

90,000,000 shares of Common Stock are authorized, with a par value of US\$0.0001 per share. The Company has reserved shares of common stock for future issuance as follows:

| | <i>31 December 2007</i> |
|--|-------------------------|
| Stock options outstanding | 9,162,565 |
| Stock options available for future grant | 4,041,662 |
| Warrants to purchase common stock | 112,634 |
| | <hr/> |
| | 13,316,861 |

In January 2007, Napo sold 2,431,304 shares of common stock to an investor at US\$1.85 per share. Total cash proceeds were US\$4.1 million, net of issuance costs of US\$423,000.

In October 2007, Napo sold 2,490,171 shares of common stock to various investors at US\$1.46 per share. Total cash proceeds were US\$1.2 million, net of issuance costs of US\$2.4 million.

On 23 October 2007, the Company entered into an Agreement and Plan of Merger (the "Merger") with Indus Pharmaceuticals, Inc. ("Indus") whereby the Company agreed to acquire 100% of the outstanding shares of Indus for 2,906,193 shares of Napo common stock valued at US\$4.1 million. Although there were also net assets of US\$8,000 acquired in the Merger, the substance of the transaction was to purchase in-process research and development related to cancer, diabetes and infectious disease from Indus. As of the date of the Merger, Napo recorded current assets of US\$79,000 and current liabilities of US\$71,000. The remainder of the purchase price was immediately recorded as in-process research and development expense.

Optionally Convertible, Redeemable, Non-Cumulative, Non-Participating Preference Shares

In October 2007, IL&FS Investment Managers Limited ("IL&FS"), a third-party investor, invested US\$500,000 in Sindu Private Limited ("Sindu") in exchange for 10 shares of Sindu common stock and 357,143 optionally convertible, redeemable, non-cumulative, non-participating preference shares of Sindu having a par value of Rupee Ten ("Sindu OCRPS"). The Sindu OCRPS held by IL&FS has a term of four (4) years from the completion of the subscriptions as set forth in the subscription agreement. During the four (4) year term, IL&FS can require Sindu to sell in part or in full the number of shares that Sindu holds of Napo Pharmaceutical common stock and pay the proceeds to IL&FS. Also, during the term, IL&FS can convert the OCRPSs into Sindu's common shares, such that the value of

Sindu's common shares will be the initial investment plus the 30% annualized premium. At the end of the four (4) year term, the redemption, as described below, is compulsorily redeemable.

Subsequent to this investment, Napo US acquired 100% of the stock of Sindu. These consolidated financial statements include the accounts of Sindu at 31 December 2007.

The Sindu OCRPS have a redemption premium that yields for IL&FS an internal rate of return of 30 *per cent* per annum on their US\$500,000 investment, calculated from the date of the investment in Sindu until the date of actual receipt by IL&FS of the redemption of the OCRPS. This redemption premium resulted in deemed dividends of US\$38,000 during the year ended 31 December 2007.

In April 2006, IL&FS invested US\$3 million in Napo India Private Limited ("Napo India"), a company organized by Napo for the purpose of this investment and its ongoing activity in India, in exchange for 100 shares of Napo India and 3,529,412 optionally convertible, redeemable, non-cumulative, non-participating preference shares of Napo India having a par value of Rupee One ("Napo India OCRPS"). Napo India subsequently invested the US\$3 million invested by IL&FS in the Company's Series C Preferred Stock at US\$0.85 per share pursuant to a subscription agreement dated 19 April 2006. The Napo India OCRPS held by IL&FS has a term of four (4) years from the completion of the subscriptions as set forth in the subscription agreement. During the four (4) year term subsequent to the initial public offering and associated lock-up period, IL&FS can exchange, one for one, into common shares of Napo India, in part or in full, the OCRPSs; or require Napo India to sell the common shares of Napo Pharmaceuticals it holds and pay the proceeds to IL&FS. If no action is taken during the four (4) year term and the term expires, the OCRPS is then compulsorily exchangeable for an amount equal to the investment plus the 20% annualized redemption premium.

Subsequent to Napo India's investment in Napo Series C Preferred stock, the Company bought 10,000 Shares of Napo India from the existing shareholders of Napo India, and Napo India became an approximately 99 *per cent* owned subsidiary of the Company. These consolidated financial statements include the accounts of Napo India at 31 December 2007.

The Napo India OCRPS have a redemption premium that yields for IL&FS an internal rate of return of 20 *per cent* per annum on their US\$3,000,000 investment, calculated from the date of the investment in Napo India until the date of actual receipt by IL&FS of the redemption of the OCRPS. This redemption premium resulted in deemed dividends of US\$600,000 and US\$417,000 during the years ended 31 December 2007 and 2006, respectively. In addition, it was determined that there was a beneficial conversion feature associated with the Napo India OCRPS due to the fair value of the Company's common stock being more than the price per share paid by the investor for the Napo India OCRPS. As such, the Company recorded a deemed dividend of \$2,294,118 in 2006.

The rights under these agreements are subject to any changes in current India law.

Warrants

During 2002, the Company issued fully vested and immediately exercisable warrants to purchase

83,479 shares of common stock at US\$0.30 per share, for a period of ten years, to three individuals in return for services provided to the Company. These warrants were valued at US\$3,000, and recorded as additional paid-in capital. As of 31 December 2007, none of these warrants have been exercised.

During 2002, the Company issued warrants to purchase 100,067 shares of Series A Preferred Stock at US\$0.2998 per share, valued at US\$3,000, to its outside counsel for legal fees. These warrants were exercised at the time of the Company's initial public offering.

In March 2004 the Company issued warrants to purchase 2,329,616 shares of common stock at US\$0.50 per share, valued at US\$108,000, to investors in connection with the issuance of Series A preferred stock. These warrants were exercised at the time of the Company's initial public offering.

In September 2004, the Company issued warrants to purchase 175,000 shares of common stock at US\$0.50 per share, valued at US\$8,000, to investors in connection with the issuance of Series B preferred stock. These warrants were exercised at the time of the Company's initial public offering.

In September 2005, the Company issued warrants to purchase 90,000 shares of common stock at US\$0.85 per share, valued at US\$6,000, in connection with the issuance of Series C preferred stock. These warrants were exercised at the time of the Company's initial public offering.

In September 2006, the Company issued fully vested and immediately exercisable warrants to a consultant to purchase 15,625 shares of common stock at US\$1.80, valued at US\$26,000, and recorded as additional paid-in capital. These warrants are exercisable for three years from 15 September 2006. As of 31 December 2007, none of these warrants have been exercised.

In December 2006, the Company issued fully vested and immediately exercisable warrants to purchase 13,530 shares of common stock at US\$1.85 per share, for a period of five years, to a consultant for services rendered in connection with an equity financing. These warrants were valued at US\$25,000 and considered financing related costs. As of 31 December 2007, none of these warrants have been exercised.

Stock Options

The Napo Pharmaceuticals, Inc. 2001 Equity Incentive Plan (the "2001 Plan"), provides for grants of incentive and nonqualified stock options, restricted stock awards, and stock bonuses to its employees, directors and consultants. Under the 2001 Plan, the total number of shares originally reserved and available for grant was 2,600,000. As a result of a series of amendments which were approved by the stockholders, the number of shares reserved and either granted or available for grant as of 31 December 2007 is 8,500,000. Under the 2001 Plan, incentive stock options may be granted at a price per share not less than the fair market value at the date of grant, and nonqualified stock options may be granted at a price per share not less than 85% of the fair market value at the date of grant. If, at the time the Company grants an option, the optionee owns stock possessing more than 10% of the total combined voting power of all classes of stock of the Company, the option price shall be 110% of the fair market value of the shares of the date of grant. Options granted generally have a maximum term of ten years from the grant date and become exercisable over two to three years. As of 31 December 2007,

there were options to purchase 4,750,367 shares outstanding under the 2001 Plan and 3,749,633 shares available for future grant.

The Napo Pharmaceuticals, Inc. 2006 Equity Incentive Plan (the "2006 Plan"), provides for grants of incentive and nonqualified stock options, restricted stock awards, and stock bonuses to the Company's employees, directors and consultants. Under the 2006 Plan, the total number of shares reserved and available for grant is not to exceed 10% of the outstanding common stock of the Company. Under the 2006 Plan, incentive and nonqualified stock options may be granted at a price per share not less than the fair market value at the date of grant. If, at the time an option is granted, the optionee owns stock possessing more than 10 per cent of the total combined voting power of all classes of stock of the Company, the option price shall be 110 per cent of the fair market value of the shares of the date of grant. Options granted generally have a maximum term of ten years from the grant date and become exercisable over two to three years. As of 31 December 2007, there were options to purchase 4,412,198 shares outstanding under the 2006 Plan and 292,029 shares available for future grant.

The application of the Black-Scholes option valuation model (see Summary of accounting policies) involves the use of assumptions that are judgmental and sensitive in the determination of stock-based compensation expense. Expected price volatility is based on historical data and industry experience. The key assumptions used in determining the fair value of options granted during the years ended 31 December 2007, 2006 and 2005 are as follows:

| | <i>Years ended 31 December</i> | | |
|---|--------------------------------|-------------|-------------|
| | <i>2007</i> | <i>2006</i> | <i>2005</i> |
| Expected price volatility | 267% | 267% | 267% |
| Risk-free interest rate | 4.00% | 4.52% | 4.42% |
| Weighted average expected life in years | 10 | 10 | 10 |
| Dividend yield | — | — | — |
| Forfeiture rate | — | — | — |

A summary of activity under the Plans is as follows:

| | <i>Outstanding Options</i> | | |
|------------------------------|-----------------------------------|-------------------------|---|
| | <i>Shares Available for Grant</i> | <i>Number of Shares</i> | <i>Weighted-Average Price Per Share</i> |
| Balances at 31 December 2002 | 902,316 | 1,697,684 | \$0.043 |
| Additional shares authorized | 1,700,000 | — | — |
| Options granted | (2,550,251) | 2,550,251 | \$0.045 |
| Balances at 31 December 2003 | 52,065 | 4,247,935 | \$0.044 |
| Additional shares authorized | 1,600,000 | — | — |
| Options granted | (480,212) | 480,212 | \$0.059 |
| Balances at 31 December 2004 | 1,171,853 | 4,728,147 | \$0.046 |
| Options granted | (443,924) | 443,924 | \$0.085 |
| Balances at 31 December 2005 | 727,929 | 5,172,071 | \$0.049 |
| Additional shares authorized | 8,600,000 | — | — |

| | | | |
|------------------------------|------------------|------------------|---------|
| Options granted | (4,033,349) | 4,033,349 | \$0.594 |
| Options exercised | — | (1,247,090) | \$0.031 |
| Options forfeited | 275,105 | (275,105) | \$0.180 |
| Balances at 31 December 2006 | <u>5,569,685</u> | <u>7,683,225</u> | \$0.333 |
| Additional shares authorized | 648,786 | — | — |
| Options granted | (4,259,000) | 4,259,000 | \$1.493 |
| Options exercised | — | (697,469) | \$0.069 |
| Options forfeited | 2,082,191 | (2,082,191) | \$0.675 |
| Balances at 31 December 2007 | <u>4,041,662</u> | <u>9,162,565</u> | \$0.815 |

The following table summarizes information about stock options outstanding at 31 December 2007:

| <i>Exercise Prices</i> | <i>Outstanding Options</i> | | |
|------------------------|---|---|---|
| | <i>Number Outstanding at 31 December 2007</i> | <i>Weighted-Average Remaining Contract Life</i> | <i>Options Vested at 31 December 2007</i> |
| \$0.030 | 681,731 | 4.79 | 681,731 |
| \$0.050 | 1,408,932 | 6.07 | 1,408,932 |
| \$0.085 | 252,899 | 7.56 | 205,495 |
| \$0.170 | 754,669 | 8.01 | 486,295 |
| \$0.340 | 1,552,136 | 8.31 | 1,093,760 |
| \$0.850 | 100,000 | 8.46 | 100,000 |
| \$1.400 | 2,729,000 | 9.88 | 423,574 |
| \$1.520 | 770,000 | 9.75 | 168,735 |
| \$1.730 | 300,000 | 8.59 | 165,502 |
| \$1.800 | 613,198 | 8.83 | 454,463 |
| | <u>9,162,565</u> | <u>8.29</u> | <u>5,188,487</u> |

The weighted-average fair value of options granted during the years ended 31 December 2007, 2006 and 2005 was US\$1.493, US\$0.586 and US\$0.085, respectively. The weighted average grant date fair value of options vested at 31 December 2007, 2006 and 2005 was US\$0.501, US\$0.174 and US\$0.170, respectively. The weighted-average fair value of options granted during the period from inception (15 November 2001) through 31 December 2007 was US\$0.667. The weighted average exercise price of options vested at 31 December 2007, 2006 and 2005 was US\$0.501, US\$0.174 and US\$0.170, respectively. There was no aggregate intrinsic value of options vested at 31 December 2007. There was no aggregate intrinsic value of options exercised as of the date of exercise during the years ended 31 December 2007, 2006 and 2005.

As of 31 December 2007, there was US\$4 million of total unrecognized compensation cost related to nonvested options granted under the Plans. That cost is expected to be recognized over a weighted average period of 2.1 years.

7. 401(k) Plan

In April 2005, the Company adopted a Tax Deferred Savings Plan under Section 401(k) of the Internal Revenue Code (the "Plan") for all full-time employees. Under the Plan, eligible employees can contribute amounts to the Plan via payroll withholding, subject to certain limitations. The Company's matching contributions to the Plan are discretionary and can only be made in cash. To date, no employer contributions have been made to the plan.

8. Income Taxes

The provision for income taxes differs from the amount of income tax determined by applying the applicable statutory federal income tax rate to pretax loss as a result of the following:

| | <i>For the year ended 31 December,</i> | | |
|-------------------------------------|--|-------------|-------------|
| | <i>2007</i> | <i>2006</i> | <i>2005</i> |
| | <i>%</i> | <i>%</i> | <i>%</i> |
| Statutory federal tax rate | (34.0) | (34.0) | (34.0) |
| State taxes | (9.0) | (7.9) | (5.8) |
| Research credits | (0.6) | (2.2) | — |
| Change in valuation allowance | 33.3 | 47.9 | 39.7 |
| Non-cash compensation | 1.4 | (3.1) | — |
| In-process research and development | 5.5 | — | — |
| Other | 3.4 | (0.7) | 0.1 |
| Total provision for income taxes | <u>0.0</u> | <u>0.0</u> | <u>0.0</u> |

Deferred tax assets are comprised of the following:

| | <i>31 December,</i> | |
|--------------------------------------|---------------------|--------------------|
| | <i>2007</i> | <i>2006</i> |
| | <i>\$</i> | <i>\$</i> |
| Capitalized research and patents | 85,031 | 87,103 |
| Non deductible reserves and accruals | 313,078 | 179,021 |
| Credit carryforwards | 641,184 | 433,888 |
| Loss carryforwards | 15,142,445 | 6,722,375 |
| Deferred compensation | 653,266 | 906,834 |
| Other | 99,217 | 95,324 |
| Gross deferred tax assets | <u>16,934,221</u> | <u>8,424,545</u> |
| Valuation allowance | <u>(16,934,221)</u> | <u>(8,424,545)</u> |
| Net deferred tax assets | <u>—</u> | <u>—</u> |

Based on the available objective evidence, including cumulative losses since inception and expected future losses, the Company has determined that it is more likely than not that the entire deferred tax asset amount will not be realized, and therefore, a valuation allowance has been provided on all net deferred tax assets.

The increases in the valuation allowance for deferred tax assets of approximately US\$8.6 million in 2007

and US\$3.5 million in 2006 are primarily attributable to increases in net operating loss and increase to research tax credits.

At 31 December 2007, the Company had US\$35.4 million and US\$34.2 million of federal and state net operating loss carryforwards, respectively, available to offset future taxable income. The federal and state net operating loss carryforwards will expire between 2012 and 2027, if not utilized.

At 31 December 2007, the Company had approximately US\$349,000 and US\$271,000 of federal and state research credit carryovers, respectively, available to offset future taxable income. The federal credits expire in 2027 and state research credits carry forward indefinitely.

Utilization of the Company's net operating loss and tax credit carryforwards may be subject to a substantial annual limitation due to the ownership change limitations provided by the United States Internal Revenue Code and similar state provisions. Such an annual limitation could result in the expiration or elimination of the net operating loss and tax credit carryforwards before utilization.

Effective 1 January 2007, the Company adopted the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* ("FIN No. 48"), which prescribes a comprehensive model for how a company should recognize, measure, present and disclose in its financial statements uncertain tax positions that the company has taken or expects to take on a tax return. The cumulative effect of adopting FIN No. 48 resulted in no adjustment to retained earnings as of 1 January 2007.

A reconciliation of the unrecognized tax benefits for the year ended 31 December 2007 is as follows:

| | |
|---|--|
| Balance as of 1 January 2007 | \$255,000 |
| Additions for current year tax positions | — |
| Reductions for current year tax positions | — |
| Additions for prior year tax positions | — |
| Reductions for prior year tax positions | — |
| Settlements | — |
| Reductions related to expirations of statute of limitations | — |
| Balance at 31 December 2007 | <u> </u> <u> </u> <u> </u> \$255,000 |

None of the unrecognized tax benefits as of 31 December 2007 would affect the Company's effective tax rate if recognized. As the Company would currently need to increase their valuation allowance for any additional amounts benefited, the effective rate would not be impacted until the valuation allowance was removed.

Penalties and interest expense related to income taxes are included as a component of other expense and interest expense, respectively, if they are incurred. For the years ended 31 December 2007 and 2006, no penalties or interest expense related to income tax positions were recognized. As of 31 December 2007 and 2006, no penalties or interest related to income tax positions were accrued. The Company does not anticipate that any of the unrecognized tax benefits will increase or decrease significantly in the next twelve months.

8. Subsequent Events

In January 2008, the Company issued convertible notes payable (the "2008 Notes") for US\$500,000 on the same terms as the 2007 Notes.

In March 2008, the 2007 and 2008 Notes were amended to have a maturity date of 31 May 2009. The Notes, as amended, are convertible at US\$0.55 per share, representing 2,665,896 common shares of Napo and holders of the notes also received warrants to purchase 1,332,948 shares of Napo for US\$0.55 per share.

In March 2008, the Company entered into subscription agreements for the issuance of convertible notes totaling US\$2.3 million. These notes bear interest at 3.2% and are due 31 July 2008. Up to 25% of the principal amount of these notes may be converted into 1,016,655 shares of common stock and the note holders were also issued ten-year warrants to purchase 3,049,965 shares of common stock at US\$0.55 per share.

In March 2008, the Company issued 600,000 shares of common stock to an investor at 25 pence per share.