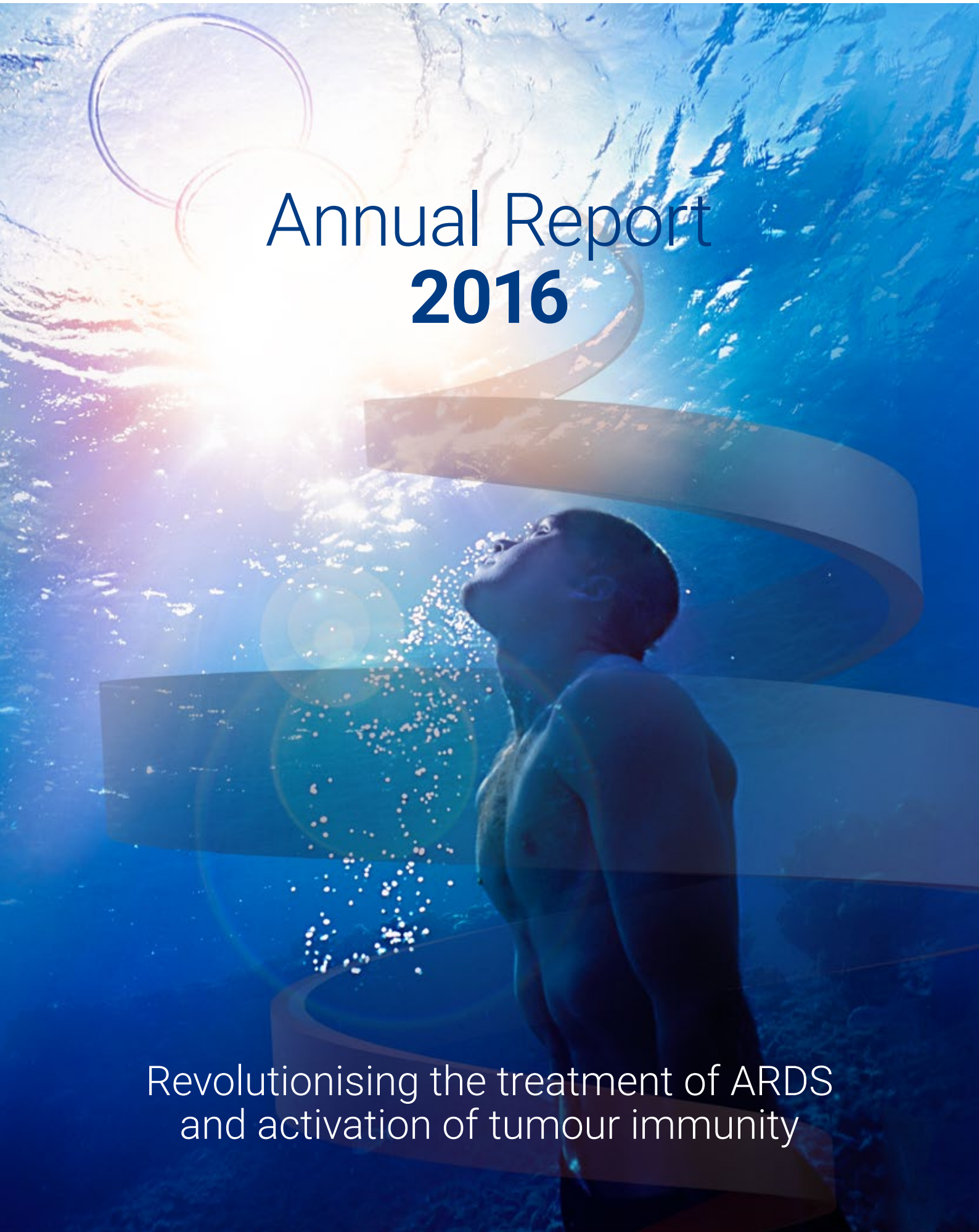
FARON

Pharmaceuticals



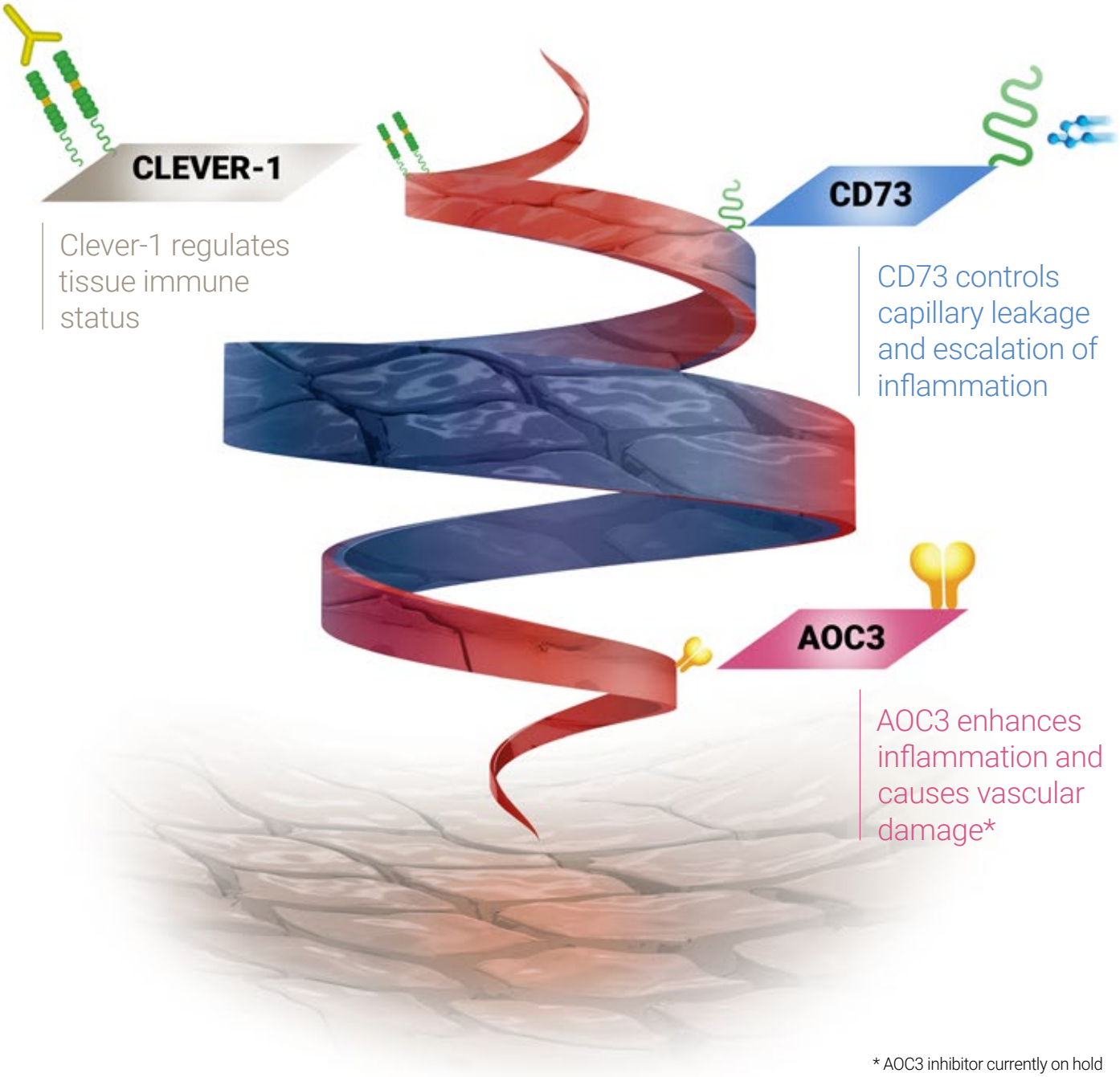
Annual Report 2016

Revolutionising the treatment of ARDS and activation of tumour immunity

Contents

Endothelial barrier is everything

Faron's pipeline is based on endothelial receptors involved in regulation of immune responses



Clever-1 regulates tissue immune status

CD73 controls capillary leakage and escalation of inflammation

AOC3 enhances inflammation and causes vascular damage*

* AOC3 inhibitor currently on hold

The endothelial surface of exhaustive capillary networks control fluid and cell balance between circulation and tissues, and is a factor in many devastating diseases like organ failures and cancer metastasis.

FARON PHARMACEUTICALS

Saving lives

Faron Pharmaceuticals Ltd is a clinical stage biopharmaceutical company developing novel treatments for medical conditions with significant unmet needs. The Company currently has a pipeline focusing on acute organ traumas, vascular damage and cancer immunotherapy.

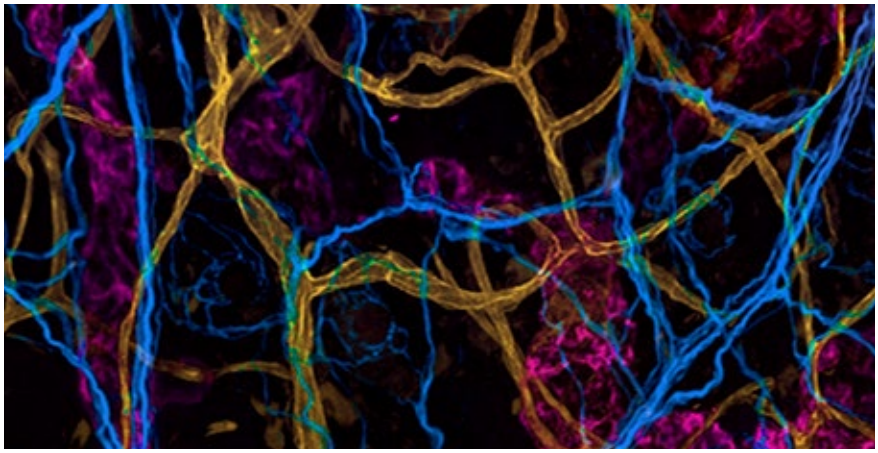
The Company's lead candidate Traumakine, to prevent vascular leakage and organ failures, is currently the only treatment for Acute Respiratory Distress Syndrome (ARDS) undergoing Phase III clinical trials. There is currently no approved pharmaceutical treatment for ARDS. An additional European Phase II Traumakine trial is underway for the Rupture of Abdominal Aorta Aneurysm ("RAAA"). Both patient groups have high mortality due to multi organ failure (MOF) caused by ischemic reperfusion injury.

Faron's second candidate Clevegen is a ground breaking pre-clinical anti-Clever-1 antibody. Clevegen has the ability to switch immune suppression to immune activation in various conditions, with potential across oncology, infectious disease and vaccine development. This novel macrophage-directed immuno-oncology switch called Tumour Immunity Enabling Technology ("TIET") may be used alone or in combination with other immune checkpoint molecules for the treatment of cancer patients.

Faron is based in Turku, Finland and is listed on London AIM under the ticker 'FARN'.

FARON PHARMACEUTICALS

Endothelial Barrier Is Everything



Imagine cars speeding in a dark tunnel, 100,000 kilometers long, without lights, at a speed of 700–800 km/h, navigating their way to their destinations.

The situation described above applies to cells, which migrate in our vasculature system and need to move around. This movement is part of the normal surveillance system to detect any harmful event that would put our existence at risk. This is our innate defense system, but it also provides the initial immunological reaction against any foreign material entering the body.

The "GPS" for these moving cells is a molecular recognition system consisting of special molecules on the surface of migrating cells and their counterparts on the surface of vascular endothelial cells. These "homing" molecules form an essential cellular trafficking guidance system, which we all need to maintain our normal physiology. Unfortunately, many diseases utilise this system as well. This calls for ways to control the guidance system in order to prevent or heal diseases. Among these diseases the most harmful ones are extended inflammations and cancer spread.

Our vascular system also includes a drainage system called lymphatics. The same guidance system also operates there but the recognition molecules are unique. In both of these capillary networks the endothelial cells control the entry of migrating cells and maintain a barrier between circulation and tissues. Without this barrier, we encounter a catastrophic situation, which can lead to life-threatening conditions.

Faron is targeting several endothelial molecules involved in this guidance system and the maintenance of the endothelial barrier. We believe that the control of these molecules provides a unique way of treating many life-threatening conditions with high unmet medical needs. Our two lead indications – acute respiratory lung injury and control of tumour immunity – are both based on the malfunction of the endothelial barrier, both of which we have learned to control (see page 3).

We hope that our 2016 Annual Report inspires you to explore our technologies, which have originated from world-class academic laboratories and developed by Faron as novel proprietary treatments for Acute Respiratory Distress Syndrome (ARDS), and tumour immune suppression.

FARON PHARMACEUTICALS

Highlights 2016

TRAUMAKINE

- Pivotal, pan-European, Phase III INTEREST trial for the treatment of Acute Respiratory Distress Syndrome ("ARDS"), has continued to progress as planned.
- Maruishi, Faron's Japanese licensing Partner, reported top line results from its Phase II safety study which indicated there were no safety concerns and, similarly to Faron's phase I/II UK study, also showed reduction of 28-day mortality.
- Initiation of Maruishi's own pivotal Phase III study in Japan which aims to recruit 120 severe and moderate ARDS patients split between treatment and placebo arms.
- Initiated filing of a clinical trial application (CTA) for the use of Traumakine in a second indication for the prevention of mortality among operated RAAA (Rupture of Abdominal Aorta Aneurysm) patients.
- Filed patent application in Finland for the intravenous formulation of interferon-beta and received a first allowance letter from the Finnish Patent Authorities indicating potential success in Europe and USA.
- Entered into licensing agreement with Pharmbio Koreo Inc (Pharmbio) for the commercialisation of Traumakine in Korea and received a signing fee of €750,000.

CLEVEGEN

- Established production clones for the humanised, and de-immunized, monoclonal antibody FP-1305 with Faron's technology partner, Selexis.
- Entered into a collaboration agreement with Abzena Corp (LSE: ABZA) to establish large scale GMP manufacturing for Clevegen.
- Filed two new patent applications to seek further protection for Clevegen. If successful, Clevegen will be protected for the next 20 years.
- Expansion of Clevegen's use to include removal of local immune suppression around tumors (TIET), chronic infections (CIRT) and vaccination sites (VRET).

Financial Highlights

- Raised total equity of €9.3 million (net €8.5 million) by issuing 3,200,000 new ordinary shares at a price of 250 pence per share. The proceeds are being used to fund Traumakine US safety trials (INTRUST), Clevegen pre-clinical and clinical development to Phase I/II for lead indication of hepatocellular carcinoma (HCC) and the RAAA European clinical development to Phase II (INFORAAA trial), as well as further R&D and operational expenses.
- Generated €1.2 million (2015: €0.5 million) revenues mainly from sales of active pharmaceutical ingredient (API) and sales of medical products for trials. The €0.7 million licence agreement cash siging fee from Pharmbio was recorded as advance payment. In addition, the Company recorded grant income of €1.7 million (2015: €0.7 million) from the EU FP7 grant.
- Drew down €0.6 million of a €1.5 million R&D loan granted by Tekes in 2015 to progress the Clevegen programme.
- On 31 December 2016, the Company held cash balances of €11.5 million (2015: €11.1million).
- Operating loss for the financial year ended 31 December 2016 was €9.3 million (2015: €6.2 million loss).
- Net assets on 31 December 2016 were €10.9 million (2015: €11.2 million)

Post-Period End Highlights

- On 9 February 2017, announced a third IDMC recommendation to continue the Phase III INTEREST trial as planned and also confirmed the expected read-out from the trial to be in H2 2017.
- On 20 February 2017, announced recruitment of the first patient in the Traumakine INFORAAA trial for the prevention of multi-organ failure and patient mortality after surgical repair of a RAAA.
- On 1 March 2017, announced the successful raise of approximately €5.8 million before expenses from the placing of 1,422,340 ordinary shares at a price of 350 pence per share.

STRATEGIC REPORT

Addressing significant unmet medical needs

Strategy

Faron's strategy is to maximise the potential of its pipeline of drug candidates and to progress the development of its lead product Traumakine. Faron targets several endothelial molecules involved in the maintenance of the endothelial barrier which is a thin layer (membrane) of cells that lines blood and lymphatic vessels to separate blood content from tissue. The Company believes that the control of these molecules provides a unique way to treat many life-threatening conditions with high unmet medical needs. Faron collaborates with its strategic partners in research, manufacturing and drug development to bring new pharmaceutical products to market in a timely and cost-effective manner and has formed a core team of leading scientists in capillary biology and diseases arising from vascular leakage. The Company has established links with leading laboratories and clinics based at Turku University in Finland, University of Birmingham Medical School in UK and other institutions.

To date, Faron has operated on a relatively low cost basis by employing only key members of staff and outsourcing where possible. Typically, all development work up to the proof-of-concept stage of drug development is carried out in the innovators' laboratories. The Company outsources all of its manufacturing activities in relation to its products to third parties and collaborates with Contract Research Organisations (CROs) to carry out the clinical development programmes. Faron monitors and evaluates potential commercial opportunities for its established drug candidates, such as Traumakine and Clevegen and its technologies, as and when they arise and will consider how best to crystallise as much value as possible for Shareholders, which may include holding rights in main territories for as long as it is feasible, or, in certain circumstances, up to the marketing stage.

STRATEGIC REPORT

Chairman´s Statement

2016 was an important year for Faron. The highly experienced management team has made significant progress with Traumakine and Clevegen during its first full financial year following the successful AIM listing on the London Stock Exchange in November 2015.

The Company's novel therapies, Traumakine and Clevegen, have been developed from a thorough and deep scientific knowledge and understanding of endothelial barrier function and control, and both products are delivering exciting data.

Faron's lead drug candidate, Traumakine, continues to recruit patients into the pivotal, pan-European Phase III INTEREST trial, which is due to report the critical end points (e.g. mortality difference between placebo and active treatment) in the second half of 2017. We believe that Traumakine, as the only product in late stage clinical development for the treatment of ARDS, represents a significant opportunity to treat patients with this serious condition.

The Company also believes that Traumakine could have applications across other serious indications and in early 2017, recruited the first patient in a phase II trial (INFORAAA) assessing Traumakine for the prevention of Multi-Organ Failure (MOF) and patient mortality after surgical repair of a RAAA. RAAA is a medical emergency with no known treatment and an overall mortality of 30 to 50% for post-operative refusion injury for RAAA patients.

Faron's second product, its pre-clinical immunotherapy candidate, Clevegen, causes conversion of the immune environment around a tumour from immune suppressive to immune stimulating by reducing the number of tumour-associated macrophages (TAMs). Recent developments in the exciting field of cancer immunotherapy have been well documented with a number of important indications of clinical success. We believe that Clevegen is well differentiated from other immunotherapies through its specific targeting of M2 TAMs which facilitate tumour growth, while leaving intact the M1 TAMs that support immune activation against tumours. In July, we were pleased to enter an agreement with Abzena for the manufacture of Clevegen for use in primate toxicity and Phase I/II clinical studies.

The Company is well funded, having secured €9.3 million in a private placing in September 2016 and a further €5.8 million in February 2017. Both placements were executed at a premium to the Company's share price, which indicates the level of confidence our investors, both new and established, have in our products, our strategy and the ability of our management to deliver.

Faron's key focus for 2017 will be to prepare the business for the anticipated commercial launch of Traumakine in the event of a positive European Phase III data readout and prepare for the commencement of a Phase II safety trial in the US, whilst also continuing the pre-clinical and planned early-stage clinical development of Clevegen.

As ever the Board will continue to look for opportunities to deliver and enhance value to our Shareholders as well as patients who will benefit from the new drugs Faron is developing.

The Board recognises the efforts of the management team to deliver the successes achieved in 2016 and is grateful to the investigators and patients who are part of our clinical trials.

We look forward to an exciting 2017 with continued support from shareholders as we progress our exciting products, Traumakine and Clevegen.

Dr Frank M Armstrong – Chairman

STRATEGIC REPORT

Operational Review

When Faron listed on the London Stock Exchange's AIM in November 2015, the Company had ambitions to deliver on its promises and exceed expectations. Faron has so far achieved its stated goals and with a lower than anticipated cash burn. We expect this momentum to continue into the coming year and our focus remains stronger than ever.

We have complemented our funds raised at IPO with additional successful equity finance rounds (September 2016 and February 2017) in order to expand our pipeline development to new indications and territories, as well as broadening our institutional shareholder base.

Traumakine® Development

Our lead drug, Traumakine, progressed as planned to the full scale Phase III trial (INTEREST) during 2016 for the treatment of ARDS. ARDS is a severe, life-threatening medical condition characterised by widespread capillary leakage and inflammation in the lungs, most often as a result of sepsis, pneumonia or significant trauma. Currently there are no pharmacological treatments for ARDS, an orphan disease with a 30-45% mortality rate. Traumakine has been granted Orphan Drug Designation in Europe which allows a period of 10 years of market exclusivity following marketing approval by the European Medicines Agency. The Phase III INTEREST trial is being led by Professor Geoff Bellingan from University College London Hospital and Professor Marco Ranieri from the University of Rome. Subject to the successful completion of the Phase III INTEREST trial in the second half of 2017 and achievement of regulatory approvals, Traumakine will potentially be the first effective, mechanistically-targeted, disease-specific pharmacotherapy for ARDS patients and has the potential to revolutionalise intensive care practices.

To date, Faron has entered into agreements with three pharmaceutical companies to carry out the clinical development and commercialisation of Traumakine in Japan, Greater China and Korea. Faron owns the intellectual property and marketing rights in respect of Traumakine in all other territories.

Our Japanese licensing partner, Maruishi Pharmaceutical Co., Ltd announced similar positive from its Phase II Japanese study for Traumakine. Based on these results Maruishi is now conducting a pivotal phase III trial in Japan according to the advice from the Japanese FDA (PMDA).

Faron continued out-licensing of Traumakine in Asia signing a profit sharing agreement with Pharmbio, a Korean pharmaceutical company, on rights to develop and commercialise Traumakine in Korea. Faron received a signing fee of €750,000, with additional milestones and royalty payments agreed.

Parallel to completion of the European Phase III study, Faron plans to commence a Phase II US safety study (INTRUST) with Traumakine in H2 2017, which is expected to take 12 months to complete. The timing of this planned trial remains subject to regulatory approvals, with a pre-IND FDA meeting targeted to occur in mid 2017. Faron is currently in the process of establishing the trial structure and is recruiting PI's, IDMC, sites and CROs in the US.

Clevegen® Development

One of Faron's key areas of focus is to develop a cancer treatment that supports the hosts' immune defences against tumours, as these are often suppressed in cancer patients. Faron's second most advanced drug development project, Clevegen, revolves around Clever-1, a cell surface molecule involved in cancer growth and spread. The active pharmaceutical ingredient of Clevegen is a humanised anti-Clever-1 antibody.

Faron has an agreement with Geneva based Selexis to prepare high yield production clones for Clevegen (FP-1305) which was successfully completed in mid 2016. In order to obtain GMP grade antibodies, Faron contracted Abzena to build a manufacturing process for Clevegen, allowing Faron to design a final primate tox study and plan human clinical studies in several cancer groups. Abzena informed the Company at the end of 2016 that the selected clones produce more than 5 g/l, which is widely considered a commercially feasible level.

During 2016, Faron has utilised €0.8 million of the €1.5 million loan funding from Tekes, the Finnish Funding Agency for Innovation, to progress the preclinical development of Clevegen. The funding is a government loan which covers 50% of the budgeted cost of the preclinical development of Clevegen.

Upcoming Newsflow

The Board anticipates the following pipeline progress during 2017:

Traumakine:

- Read-out for the pan-European phase III trial (INTEREST) results (all-cause mortality at day 28) during H2 2017.
- Advanced advice from IDMC (Independent Data Monitoring Committee) on the INTEREST study is expected in May 2017. Faron recently received the third recommendation from IDMC for the trial to continue without any modifications.
- The Company has established a manufacturing plan to build its stocks of Traumakine. Subject to a positive outcome of the INTEREST study, having manufacturing in place should facilitate the application process for market approval of Traumakine.
- The Company plans to commence a Phase II US safety study (INTRUST) with Traumakine in H2 2017. It is expected that the full study will take 12-15 months to get to D28 and D90 all cause mortality data. Timing remains subject to regulatory approvals with a pre-IND FDA meeting targeted to occur in mid 2017.
- The Company currently expects recruitment in the Japanese Phase III pivotal study for the treatment of ARDS with Traumakine, run by its Japanese licensing partner Maruishi Pharmaceutical Co., to progress towards completion during 2017.
- Interim results from the 160 patient Traumakine clinical study (INFORAAA) for the treatment of patients with rupture of acute abdominal aorta (RAAA), which began recruiting in February 2017, is expected in 12 to 18 months. The aim of this trial is to reduce mortality in operated RAAA patients, which normally varies from 30 to 50% of all patients surgically operated on. The INFORAAA study will also assist in the design of Traumakine trials for single organ failures.

Clevegen:

- Subject to access of Clevegen's active pharmaceutical incredient (FP-1305), Faron has contracted a toxicological pre-clinical study for Clevegen to start in mid 2017.
- The Company expects to file the first CTA with the UK regulatory authorities (MHRA) in late 2017 / early 2018 and this study is expected to provide enough safety data for acceptance of the CTA. The first, and primarily safety focused clinical trial is expected to be conducted with liver cancer patients at the Birmingham University Liver Cancer Centre and is expected to continue into a Phase II study via an adapted trial design for HCC patients to recognise early efficacy signals.
- The second set of clinical cancer trials will be conducted in parallel with the HCC trial in Scandinavia with melanoma, pancreas and ovarian cancer patients.

Commerical:

Faron is exploring various commercial opportunities while continuing to develop the pipeline with the existing resources.

"Subject to the successful completion of the Phase III INTEREST trial and achievement of regulatory approvals, Traumakine will potentially be the first effective, mechanistically-targeted, disease-specific pharmacotherapy for ARDS patients."

Markku Jalkanen – CEO

STRATEGIC REPORT

Financial Review

Key Performance Indicator

Faron is a late clinical stage drug development company with no recurring sales and thus the primary Key Performance Indicators (KPIs) followed by the Board focus on cash balances and other related information. During 2016, the Company was able to generate positive (€0.4 million) cash flow despite strong investments in R&D. This was possible mainly due to successful fundraising and stronger than expected income, both revenues and other operating income. The Board will consider the appropriateness of monitoring additional KPIs as the Company's operations advance.

Revenue and Other Operating Income

The Company's revenue was €1.2 million for the year ended 31 December 2016 (2015: €0.5million), which comprised of sale of excess API material and sales of IMP –material. The €0.7 million signing fee milestone from Korean license partner PharmBio was not recorded as revenue but as advance payment. The Company also recorded €1.7 million (2015: €0.7 million) of other operational income. This comprised of income recognised from the European Commission FP7 grant in support of the Traumakine programme as well a grant component from public loans.

Research and development costs

The R&D costs increased by €5.6 million (141%) from €4.0 million to €9.6 million. This was mainly due to the INTEREST –trial which recruited its first patient very late 2015 and was in full capacity during 2016. Also, Clevegen development entered a more active phase. The third contributor to the R&D cost increase was preparatory work for eventual Traumakine launch including ramp-up of production of API.

Share-based compensation

According to the 2015 Option program a number of options were awarded to Directors and key personnel during 2016. This had no cash impact on the results for the year, however accounting standards required this share based compensation to be recognised in the Consolidated Statement of Comprehensive Income, resulting in a charge of €0.5 million (2015: €0.5 million.).

Taxation

The Company's tax credit for the fiscal year 2016 can be recorded only after the Finnish tax authorities have approved the tax report and confirmed the amount of tax-deductible losses for 2016. The total amount of cumulative tax losses carried forward approved by tax authorities on 31 December 2016 was €13.9 million (2014: €5.7 million). These losses can be utilised during the years 2019 to 2025 by offsetting them against profits. In addition, Faron has €2.8 million research and development costs incurred in the financial years 2010 and 2011 that have not yet been deducted in its taxation. This amount can be deducted over an indefinite period at the Company's discretion.

Losses

Loss before income tax was €9.3 million (2015 €6.2 million). Net loss for the year was €9.2 million (2015 €6.2 million) representing a loss of €0.39 per share (2015 € 0.30 per share) (adjusted for the changes in share capital).

Cash Flows

The Company was able to maintain a positive net cash inflow of €0.4 million for the year ended 31 December 2016, compared to a positive cash inflow of €10.8 million for the previous year. Cash used by operating activities increased with €1.3 million to €8.5 million for the year, compared to €7.1 million for the year ended 31 December 2015. This increase was driven by €5.6 million (142%) increase in research and development costs, and was offset by a €1.7 million (142%) increase in income and a €0.9 million (29%) reduction in administrative costs.

Net cash inflow from financing activities €9.0 million (2015: €18.1 million) mainly due to the receipt of net proceeds of €8.5 million from an equity placing completed in September 2016

Financial Position

As at 30 September 2016, total cash and cash equivalents held were €11.5 million (2015 €11.1 million).

Headcount

Average headcount of the Company for the year was 10 (2015:6). The increase in headcount is attributable to the commencement of the Phase III trial.

Share Capital

Based on the authorisation by the Annual General held on 26 May 2016, the Board of Directors decided to issue a total of 3,200,000 million new ordinary shares. On 23 September 2016, the number of ordinary shares was increased to 26,311,704 by the issue of 3,200,000 new ordinary shares at a subscription price of £2.50. The subscription price was credited in full to the Company's reserve for invested unrestricted equity, and the share capital of the Company was not increased

Based on a resolution of the Extraordinary General Meeting held on 15 September 2015, the Company had adopted the 2015 Share Option Plan. On 18 November 2016 the Board of Directors granted the 2015B Options to the management and employees of the Company. The directors' options are detailed in Directors´ Remuneration Report set out in the Annual Report and Accounts.

Money Raised to Date

Until 31 December 2016, the Company has been funded with a total of approximately €44 million, made up of a combination of equity, debt and grant funding, which has been used to develop the Company's products and intellectual property. The Company has also generated revenue and cash of €4.2 million to date through the receipt of milestone payments pursuant to certain of its licensing arrangements and the sale of surplus raw materials.

Yrjö E K Wichmann – CFO

STRATEGIC REPORT

Risks and Uncertainties

Faron is a late clinical stage biopharmaceutical company and, in common with other companies operating in this field, is subject to a number of risks and uncertainties. The principal risks and uncertainties identified by Faron for the year ended 31 December 2016 are below.

Research and Development

Faron's main product is in the late stages of clinical development however may not be successful in the clinical trials and may not be able to develop approved or marketable products. Technical risk is also present at each stage of the discovery and development process of other, earlier stage products with challenges in biology (including the ability to produce candidate drugs with appropriate safety, efficacy and usability characteristics). Additionally, drug development is a highly regulated environment which itself presents technical risk through the need for study designs and data to be accepted by regulatory agencies. Furthermore, there can be no guarantee that the Company will be able to, or that it will be commercially advantageous for the Company to, monetize the value of its intellectual property through entering into licensing or other co-operation deals with pharmaceutical companies.

Commercial

Faron's industry, being biotechnology and pharmaceutical industries, are very competitive. The Company's competitors include major multinational pharmaceutical companies, biotechnology companies and research institutions. Many of its competitors have substantially greater financial, technical and other resources, such as larger research and development resources and staff. The Company's competitors may succeed in developing, acquiring or licensing drug product candidates that are more effective or less costly than any of the product candidates which the Company is currently developing or which it may develop and may have a material adverse impact on the Company.

Dependence on key personnel and scientific and clinical collaborators

The Company's success is highly dependent on the expertise and experience of the Directors and the key Management. Whilst the Company has entered into employment and other agreements with each of these key personnel, the retention of such personnel cannot be guaranteed. Should key personnel leave or no longer be party to agreements or collaborations with the Company, the Company's business prospects, financial condition and/or results of operations may be materially adversely affected. To develop new products and commercialise its current pipeline of products, the Company relies, in part, on the recruitment of appropriately qualified personnel, including personnel with a high level of scientific and technical expertise. There is currently a shortage of such personnel in the pharmaceutical industry, meaning that the Company is likely to face significant competition in recruitment. The Company may be unable to find a sufficient number of appropriately highly trained individuals to satisfy its growth rate, which could affect its ability to develop as planned.

Regulatory environment

The Company operates in a highly regulated environment. Whilst the Company will take every effort to ensure that the Company and its partners comply with all applicable regulations and reporting requirements, there can be no guarantee of this. Failure to comply with applicable regulations could result in the Company being unable to successfully commercialise its products and/or result in legal action being taken against the Company, which could have a material adverse effect on the Company.

The Company will need to obtain various regulatory approvals (including from the FDA and the EMA) and comply with extensive regulations regarding safety, quality and efficacy standards in order to market its products. While

efforts have been and will be made to ensure compliance with governmental standards and regulations, there is no guarantee that any product will be able to achieve the necessary regulatory approvals to promote that product in any of the targeted markets and any such regulatory approval may include significant restrictions for which the Company's products can be used. In addition, the Company may be required to incur significant costs in obtaining or maintaining its regulatory approvals. Delays or failure in obtaining regulatory approval for products would likely have a serious adverse effect on the value of the Company and have a consequent impact on its financial performance.

Intellectual property and proprietary technology

The Company relies and will rely on intellectual property laws and third party non-disclosure agreements to protect its patents and other proprietary rights. The IPR on which the Company's business is based is a combination of patent applications and confidential business know-how. No assurance can be given that any currently pending patent applications or any future patent applications will result in patents being granted. In addition, there can be no guarantee that the patents will be granted on a timely basis, that the scope of any patent protection will exclude competitors or provide competitive advantages to the Company, that any of the Company's patents will be held valid if challenged, or that third parties will not claim rights in, or ownership of, the patents and other proprietary rights held by the Company.

Despite precautions taken by the Company to protect its products, unauthorized third parties may attempt to copy, or obtain and use the Company's IPR and other technology that is incorporated into its pharmaceutical products. In addition, alternative technological solutions similar to the Company's products may become available to competitors or prospective competitors of the Company. It should be noted that once granted, a patent could be challenged both in the relevant patent office and in the courts by third parties. Third parties can bring material and arguments, which the patent office granting the patent may not have seen at the time of granting the patent. Therefore, whilst a patent may be granted to the Company it could in the future be found by a court of law or by the patent office to be invalid or unenforceable or in need of further restriction. Should the Company be required to assert its IPR, including any patents, against third parties it is likely to use a significant amount of the Company's resources as patent litigation can be both costly and time consuming. No assurance can be given that the Company will be in a position to devote sufficient resources to pursue such litigation. Any unfavorable outcomes in respect of patent litigation could limit the Company's IPR and activities moving forward.

The Directors do not believe that its lead pharmaceutical drug candidates, future drug candidates in development, and proprietary processes for generating those candidate compounds infringe the IPR of any third parties although shareholders should note the risk factor headed "US Patent owned by Biogen" in the admission document dated 18 November 2015. However, it is impossible to be aware of all third party intellectual property. The Company's research has included searching and reviewing certain publicly available resources, which are examined by senior levels of management in order to keep abreast of developments in the field.

Financial

The Company has incurred significant losses since its inception and does not have any approved or revenue-generating products. The Company expects to incur losses for the foreseeable future, and there is no certainty that the business will generate a profit. The Company may not be able to raise additional funds that will be needed to support its product development programs or commercialisation efforts, and any additional funds that are raised could cause dilution to existing investors.

Operational

The Company's development and prospects depend to a significant degree on the experience, performance and continued service of its senior management team including the Directors. The Company has invested in its management team at all levels. The Directors also believe that the senior management team is appropriately structured for the Company's size and is not overly dependent upon any particular individual. The Company has entered into contractual arrangements with these individuals with the aim of securing the services of each of them. Retention of these services or the identification of suitable replacements, however, cannot be guaranteed. The loss of the services of any of the Directors or other members of the senior management team and the costs of recruiting replacements may have a material adverse effect on the Company and its commercial and financial performance and reduce the value of an investment in the Ordinary Shares.

This report was approved by the Board on 28 March 2017 and signed on its behalf.

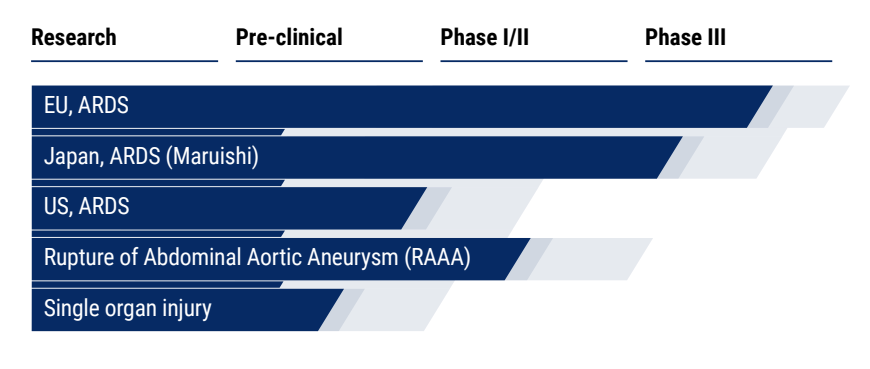
PIPELINE

Revolutionising the treatment of ARDS and activation of tumour immunity

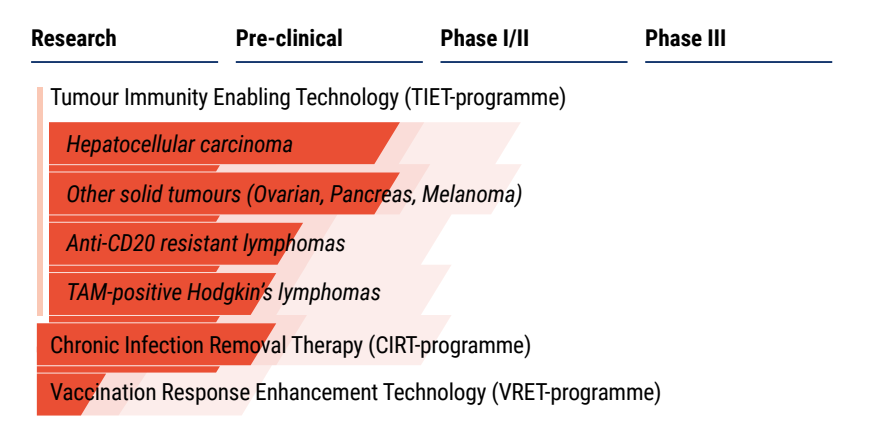
Faron has identified several molecular mechanisms involved in the control of endothelial functions as a source of innovation. The Company currently has a pipeline focusing on acute organ traumas, cancer immunotherapy and vascular damage.

The fast evolving Faron pipeline consists of drug candidates (FP-1201-lyo and FP-1305) from two major Faron programmes – Traumakine and Clevegen, respectively. The lead indication of the Traumakine programme is Acute Respiratory Distress Syndrome (ARDS). This and the other indications (Rupture of Abdominal Aortic Aneurysm RAAA) are all based on the same Chemistry and Manufacturing Controls (CMC) dossier sections, allowing fast protocol adjusted filing for indication expansion. Similarly, Clevegen indications utilise one common dossier with a protocol adapted to each indication.

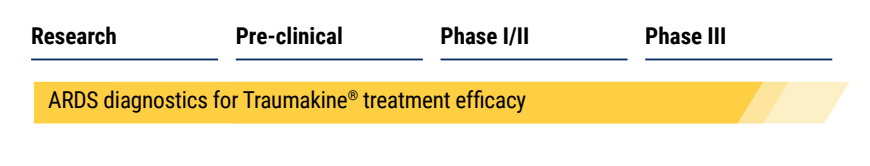
Traumakine® is Faron's spearhead project



Clevegen®



D-ARDS



TRAUMAKINE

Faron´s lead candidate, Traumakine, addresses the treatment of Acute Respiratory Distress Syndrome (ARDS), a severe, orphan lung disease. Currently there is no pharmaceutical treatment for this condition with a reported mortality rate of 30 to 45%. The scientific rationale for Traumakine treatment is based on the use of interferon-beta for the restoration of the endothelial barrier function in ARDS patients.

PIPELINE: TRAUMAKINE®

Acute Respiratory Distress Syndrome (ARDS)

ARDS is a life-threatening medical condition characterised by widespread inflammation in the lungs and sudden failure of the respiratory system. ARDS causes inflammation of the alveoli in the lungs which become unable to perform the normal oxygenation of blood. It is characterised by rapid breathing, difficulty getting enough air into the lungs and low blood oxygen levels. Common causes of ARDS include sepsis, pneumonia, aspiration of fumes, food or stomach contents going into the lung or significant trauma. The condition was first described in 1967 and gained wide attention during the Vietnam War when it was nicknamed "white lung" as X-rays presented the lungs of the patients as white.

ARDS is the leading cause of respiratory failure in intensive care unit patients requiring mechanical ventilation. Despite progress in critical care medicine, ARDS is currently associated with a mortality rate of 30 to 45% depending on the severity of the condition. Although ARDS mortality has decreased in the last decade due to improvements in supportive care and in the treatment of the underlying conditions, it still remains high.

Currently, patients suffering from ARDS are generally treated with lung-protective mechanical ventilation. This treatment is accompanied by ancillary support such as positioning, fluid management and food restrictions. Extra corporeal support may also be provided depending on the severity of the condition. Complications which can also arise whilst a patient is being treated for ARDS include the development of infections, pneumothorax, lung scarring and blood clots which can develop into a pulmonary embolism. Patients who recover from ARDS may suffer other consequences of the condition after being discharged from the intensive care unit. A recovering patient's quality of life may be adversely affected by permanent damage to the lungs, respiratory problems, scar tissue, muscle weakness and depression, all of which can have an adverse effect on the patient's quality of life.

Treating ARDS

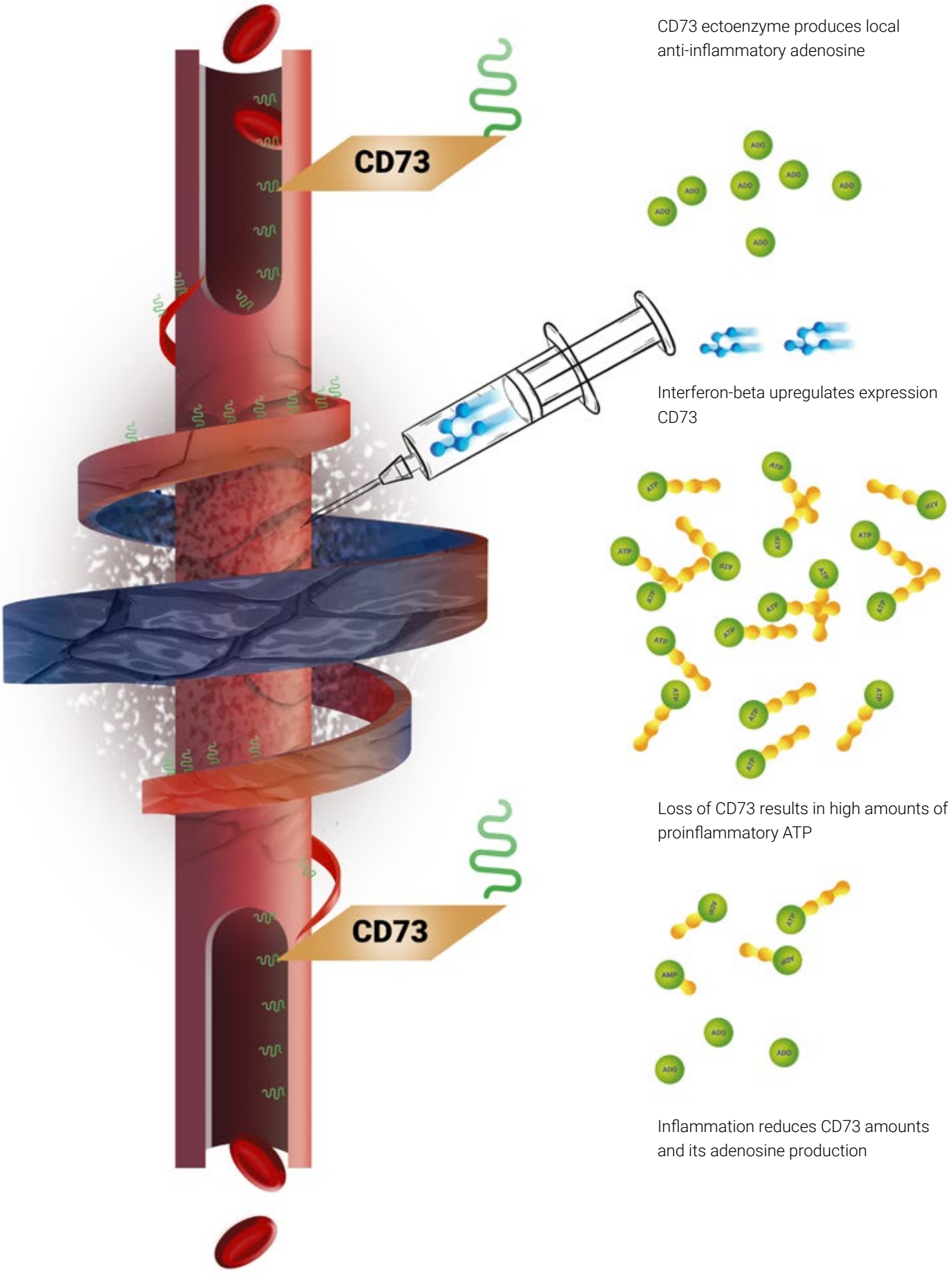
Supply of oxygen and nutrients to individual cells of various organs are maintained by vasculature and especially by the long and thin blood vessels called capillaries. Their integrity is sustained by endothelial cells covering the inner surfaces of these vessels forming a barrier between circulation and tissues. The breakdown of this barrier results in leakage of blood content to tissues. If this happens in lungs, the lung air space is filled with protein-rich fluid and blood cells preventing normal gas exchange.

The key molecule involved in maintaining endothelial barrier and lung function is CD73, an endothelial ectoenzyme, which can produce local adenosine. Traumakine's active pharmaceutical ingredient, interferon-beta, increases CD73 expression resulting in increased local adenosine. Subsequently, high local adenosine levels reduce capillary leakage and increase lung function by allowing normal gas exchange to return.

"ARDS is the leading cause of respiratory failure in intensive care unit patients requiring mechanical ventilation."

ARDS

- **A severe, life-threatening medical condition, most often as a result of sepsis, pneumonia or significant trauma**
- **Orphan lung disease with no available drug treatment**
- **The leading cause of respiratory failure in intensive care unit patients who require mechanical ventilation**
- **Annual ARDS incidence in Europe is c. 125,000 and in the US c. 170,000 patients**
- **High mortality rate of 30 to 45% and survivors suffer long-term mental and physical problems**



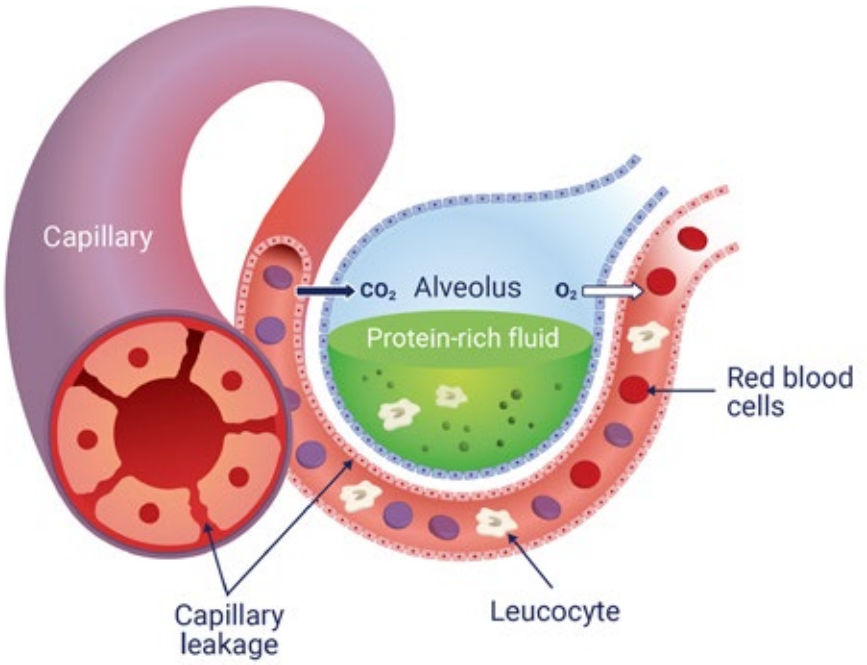
CD73 ectoenzyme produces local anti-inflammatory adenosine

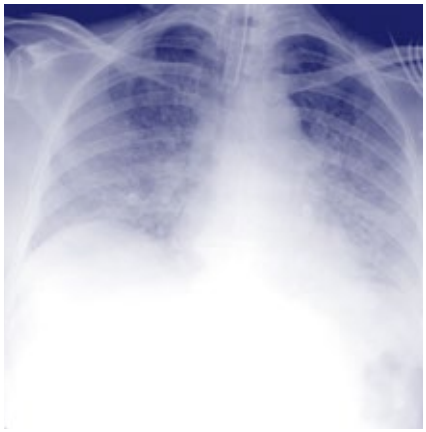
Interferon-beta upregulates expression CD73

Loss of CD73 results in high amounts of proinflammatory ATP

Inflammation reduces CD73 amounts and its adenosine production

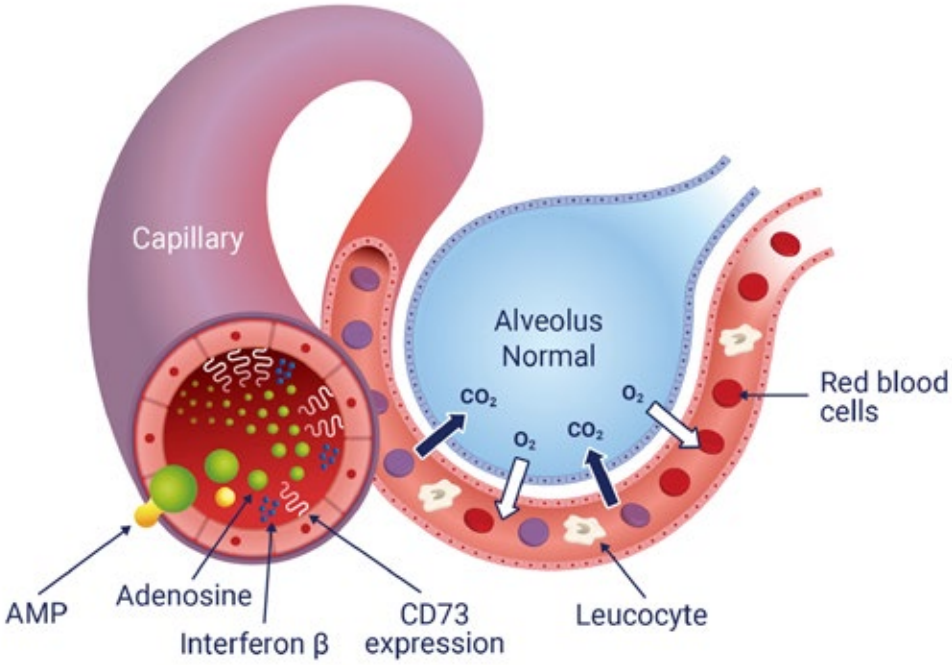
ARDS lung

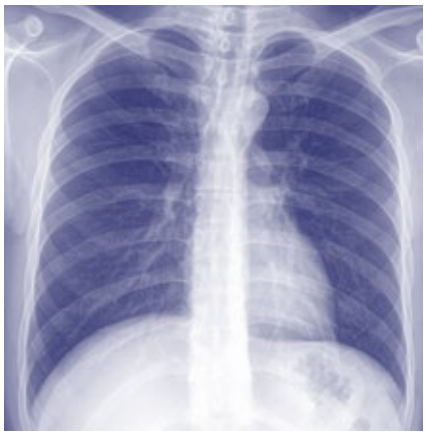




Widely used X-ray pictures can reveal lungs filled with blood material. This shows up as white dense material in lung air space and for this reason the lungs of these patients are often called "white lungs". Typically this picture confirms that the patient has a condition called Acute Respiratory Distress Syndrome (ARDS) and has a life-threatening disease.

Normal lung





Normally functioning lung X-ray shows no "white" material, indicating that lung air space is free of blood material, in contrast to the ARDS lungs above. Long term exposure to a respiratory syndrome like ARDS, can also cause permanent loss of lung capacity due to a fibrotic process that replaces lung alveoli with scar tissue. This serious side effect of ARDS results in permanently reduced respiratory capacity.

Traumakine® Clinical Programme

The first indication that Faron´s lead candidate, Traumakine, addresses is the treatment of ARDS. The scientific rationale for Traumakine treatment is based on the use of interferon beta for the restoration of the endothelial barrier function in ARDS patients. Traumakine (FP-1201-lyo) is based on a patent-protected use of interferon beta to prevent leakage of vascular beds in acute lung injuries. The active pharmaceutical ingredient in Traumakine is recombinant human IFN beta-1a. Traumakine has commenced a pan-European Phase III trial in respect of the treatment of ARDS. The first patient in the INTEREST Study was enrolled in December 2015 and the study has progressed as planned during 2016. This was also confirmed by the Independent Data Monitoring Committee twice during the year.

The first clinical trial in the Traumakine programme was a phase I/II open-label study to assess the safety, tolerability and preliminary efficacy of interferon beta in the treatment of patients with ARDS. This study consisted of dose escalation (Phase I) and dose expansion (Phase II) phases. In the dose escalation phase, four interferon beta levels were tested. The dose expansion phase was conducted using the optimal tolerated dose.

A total of 37 ARDS patients were treated at nine hospitals in the UK with highly encouraging results. Interferon beta was found to be safe and well tolerated in ARDS patients and the optimal tolerated dose was established. The selected pharmacodynamic marker for interferon beta bioactivity showed clear dose response and the treatment target molecule (CD73) levels were induced during the dosing period. Most importantly, interferon beta treatment significantly reduced the all-cause mortality at day 28, the primary end point of the study, compared to the control cohort[1]. Traumakine was associated with an 81% reduction in odds of 28-day mortality. Comparable results were obtained from Traumakine Phase II Japanese study conducted by Faron´s Japanese licensing partner, Maruishi Pharmaceutical Co., Ltd. in Japan, as announced in January 2016.

Ongoing Phase III INTEREST Study

The Phase III ongoing, clinical trial is a double-blind, randomised, parallel-group comparison of efficacy and safety of interferon beta and placebo in the treatment of patients with moderate to severe ARDS. The study named INTEREST will be conducted in 60 hospitals across Belgium, Finland, France, Germany, Italy, Spain and the UK and 300 ARDS patients in total will be recruited. INTEREST has received €6 million funding from the European Union Seventh Framework Programme (FP7).

Mechanism of Action

The mechanism behind Traumakine's action was invented by scientists at Turku University during the period 1995 to 2003. Through extensive research and ex-vivo studies, it was identified that a molecule called CD73 is essential in maintaining the endothelial barrier function. CD73 is an ectoenzyme capable of breaking down extracellular AMP to produce locally active adenosine. Adenosine maintains the endothelial barrier and downregulates inflammation escalation, preventing both early vascular leakage and escalation of inflammation, which are the two early patho-physiological events leading to ARDS.

One of the key findings that led to the development of Traumakine, was a discovery that interferon-beta could enhance CD73 expression and could therefore, be used to treat a range of vascular leakage conditions including ARDS. Traumakine works by enhancing CD73 expression in the lungs and increasing production of anti-inflammatory adenosine such that vascular leaking and escalation of inflammation are reduced.

Recombinant human IFN beta-1a is an approved treatment for patients with relapsing remitting MS and the safety profile of recombinant human IFN beta-1a in such patients is well characterised.

"Traumakine (FP-1201-lyo) is based on a patent-protected use of interferon-beta to prevent leakage of vascular beds in acute lung injuries."

[1] Bellingan et al. (2014). The effect of intravenous interferon-beta-1a (FP-1201) on lung CD73 expression and on acute respiratory distress syndrome mortality: an open-label study. The Lancet Respiratory Medicine 2014: 2: 98-107.

PIPELINE: TRAUMAKINE®

The INTEREST Study

The INTEREST Study (protocol FPCLI002) is a Phase III clinical study to investigate efficacy and safety of FP-1201-lyo (recombinant human interferon-beta-1a) in patients with moderate or severe ARDS. This study is designed based on previous results from the UK clinical trial which demonstrated a significant reduction in mortality of ARDS patients and has been published in the Lancet Respiratory Medicine[1]. In the double-blinded and randomised INTEREST Study pivotal effectiveness and safety of FP-1201-lyo is compared to placebo. Both treatment groups also receive standard supportive care.

The primary objective of the INTEREST Study is to demonstrate the efficacy of FP-1201-lyo in improving the clinical course and outcome based on survival and need for mechanical ventilation in patients with moderate or severe ARDS. Other study objectives are to assess the safety and efficacy of FP-1201-lyo compared to placebo, in regard to mortality, organ failure, need for mechanical ventilation and vasoactive support, length of the stay in ICU and hospital as well as quality of life and pharmacoeconomic parameters.

60 Intensive Care Units in Seven European Countries

In total, approximately 60 hospitals in seven countries within the European Union – Belgium, Finland, France, Germany, Italy, Spain, UK – are participating in the INTEREST Study. A total of 300 adult patients with moderate or severe ARDS will be enrolled (on average six patients per hospital).

Faron Pharmaceuticals is running the study in collaboration with external research service providers. INTEREST has received funding from the European Union Seventh Framework Programme (FP7) under the Traumakine project name.

Progressing as planned

The first approvals from competent authorities and favourable opinions from independent ethics committees to conduct the study were obtained towards the end of 2015 with the first patient enrolled in December 2015. The majority of sites were opened during the first half of 2016 and currently 60 sites are recruiting. The read-out for the primary and secondary end points is expected in the second half of 2017.

The patients enrolled in the study are screened from patients who have been admitted to intensive care units (ICU) at participating hospitals. To further ensure appropriate patient enrolment into the study across all hospitals, the study design incorporates an eligibility process via the electronic data capture system, involving an independent medical monitor. After all screening procedures

have successfully been performed, and eligibility for inclusion in the study has been confirmed, the patient can be randomised into the study.

Following randomisation, the patients will be treated daily with either FP-1201-lyo 10 µg or placebo for 6 days and will undergo daily assessments while in the ICU for a maximum of 28 days. The patients are followed up at 3, 6 and 12 months after enrolment. Information on the need for ventilator support, as well as the need for hospital and ICU care, is collected during this follow-up period. Other collected data include e.g. respiratory and neurological functions and quality of life.

The main analysis and clinical study report will be written on the data from the 6 months long-term follow-up. The data from the extended follow-up period from 6–12 months will be reported separately in an addendum to the clinical study report.

Safety Monitoring

An Independent Data Monitoring Committee has been established in order to monitor safety in this study. This safety review committee will periodically conduct an independent unblinded review of safety data generated during the study and provided two recommendations during 2016 to continue the study as planned.

The study also has an esteemed Steering Committee that provides expert scientific and clinical guidance to the practical study design and conduct. The rights, safety and well-being of the patients are the basis for all considerations.

More details on the study can be found on www.clinicaltrialsregister.eu (reference EudraCT No. 2014-005260-15) and clinicaltrials.gov (reference NCT02622724).

The mode of action of FP-1201-lyo is described on the video found at Faron web pages (www.faronpharmaceuticals.com).

INTEREST Study

- **Pivotal Phase III trial for Traumakine in development for the treatment of ARDS**
- **Conducted in 60 ICUs (Intensive Care Units) in seven European countries**
- **300 adult patients with moderate to severe ARDS will be enrolled in the study**
- **First patient enrolled in December 2015**
- **The enrolment period is estimated to last until H2 2017**
- **Subject to the study results and achievement of regulatory approvals Traumakine could be the first effective, disease-specific pharmacotherapy for patients suffering from ARDS**

INFORAAA trial initiation

Ruptured Abdominal Aortic Aneurysm (RAAA) is a surgical emergency with an overall mortality of 70 to 80%. It requires immediate surgery and aortic repair. Approximately half of the deaths of RAAA patients are due to not reaching the hospital in time, and, despite immediate surgery and intensive care treatment, the second half die in hospital within 30 days post-operatively, mostly due to multi-organ failure. The cause of high post-operative mortality is mainly due to prolonged hypotension/hypoxia from the ruptured aorta and the aftermath of restoring blood flow: reperfusion, vascular leakage and failure of vital organs. Currently, there are an estimated 20,000 US and European patients per annum eligible for treatment.

The high mortality rate of RAAA, which accounts for 4-5 deaths per 100,000 population[2], requires new treatments to prevent post-operative reperfusion injury leading to the death of RAAA patients, which exhibits a 30-50% mortality rate post-operatively. RAAA accounts for 13-14/100,000 hospital admissions annually[3], and is the second indication for Traumakine targeted by Faron.

Open surgical aortic repair to treat RAAA patients is associated with a Systemic Inflammatory Response Syndrome (SIRS) affecting vital organs, especially the heart, lungs, kidneys, and intestines. The death of approximately 80% of the operated RAAA patients is caused by MOF, similar to patients with ARDS. Traumakine (FP-1201-lyo) is currently in a European Phase III clinical trial for the treatment of ARDS, with encouraging Phase I/II data. The Directors consider that data seen to date supports the rationale for extending the use of Traumakine in similar conditions to potentially treat single, and multiple, organ failures. For example, during the Traumakine phase I/II study, there was a reduced need for haemodialysis (an indication of improved kidney function) among the ARDS patients on Traumakine.

Soon after closing the September 2016 financing round, Faron initiated filing of a clinical trial application to open the INFORAAA study. This CTA was accepted in late 2016 and the first patient for the trial was recruited in February 2017, as announced previously.

INFORAAA

[1] Bellingan et al., 2014

[2] Karthikesalingam et al., 2014

[3] Anjum et al., 2012

CLEVEGEN

One of Faron's key areas of focus is to develop a cancer treatment support the hosts' immune defences against tumours, as these are often suppressed in cancer patients. Our second most advanced drug development project, Clevegen, revolves around Clever-1, a cell surface molecule involved in cancer growth and spread. The active pharmaceutical ingredient of Clevegen is a humanised anti-Clever-1 antibody, which modulate Clever-1 function to switch the immunosuppressive M2 macrophages to immune stimulating M1 macrophages.

PIPELINE: CLEVEGEN®

Mechanism of Action

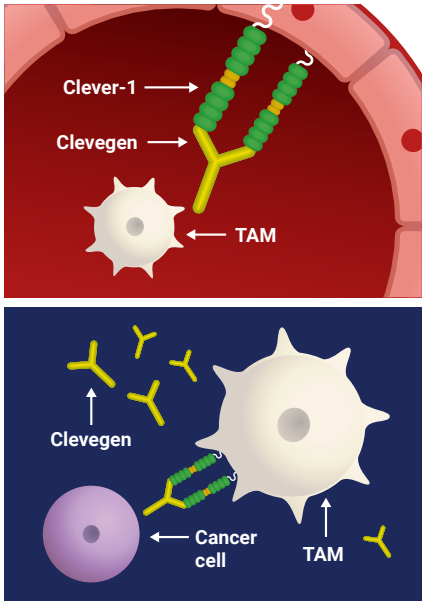
All tumours are infiltrated by immune cells, for example macrophages, neutrophils, T cells, dendritic cells, mast cells, myeloid derived suppressor cells and natural killer cells. Depending on the immune cells stimulated and activated, they can either have a protective effect for the host through suppression of tumour growth or deleterious effect by promoting tumour growth, invasion, metastasis and angiogenesis. Tumour associated macrophages (TAMs) have emerged as an essential constituent of the tumour environment, with influence over many aspects of cancer (proliferation and survival) as well as interaction with surrounding elements (angiogenesis, escape from antitumour specific immunity). When TAMs populate a tumour, one of the very significant influences they exert over it is a strong increase in immune suppression. Clever-1-positive TAMs represent one major macrophage population involved in the elimination of host immune activity against the tumour cells. Clevegen is an anti-Clever-1 antibody which targets and eliminates Clever-1-positive TAMs from cancer patients by converting the immune suppressive type 2 macrophages (M2) to immune stimulating type 1 (M1) macrophages.

Clevegen also prevents TAM infiltration into a tumour and therefore blocks their accumulation at tumour sites and can, therefore, also control the tumour content of regulatory T-cells, which are dependent on M2 macrophage support.

Expansion of Clevegen's use, to include removal of local immune suppression in chronic infections and vaccination sites, are also being explored alongside tumours. These platforms are called CIRT, VRET and TIET, respectively and are all based on the same anti-Clever-1 antibody.

"Clever-1-positive TAMs represent one major macrophage population involved in the elimination of host immune activity against the tumour cells."

"Clevegen converts immune suppressive type 2 (M2) macrophages to immune stimulating (M1) macrophages and provides new ways to stimulate host immune system to fight cancer."



Blocking TAM infiltration into a Tumour

Tumour endothelial cells are Clever-1 positive and when anti-Clever-1 antibodies bind to the Clever-1 receptor, the infiltration of TAMs is prevented. Through blocking the infiltration of TAMs into the tumour, the ability of the tumour to suppress the hosts' immune system is reduced.

Change in Tumour Immunity

Anti-Clever-1 antibodies change the tumour immunity by lowering the presence of tumour supportive TAMs in the tumour. This will allow other immune cells to attack tumour cells and drive them to programmed cell death (apoptosis). In some tumours up to 50% of the tumour mass may contain TAMs and the only way to eliminate this dominance is remove them from tumours. It is these TAM cells that are the main target of the Clevegen programme.

About Tumor Immunity Enabling Technology (TIET)

The TIET technology is built around the humanised anti-Clever-1 antibody FP-1305, which binds to a specific Clever-1 proprietary epitope. Clevegen binds to this epitope, activating conversion of type 2 tumour associated macrophages to type 1 macrophages, resulting in the transformation of the tumour environment from immune suppression to immune activation. As the TIET technology is based on a humanised antibody, the Faron Directors believe it can be combined with a number of other immune therapies without a significant risk of increased adverse events. The TIET technology could provide a significant boost for the efficacy of other immune checkpoint molecules, as its target is unique and represents a completely separate control of immunity.

"In some tumours up to 50% of the tumour mass may contain TAMs and the only way to eliminate this dominance is remove them from tumours."

References:

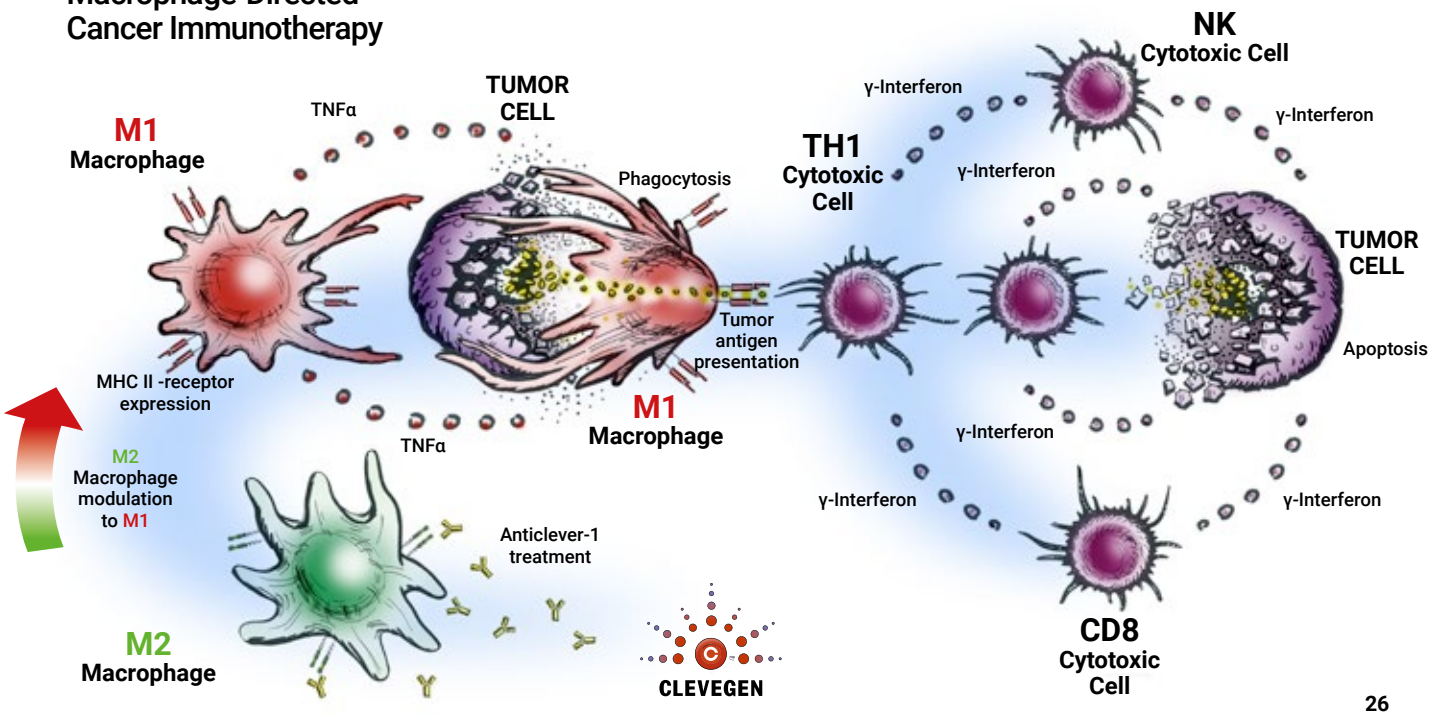
Karikoski et al. (2014) Clever-1/Stabilin-1 controls cancer growth and metastasis. Clin. Cancer Res. 2014: 20: 6452-64.

Palani et al. (2016). Monocyte Stabilin-1 suppresses the activation of Th1 lymphocytes. Journal of Immunology 2016: 196: 115-123.

INNATE IMMUNITY / MACROPHAGES

ADAPTED IMMUNITY / LYMPHOCYTES

Macrophage-Directed Cancer Immunotherapy



Corporate Governance

The Board of Faron emphasises the importance of good corporate governance and is aware of its responsibility for overall corporate governance, and for supervising the general affairs and business of the Company.

Faron is not required to comply with the UK Corporate Governance Code by virtue of being an AIM quoted company. The Board does, however, seek to apply the QCA´s Corporate Governance Code for Small and Medium Sized Companies (as devised by the QCA in consultation with a number of significant institutional small company investors) to the extent that is appropriate and practical for a Company of its nature and size.

CORPORATE GOVERNANCE

Board of Directors

Dr Frank Armstrong

Non-Executive Chairman

Dr Armstrong has held Chief Executive roles with five biotechnology companies (both public and private) including Fulcrum Pharma PLC (AIM). He led Medical Science and Innovation at Merck Serono and was previously Executive Vice President of Product Development at Bayer and Senior Vice President of Medical Research and Communications at Zeneca. Dr Armstrong is currently the Chairman of Xceleron Inc., Summit Therapeutics (AIM and NASDAQ) and a Non-Executive Director of Actino Pharma, Juniper Therapeutics (NASDAQ) and Mereo Pharma.

Dr Armstrong is a physician and a Fellow of the Royal College of Physicians (Edinburgh). He is also a member of the Scientific Advisory Board of Healthcare Royalty Partners. He was appointed as a Non-Executive Director of the Company in September 2015.

Matti Manner

Non-Executive Vice-Chairman

Mr Matti Manner was appointed as a partner of Brander & Manner Attorneys Ltd in 1980 having previously sat as a judge at Turku Appeal Courts. He has significant experience in national and international business deals, corporate law and mergers and acquisitions having held a number of board memberships throughout his career. Mr Manner joined the Board of the Company as Chairman in 2007 having previously been the Chairman of Faron Ventures Oy from 2002. He is currently Chairman of Turun Osuuskauppa and Ruissalo Foundation and a member of the board of Marva Media Ltd, Satatuote Ltd, YH VS-Rakennuttajat Ltd and Kauppakeskus Mylly Ltd.

Mr Manner has experience of several trustee posts including the Presidency of the Finnish Bar (Lawyers) Association during the period of 1998 to 2004. Mr Manner obtained a Master of Laws from the University of Turku. He became an honorary Chief Justice in Finland in 2013.

Dr Markku Jalkanen

Chief Executive Officer

Dr Jalkanen has more than 25 years of experience within biomedical research, biotech development and the biopharmaceutical industry. He was a founding member of the Company and is the Company´s CEO. In addition to his role as CEO of the Company, Dr Jalkanen is an advisor for the only active Finnish life sciences fund – Inveni Capital. Between 1996 and 2002, Dr Jalkanen was the founding CEO and President of BioTie Therapies Corp which has since become the first publically traded Finnish biotech company to have listed on NASDAQ.

Dr Jalkanen has published over 130 peer reviewed scientific publications in various highly ranked international journals and has held several board memberships for both public and private companies.

Dr Jalkanen obtained a Masters in Medical Biochemistry from the University of Kuopio and subsequently received a PhD in Medical Biochemistry from the University of Turku. He completed a side-laudatur examination in Molecular Biology from the University of Turku and completed his post-doctoral training at Stanford University, California between 1983 and 1986. Dr Jalkanen obtained the position of docent in Biochemistry from University of Helsinki and the same qualification in Molecular and Cell Biology from the University of Turku. He became a Professor at the University of Turku in 1992 as well as Head of Turku Centre for Biotechnology.

Dr Juho Jalkanen

Non-Executive Director

Dr Jalkanen is currently a consultant in vascular surgery at Turku University Hospital, having previously held positions as Resident in Surgery at the Hospital District of Southwest Finland, General Hospitals of Raisio and Salo and at Turku University Hospital.

For the period of 2009 to 2012 Dr Jalkanen was a board member of Duodecim Medical Association on Southwest Finland and subsequently joined the Board of the Company in 2013.

Dr Jalkanen holds degrees in both business and medicine. He has a Master's degree in Economics and Business Administration from the Turku School of Economics, a Medical Doctor's degree from the University of Turku and subsequently became a fully licensed General Practitioner. At the moment Dr Jalkanen is conducting his PhD on the molecular mechanisms of atherosclerosis. He has published six articles in various publications including the International Journal of Biotechnology and Circulation Research.

Dr Jonathan Knowles

Non-Executive Director

Dr Jonathan Knowles has a career spanning over 40 years in the biotech industry. Dr Knowles held a number of research and teaching positions in the early part of his career before founding the molecular biology group within the Biotechnical Laboratory, Helsinki in 1980.

Dr Jonathan Knowles is currently the Chairman of Adaptimmune Therapeutics PLC (NASDAQ) and Immunocore Ltd and serves on the boards of a number of biotech companies in Europe and the USA. He is a trustee of CRUK and Chairman of the Genomics England Access committee. Jonathan Knowles is a visiting Professor at the University of Oxford, a Research Director at FIMM institute in University of Helsinki (20010-2014 FiDiPro Distinguished Professor), and Professor Emeritus at EPFL, Lausanne. He is a member of EMBO and a member of the Board of A*Star in Singapore.

Dr Knowles was appointed as the President of Global Research at F. Hoffman-La Roche Ltd and subsequently the President of Group Research. He was a member of the Genentech Board for 12 years and a member of the Chugai Board for seven years. He was also the Chairman of the Corporate Governance Committee of Genentech. Under his leadership, the company developed and implemented a strategy of highly effective therapies based on personalised healthcare. Dr Knowles retired from his position at F. Hoffman-La Roche Ltd at the end of 2009. Prior to joining Roche, Dr Knowles was the Head of the Glaxo Institute for Molecular Biology in Geneva and subsequently the Research Director for Glaxo Wellcome Europe.

Dr Knowles was, for 5 years, the Chairman of the Hever Group and the Chairman of the Research Directors' Group of EFPIA (European Federation of Pharmaceutical Industry Associations) and was the first Chairman of the Board of the Innovative Medicines Initiative, a unique public-private partnership between 28 pharmaceutical companies and the European Commission with the participation of over 200 academic institutions in Europe with a budget of more than 5 billion euros over ten years.

Dr Knowles obtained a Bachelor of Science in Biological Sciences from the University of East Anglia, Norwich and subsequently received a PhD in Mitochondrial Genetics from the University of Edinburgh. Dr Knowles was appointed as a Non-Executive Director of the Company in September 2015.

Dr Huaizheng Peng

Non-Executive Director

Dr Peng is a General Manager of China Medical System Holdings, a specialty pharmaceutical company listed on the Hong Kong Stock Exchange. He is in charge of international operations for the Company, including pharmaceutical asset acquisition/product licensing-in/out, international business development, outbound investment and asset management, among others. Dr Peng served as an independent Non-Executive Director of China Medical System Holdings Ltd for three years, and the Company was admitted to trading on AIM (between 2007 and 2010).

Dr Peng was a partner of Northland Bancorp, a private equity firm. Before that, he worked as a head of life sciences and as a director of corporate finance at Seymour Pierce, a London-based investment bank and stockbroker. In addition, he was a Non-Executive Director of China Medstar, an AIM listed medical device company. Earlier in his career Dr Peng was a senior portfolio manager, specialising in global life science and Asian technology investment at Reabourne Technology Investment Management Limited.

Dr Peng received his Bachelor´s degree in medicine from Hunan Medical College (now Central South University Siangya School of Medicine) in Changsha, Hunan Province, China and subsequently he obtained a Master´s degree in medicine from Hunan Medical College. Dr Peng was awarded his PhD in molecular pathology from University College London (UCL) Medical School and subsequently practiced as a clinical lecturer there. Dr Peng was appointed as a Non-Executive Director of the Company in September 2015.

Leopoldo Zambeletti

Non-Executive Director

During a 19-year career as an investment banker, Mr Zambeletti led the European Healthcare Investment team at JP Morgan for eight years before taking up the same position at Credit Suisse for a further five years. Since 2013 he has been an independent strategic advisor to life science companies on merger and acquisitions, out-licencing deals and financing strategy. He is a Non-Executive Director at Advanced Accelerator Applications, Qardio, Summit Therapeutics PLC (NASDAQ and AIM) and Nogra Pharma. Mr Zambeletti started his career at KPMG as an auditor.

Mr Zambeletti received a BA in Business from Bocconi University in Milan, Italy. He serves as a trustee to Barts and the London Charity, which helps to fund the hospitals of the Barts NHS Trust including St Bartholomew, the Royal London and the London Chest Hospitals. He is the founder of the cultural initiative 5×15 Italy. Mr Zambeletti was appointed as a Non-Executive Director of the Company in September 2015.

Yrjö E K Wichmann

Chief Financial Officer

Mr Wichmann has a career spanning over 20 years in financing and investment banking. He was appointed as a Chief Financial Officer of the Company in 2014. Prior to his appointment at the Company, Mr Wichmann held a number of senior positions within the life sciences and biotechnology sector, most recently at IP Finland Oy, Biohit Oyj (NASDAQ OMX Helsinki), Capman Oyj, FibroGen Europe Oyj (NASDAQ) and D. Carnegie & Co AB. Whilst carrying out these roles Mr Wichmann has participated in healthcare IPOs on the London, Stockholm and Helsinki stock exchanges as both an investment banker and as a member of the board.

Mr Wichmann is a member of the Investment Committee at Dasos Timberland Fund I and II and a member of the Innovation Board of Helsinki University, which advises the rector and the board of the university in research commercialisation. The Innovation Board also oversees the venture capital portfolio of Helsinki University Funds valued at approximately €30 million. Mr Wichmann is also a member of the board of Bioretec Oy.

Mr Wichmann obtained a Masters in Economics from Helsinki University. He was appointed as an Executive Director of the Company in 2015.

CORPORATE GOVERNANCE

Directors' Report

For the year ended 31 December 2016.

The Directors present their report together with the audited financial statements for the year ended 31 December 2016

Directors

During the year ended 31 December 2016 following persons have been members of Board of Directors of the Company:

Executive
Dr Markku Jalkanen, PhD, Chief Executive Officer
Mr Yrjö Wichmann, MSc, Chief Financial Officer

Non-Executive
Dr Frank Armstrong, FRCPE, FFPM, Chairman
Mr Matti Manner, LLM, Vice-chairman
Dr Juho Jalkanen, MD, MSc, Non-Executive Director
Dr Jonathan Knowles, PhD, Non-Executive Director
Dr Huaizheng Peng, MD, PhD, Non-Executive Director
Mr Leopoldo Zambeletti, Non-Executive Director

The Directors of the Company held the following beneficial interests in the shares and share options of Faron Pharmaceuticals Ltd on the date of this report:

	Issued Share Capital		Share options	
Executive	**Ordinary shares**	**Percentage held**	**Ordinary shares**	**Avergare exercise price, euro cent**
Markku Jalkanen[1)]	2 873 390	10.9%	160 000	3,31
Juho Jalkanen[2)]	1 082 570	4.1%	40 000	3,31
Matti Manner	484 900	1,8%	40 000	3,31
Yrjö Wichmann	69 440	0.3%	60 000	3,31
Jonathan Knowles	27 712	0.1%	40 000	3,31
Leopold Zambeletti	17 461	0.1%	40 000	3,31
Frank Armstrong[3)]	7 846	0.0%	80 000	3,31
Huaizheng Peng	4 000	0.0%	40 000	3,31
	4 567 319	17,4%	500 000	

[1)] of which, 1,794,890 are held by Markku Jalkanen directly, and 1,078,500 are held by Markku Jalkanen's wife being Sirpa Jalkanen.

[2)] of which, 1,078,500 are held by Juho Jalkanen directly, and 4,070 are held by Juho Jalkanen´s family being Aaro Jalkanen, Enna Jalkanen and Heikki Jalkanen.

[3)] held by Frank Armstrong's company Shore Capital.

For a more detailed description of the remuneration of the Directors, see page Directors´ Remuneration Report.
The Company maintained Directors' and officers' liability insurance cover throughout the year.

Principal risks and uncertainties

For a discussion of the principal risks and uncertainties which face Faron please see page Risks and uncertainties.

Results and dividends

The Consolidated Statement of Comprehensive Income for the year is set out on here.

The Company's loss for the financial year after taxation and other comprehensive losses was € 7.9 million (2015: € 6.2 million).

The Company has no distributable equity and thus the Directors do not recommend the payment of a dividend (2015: nil).

Financial information

The Company produces budgets and cash flow projections on an annual basis for approval by the Board. These are reviewed during the year and updated if needed to reflect any changes in the business. Detailed management accounts are produced on a monthly basis, with all significant variances investigated promptly. The management accounts are reviewed and commented on by the Board at Board meetings and are reviewed and reported to the Directors on a monthly basis by the management team.

Financial Key Performance Indicators ('KPIs')

The For a review of the Group's KPIs please see page Financial Review.

Research and development

Details of Company's key research and development programs can be found in the Strategic Report and the detailed program sections. Further information is also available on the Company website, www.faronpharmaceuticals.com.

Post balance sheet events

- On February 9th Faron announced that it had received a third Independent Date Monitoring Committee recommendation to continue the INTEREST trial as planned.
- On 20 February 2017, Faron announced a first patient recruited in the Traumakine INFORAAA trial.
- On 28 February 2017, Faron announced a proposed placing of up to 1,422,340 new ordinary shares in the capital of the Company at a price of 350 pence per share (the "Issue Price") to raise, in aggregate, up to approximately €5.8 million before expenses.
- On 1 March 2017, Faron announced that it had issued and placed 1,422,340 new ordinary shares at the Issue Price of 350 pence per share raising approximately €5.8 million new capital before expenses.

Financial instruments and management of liquid resources

The Company's principal financial instrument comprises cash, and this is used to finance Company's operations. The Company has also other financial instruments
such as leasing facilities that arise directly from its operations. The Company has a policy, which has been consistently followed, of not trading in financial instruments and to minimize currency exposure by actively matching currency expenses and income to the extent possible. The Company's cash is held on bank accounts in reputable bank in Finland. The Group's treasury policy is reviewed annually. See Note 1.16 'Financial instruments' and Note 2, Principles of financial risk management in the Notes to the Financial Statements for IFRS disclosure regarding financial instruments.

Substantial shareholdings

On 31 December 2016 the Company had been notified of the following holdings of more than 3 % or more of the issued share capital of the Company.

Name	Number of shares	%
A&B (HK) Company Limited	3,408,409	12.95
Marko Salmi	3,389,570	12.88
Tom-Erik Lind	2,552,523	9.70
Aviva Investors	1,983,321	7.54
Markku Jalkanen	1,794,890	6.82
Legal & General Investment Management	1,365,000	5.19
Juho Jalkanen*	1,082,570	4.11
Sirpa Jalkanen	1,078,500	4.10
Maija-Leena Hollmén**	1,078,500	4.10
Katriina Peltola***	1,078,500	4.10
City Financial	1,000,000	3.80
Timo Syrjälä****	936,076	3.56

* Held by Juho Jalkanen and connected parties.
** Held by Maija-Leena Hollmén and connected parties.
*** Held by Katriina Peltola and connected parties.
**** of which, 520,830 are held directly by Timo Syrjälä and 415,246 are held by Acme Investments SPF S.à.r.l., an entity which is wholly owned by Timo Syrjälä.

Annual General Meeting

The AGM will be held in 16 May 2017 and further details will be provided to shareholders in advance of the meeting.

Independent auditors

PricewaterhouseCoopers have expressed their willingness to continue in office as auditors for the year. A resolution to reappoint them will be proposed at the forthcoming AGM.

Disclosure and information to auditors

Each of the current Directors hereby confirms that:

(a) So far as he or she is aware, there is no relevant audit information of which the auditors are unaware; and

(b) He or she has taken all reasonable steps to ascertain any relevant audit information and to ensure that the auditors are aware of such information

On behalf of the Board
Frank M Armstrong
Chairman
28 March 2017

CORPORATE GOVERNANCE

Corporate Governance Report

The Board

At 31 December 2016, the Board comprised six Non-Executive Directors, and two Executive Directors.

The composition of the board of directors as well as Directors' biographies are described on pagesBoard of Directors.

The Board is responsible to the shareholders for the proper management of the Company and meets regularly to set the overall direction and strategy of the Company, to review scientific, operational and financial performance, and to advise on management appointments. The Board has also convened by telephone conference during the year to review the strategy and activities of the business.

All key operational and investment decisions are subject to Board approval.

The roles of Chief Executive Officer and Non-Executive Chairman are well defined and clearly separated. The Chairman oversees the Board´s work, ensures that the Board's decision-making is balanced and that the Non-Executive Directors have all relevant information on matters to be decided. The Chief Executive Officer is responsible for implementing the strategy of the Board and managing the day-to-day business activities of the Company. The management of the Company prepares a monthly management and financial accounts pack, which is distributed to the Board every month and in advance of Board meetings.

The Board considers there to be sufficient independence on the Board and that all the Non-Executive Directors are of sufficient competence and calibre to add strength and objectivity to the Board, and to bring considerable experience in terms of their knowledge of the scientific, operational and financial development of biopharmaceutical products and companies. Where necessary, the Company facilitates that Non-Executive Directors obtain specialist external advice from appropriate advisers. The term of office of each Director expires on the closing of the AGM immediately following his/her appointment to the Board. Under the Finnish Companies Act and the Articles, the Directors are elected by the Shareholders at General Meetings annually. Under the Finnish Companies Act, Directors may be removed from office at any time, with or without cause, by a majority of votes cast at a General Meeting. Vacancies on the Board may only be filled by a majority of Shareholder votes cast at a General Meeting.

Performance Evaluation

The Board has a process for evaluation of its own performance, that of its committees and individual Directors, including the Chairman. These evaluations are carried out at least annually.

Board Committees

In conjunction with the being admitted to trading on AIM, the Company has established audit, nomination and remuneration committees of the Board with formally delegated duties and responsibilities.

Remuneration Committee

The Remuneration Committee comprises Frank Armstrong as Chairman together with Huaizheng Peng and Leopoldo Zambeletti. The committee is responsible for the review and recommendation of the scale and structure of remuneration for senior management, including any bonus arrangements or the award of share options with due regard to the interests of the Shareholders and the performance of the Company. The Remuneration Committee held four meetings during 2016.

Audit Committee

The Audit Committee, which comprises Leopoldo Zambeletti as Chairman together with Frank Armstrong and Huaizheng Peng, meets not less than twice a year. The committee is responsible for making recommendations to the New Board on the appointment of auditors and the audit fee and for ensuring that the financial performance of the Company is properly monitored and reported. In addition, the Audit Committee will receive and review reports from management and the auditors relating to the interim report, the annual report and accounts and the internal control systems of the Company. The audit committee held one meeting during 2016.

Nomination Committee

The Nomination Committee comprises of Matti Manner as Chairman together with Frank Armstrong and Jonathan Knowles. The Nomination Committee monitors the size and composition of the Board and the other Board committees and is responsible for identifying suitable candidates for Board membership. The nomination committee held one meeting during 2016.

Risk management and Internal control

The Board is responsible for the systems of internal control and for reviewing their effectiveness. The internal controls are designed to manage rather than eliminate risk and provide reasonable but not absolute assurance against material misstatement or loss. The Board reviews the effectiveness of these systems annually by considering the risks potentially affecting the Company. The Company does not consider it necessary to have an internal audit function due to the small size of the administrative function. Instead there is a monthly review and authorisation of transactions by the Chief Financial Officer and Chief Executive Officer. A comprehensive budgeting process is completed once a year and is reviewed and approved by the Board. The Company's results, compared with the budget, are reported to the Board on a monthly basis and discussed in detail.

The Company maintains appropriate insurance cover in respect of actions taken against the Directors because of their roles, as well as against material loss or claims against the Company. The insured values and type of cover are comprehensively reviewed on a periodic basis.

Corporate Social Responsibility

The Company is committed to maintaining and promoting high standards of business integrity. Company values, which incorporate the principles of Corporate Social Responsibilities (CSR) and sustainability, guide the Company's relationships with clients, employees and the communities and environment in which we operate. The Company's approach to sustainability addresses both our environmental and social impacts, supporting the Company's vision to remain an employer of choice, while meeting client demands for socially responsible partners.

The Company respects laws and customs while supporting international laws and regulations.

Relations with Shareholders

The Board recognises the importance of communication with its shareholders to ensure that its strategy and performance is understood and that its remains accountable to shareholders. Our website, www.faronpharmaceuticals.com, has a section dedicated to investor matters and provides useful information for the Company's owners.

Attendance at Board meetings

During 2016 the Board held 10 meetings. The table below lists the Directors attendance to the Board meetings during the year:

Faron Board	Attendance to meetings
Executive Directors	
Markku Jalkanen	10/10
Yrjö E K Wichmann	10/10
Non-Executive Directors	
Frank M Armstrong	10/10
Matti Manner	10/10
Juho Jalkanen	9/10
Jonathan Knowles	8/10
Huaizheng Peng	10/10
Leopoldo Zambeletti	8/10

Compliance with the Principles of the QCA Code

The Principles of the QCA Code	Comply/ Explain	Reference
1. Setting out the vision and strategy	Comply	Strategic Report
2. Managing and communicating risk and implementing internal control	Comply	CGR (Risk Management and Internal Control), Risks and Uncertainties
3. Articulating strategy through corporate communication and investor relations	Comply	CGR (Relations with Shareholders)
4. Meeting the needs and objectives of Shareholders	Comply	CGR (Relations with Shareholders)
5. Meeting stakeholders and social responsibilities	Comply	GCR (Corporate Social Responsibility)
6. Using cost-effective and value-added arrangements	Comply	Strategic Report
7. Developing structures and processes	Comply	Strategic Report
8. Being responsible and accountable	Comply	CGR (The Board)
9. Having balance on the Board	Comply	CGR (The Board)
10. Having appropriate skills and capabilities on the Board	Comply	CGR (The Board)
11. Evaluating Board performance and development	Comply	CGR (Performance evaluation)
12. Providing information and support	Comply	CGR (The Board)

CGR = Corporate Governance Report

CORPORATE GOVERNANCE

Directors' Remuneration Report

Audited Information
Remuneration policy for Executive Directors

The Remuneration Committee sets the remuneration policy that aims to align Executive Director remuneration with shareholders' interests and attract and retain the best talent for the benefit of the Company.

The remuneration of the Executive Directors during the year ended 31 December 2016 is set out below:

For the year ended 31 December 2016

This report sets out Faron´s remuneration policy for the Executive and Non-Executive Directors. No Director is involved in discussions relating to their own remuneration.

Basic salary

Basic salaries are reviewed annually. The review process is managed by the Remuneration Committee with reference to market salary data, the Executive Director's performance and contribution to the Company during the year.

Bonuses

Annual bonuses are based on the achievement of Company strategic and financial targets and personal performance objectives. The Non-Executive Directors believe that bonuses are an incentive to achieve the targets and objectives, and represent an important element of the total compensation of the Executive Directors; they have established that the annual bonus potential will be 40% for the Executive Directors. On 15 February 2017 the Chief Executive Officer was awarded a bonus representing 40% and the Chief Financial Officer was awarded a bonus representing 35% of their 2016 gross basic salaries.

Longer Term Incentives

In order to further incentivise the Executive Directors and employees, and align their interests with Shareholders, the Extraordinary General Meeting of the Company approved a share option plan and granted share options to the members of the board under this option plan. Details of the option plan are in the table below.

Pension

Faron has a law-defined contribution plan under which it pays fixed contributions into a separate entity. The plan covers all the employees of Faron including the Executive Directors. Faron has no legal or constructive obligations to pay further contributions if the fund does not hold sufficient assets to pay all employees the benefits relating to employee service in the current and prior periods.

Other benefits

Some employees have the possibility to take a company car allowance, which is part of their gross salary. All employees have a company mobile phone that constitutes a company mobile phone allowance.

Executive Directors' service contracts and termination provisions

The service contracts of Executive Directors are approved by the Board and are one-year rolling contracts. The service contract may be terminated by either party giving six months' notice to the other.

The details of the Executive Directors' contracts are summarised below:

		Date of contract	Notice period
Markku Jalkanen	CEO	16.09.2015	6 months[1]
Yrjö E K Wichmann	CFO	16.09.2015	6 months[1]

[1]The 6 months notice period starts after a fixed 12 months period from Admission, i.e. from 18 November 2016.

Non-Executive Directors' service contracts and remuneration

The remuneration and compensation payable to the members of the Board including the Non-Executive Directors shall be approved by the Shareholders at the AGM. Any Non-Executive Director who, by request, goes or resides abroad for any purposes of the Company or who performs services which in the opinion of the Board goes beyond the ordinary duties of a Director may be paid extra remuneration or may receive such other benefits as the remuneration committee may approve. Non-Executive Directors are entitled to be reimbursed in respect of their reasonably and properly incurred travelling, accommodation and incidental expenses for attending and returning from meetings of the Board, committee meetings or the general meetings of Shareholders.

The Non-Executive Directors do not receive any pension, bonus or benefits from the Company. The contracts of the Non-Executive Directors, excluding remuneration and compensation, are reviewed by the Board annually.

Current contracts are summarised below:

Non-Executive Directors' Contracts	Contract	Date of Contract
Frank M Armstrong	Chairman	16.09.2015
Matti Manner	Vice-chairman	16.09.2015
Juho Jalkanen	member	16.09.2015
Jonathan Knowles	member	16.09.2015
Huaizheng Peng	member	16.09.2015
Leopoldo Zambeletti	member	16.09.2015

The appointments of Non-Executive Directors are terminable with immediate effect in accordance with the Articles of Association and pursuant to the Finnish Companies Act, through a resolution of Shareholders at a General Meeting on any grounds. The Non-Executive Directors may resign as a director by delivering three months' notice to the Registered Office of the Company or through tendering such resignation at a meeting of the Board, after a fixed 6 month's period from Admission.

Audited Information
Directors' remuneration

The Directors received the following remuneration during the year:

	Salaries and fees	Bonus 2016	Taxable benefits	Total
Executive				
Markku Jalkanen	188 244,00	80 000,00	12 720,00	280 964,00
Yrjö E K Wichmann	148 800,00	52 340,00	744,00	201 884,00
Non-Executive				
Frank M Armstrong	73 000,00	-	-	73 000,00
Matti Manner	40 000,00	-	-	40 000,00
Juho Jalkanen	35 000,00	-	-	35 000,00
Jonathan Knowles	35 000,00	-	-	35 000,00
Huaizheng Peng	35 000,00	-	-	35 000,00
Leopoldo Zambeletti	40 000,00	-	-	40 000,00
	595 044,00	132 340,00	13 464,00	740 848,00

Directors' share options

Aggregate remunerations disclosed above do not include any amounts for the value of options to acquire Ordinary Shares in the Company granted to or held by the Directors.

A share option plan was adopted by the Company at the Extraordinary General Meeting held on 15 September 2015. The option plan allows the Company to offer options for subscription free of charge to members of the Board, and to such officers and employees of the Company as the Board sees fit. Each option will entitle the holder of the option to subscribe for one Ordinary Share.

Under the terms of the option plan, an aggregate maximum number of 1,600,000 options may be granted, such aggregate being made up of a maximum of 400,000 "A" options, the subscription period for which ended on 9 May 2016 (such options exercisable between 9 May 2016 and 30 September 2021), a maximum of 400,000 "B" options to be subscribed for between 8 October 2016 and 30 September 2019 (exercisable between 8 October 2016 and 30 September 2021), a maximum of 400,000 "C" options to be subscribed for between 8 October 2017 and 30 September 2019 (exercisable between 8 October 2017 and 30 September 2021), and a maximum of 400,000 "D" options to be subscribed for between 8 October 2018 and 30 September 2019 (exercisable between 8 October 2018 and 30 September 2021).

The exercise price for Ordinary Shares based on "A" options shall be €3.71. The exercise price for Ordinary Shares based on "B" options shall be €2.90. The exercise price for Ordinary Shares based on "C" and "D" options shall be determined by the Euro equivalent to the average share price of the publicly traded Ordinary Shares of the Company on AIM between 1 July and 30 September of 2017 and 2018 respectively.

The exercise price will be disclosed in Euros based on the exchange reference rate published by the European Central Bank on the last day of the period for determination of the subscription price, and rounded to the nearest Euro cent.

Details of these options are as follows:

2015A Options	Date of grant of A options [1)]	At 1 Jan 2016	Granted during the period	Cancelled during the period	At 31 Dec 2016	Subscription Price per share, €	Date from which exercisable	Expiry date of A options
Markku Jalkanen	16.09.2015	80 000		0	80 000	3,71	02.11.2015	30.09.2021
Yrjö E K Wichmann	16.09.2015	30 000		0	30 000	3,71	02.11.2015	30.09.2021
Frank M Armstrong	16.09.2015	40 000		0	40 000	3,71	02.11.2015	30.09.2021
Matti Manner	16.09.2015	20 000		0	20 000	3,71	02.11.2015	30.09.2021
Juho Jalkanen	16.09.2015	20 000		0	20 000	3,71	02.11.2015	30.09.2021
Jonathan Knowles	16.09.2015	20 000		0	20 000	3,71	02.11.2015	30.09.2021
Huaizheng Peng	16.09.2015	20 000		0	20 000	3,71	02.11.2015	30.09.2021
Leopoldo Zambeletti	16.09.2015	20 000		0	20 000	3,71	02.11.2015	30.09.2021
		250 000			250 000			

2015B Options	Date of subscription of B options[1)]	At 1 Jan 2016	Granted during the period	Cancelled during the period	At 31 Dec 2016	Subscription Price per share, €	Date from which exercisable	Expiry date of A options
Markku Jalkanen	18.11.2016	0	80 000	0	80 000	2,90	02.11.2015	30.09.2021
Yrjö E K Wichmann	18.11.2016	0	30 000	0	30 000	2,90	02.11.2015	30.09.2021
Frank M Armstrong	18.11.2016	0	40 000	0	40 000	2,90	02.11.2015	30.09.2021
Matti Manner	18.11.2016	0	20 000	0	20 000	2,90	02.11.2015	30.09.2021
Juho Jalkanen	18.11.2016	0	20 000	0	20 000	2,90	02.11.2015	30.09.2021
Jonathan Knowles	18.11.2016	0	20 000	0	20 000	2,90	02.11.2015	30.09.2021
Huaizheng Peng	18.11.2016	0	20 000	0	20 000	2,90	02.11.2015	30.09.2021
Leopoldo Zambeletti	18.11.2016	0	20 000	0	20 000	2,90	02.11.2015	30.09.2021
			250 000		250 000			

[1)] Additionally, the Directors have the right to subscribe equal amounts of “C” and “D” Options (conditional on them continuing to remain in their respective Director roles at the time of commencement of the relevant subscription period).

Total Options	At 1 January 2016	Granted during the period	Cancelled during the period	At 31 December 2016	Average subs.price per shares, €
Markku Jalkanen	80 000	80 000	0	160 000	3,31
Yrjö E K Wichmann	30 000	30 000	0	60 000	3,31
Frank M Armstrong	40 000	40 000	0	80 000	3,31
Matti Manner	20 000	20 000	0	40 000	3,31
Juho Jalkanen	20 000	20 000	0	40 000	3,31
Jonathan Knowles	20 000	20 000	0	40 000	3,31
Huaizheng Peng	20 000	20 000	0	40 000	3,31
Leopoldo Zambeletti	20 000	20 000	0	40 000	3,31
	250 000	250 000		500 000	

Directors' shareholdings

The Directors who served during the period, together with their beneficial interests in the shares of the Company, are as follows:

	Issued Share Capital		Share options	
Executive	Ordinary shares	Percentage held	Ordinary shares	Avergare exercise price, euro cent
Markku Jalkanen[1)]	2 873 390	10.9%	160 000	3,31
Juho Jalkanen[2)]	1 082 570	4.1%	40 000	3,31
Matti Manner	484 900	1,8%	40 000	3,31
Yrjö Wichmann	69 440	0.3%	60 000	3,31
Jonathan Knowles	27 712	0.1%	40 000	3,31
Leopold Zambeletti	17 461	0.1%	40 000	3,31
Frank Armstrong[3)]	7 846	0.0%	80 000	3,31
Huaizheng Peng	4 000	0.0%	40 000	3,31
	4 567 319	17,4%	500 000	

[1)] of which, 1,794,890 are held by Markku Jalkanen directly, and 1,078,500 are held by Markku Jalkanen's wife being Sirpa Jalkanen.
[2)] of which, 1,078,500 are held by Juho Jalkanen directly, and 4,070 are held by Juho's Jalkanens' family being Aaro Jalkanen, Enna Jalkanen and Heikki Jalkanen.
[3)] held by Frank Armstrongs' company Shore Capital.

CORPORATE GOVERNANCE

Statement of Responsibilities

Under the Finnish Companies Act and the Finnish Accounting Act the Company must prepare an Annual Report and financial statements in accordance with applicable law and regulations.

The Board of Directors and the Managing Director are responsible for the preparation of financial statements that give a true and fair view in accordance with International Financial Reporting Standards (IFRS) as adopted by the EU, as well as for the preparation of financial statements and the report of the Board of Directors that give a true and fair view in accordance with the laws and regulations governing the preparation of the financial statements and the report of the Board of Directors in Finland. The Board of Directors is responsible for the appropriate arrangement of the control of the company's accounts and finances, and the Managing Director shall see to it that the accounts of the company are in compliance with the law and that its financial affairs have been arranged in a reliable manner.

In accordance with the rules of the London Stock Exchange for companies trading securities on the Alternative Investment Market, the Company is also required to prepare annual accounts and financial statements under IFRS.

In preparing these financial statements, the Board of Directors is required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and accounting estimates that are reasonable and prudent;
- state whether they have been prepared in accordance with IFRSs as adopted by the European Union, subject to any material departures disclosed and explained in the financial statements;
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the company will continue in business.

The Board of Directors and the Managing Director are responsible for keeping adequate accounting records that are sufficient to show and explain the company's transactions and disclose with reasonable accuracy at any time the financial position of the company and enable them to ensure that the financial statements comply with the requirements of the Finnish Accounting Act. They are also responsible for safeguarding the assets of the company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

Website publication

The Directors are responsible for ensuring that the annual report and the financial statements are made available on a website. Financial statements are published on the company's website in accordance with the AIM rule 26 and the recommendations of the QCA´s Corporate Governance Code for Small and Medium Sized Companies.

On behalf of the Board
Frank Armstrong
Chairman
28 March 2017

FINANCIAL STATEMENTS

Statement of Comprehensive Income

Stated in euro	Note	Year ended 31 Dec 2016 €'000	Year ended 31 Dec 2015 €'000
Revenue	3; 4	1 153	520
Cost of sales			(25)
Gross profit		1 153	496
Other operating income	5	1 742	701
Administrative expenses	6; 7	(2 161)	(3 061)
Research and development expenses	6; 7	(9 592)	(3 971)
Operating result		(8 858)	(5 835)
Financial income	2; 8	0	0
Financial expenses	2; 8	(361)	(311)
Net financial costs		(361)	(311)
Loss before income taxes		(9 219)	(6 146)
Income tax expense	9	(75)	(42)
Total comprehensive income for the financial year		**(9 294)**	**(6 188)**
Total comprehensive income, attributable to:			
Equity holders of the Company		(9 294)	(6 188)
Loss per share attributable to equity holders of the Company	**10**		
Basic and diluted loss per share, euro		(0,39)	(0,30)

FINANCIAL STATEMENTS

Balance Sheet

Stated in euro	Note	Year ended 31 Dec 2016 €'000	Year ended 31 Dec 2015 €'000
Assets			
Non-current assets			
Property, plant and equipment	11	21	28
Intangible assets	11	933	1 001
		954	**1 029**
Current assets			
Inventories	12	1 451	649
Trade and other receivables	13	3 404	2 074
Cash and cash equivalents	14	11 478	11 068
		16 333	**13 791**
Total assets		**17 287**	**14 821**
Equity and liabilities			
Capital and reserves attributable to equity holders of the Company			
Share capital		2 691	2 691
Unregistered share capital			
Reserve for invested non-restricted equity		34 006	24 533
Retained earnings		(25 814)	(16 046)
Total equity	**15; 16**	**10 884**	**11 178**
Non-current liabilities			
Interest-bearing financial liabilities	17	2 033	1 446
		2 033	**1 446**
Current liabilities			
Interest-bearing financial liabilities	18	93	245
Non-interest-bearing financial liabilities	18	1 874	436
Other current liabilities	18	2 403	1 517
		4 371	**2 197**
Total liabilities		**6 404**	**3 643**
Total equity and liabilities		**17 287**	**14 821**

FINANCIAL STATEMENTS

Statement of Cash Flows

Stated in euro	Year ended 31 Dec 2016 €'000	Year ended 31 Dec 2015 €'000
Cash flow from operating activities		
Loss(-) / profit(+) attributable to equity holders of the Company	(9 294)	(6 188)
Adjustments for		
Depreciation and amortisation	168	184
Financial items	361	298
Income taxes	75	42
Expensed R&D		78
Non-cash items (options granted)	480	474
Change in net working capital:		
Trade and other receivables	(1 330)	(2 035)
Inventories	(802)	50
Trade and other current liabilities	2 325	278
Interest and other financial costs paid	(361)	(285)
Interest and other financial income received	0	0
Income taxes paid	(75)	(42)
Net cash used in / from operating activities (A)	**(8 452)**	**(7 146)**
Cash flow from investment activities		
Investments in machinery and equipment and intangible assets	(92)	(107)
Net cash from/used in investing activities (B)	**(92)**	**(107)**
Cash flow from financing activities		
Proceeds from issue of share capital/issue, net	8 519	18 080
Proceeds from issue of convertible notes		
Proceeds from current borrowings	(151)	
Proceeds from non-current borrowings	587	
Net cash used in financing activities (C)	**8 955**	**18 080**
Net increase(+) / decrease (-) in cash and cash equivalents (A+B+C)	**410**	**10 827**
Cash and cash equivalents at 1 January	11 068	242
Cash and cash equivalents at 31 December	**11 478**	**11 068**

FINANCIAL STATEMENTS

Statement of Changes in Equity

Stated in euro	Share capital €'000	Un-registered share capital €'000	Reserve for invested non-restricted equity €'000	Retained earnings €'000	Total equity €'000
Balance at 31 December 2014	**2 691**		**6 453**	**(10 332)**	**(1 188)**
Total comprehensive income for the financial year 2015				(6 188)	(6 188)
Transactions with equity holders of the Company					
Share base payment				474	474
Increase of share capital			19 261		19 261
Transaction costs on share capital issued			(1 181)		(1 181)
Conversion of convertible notes					
			18 080	(5 714)	12 366
Balance at 31 December 2015	2 691		**24 533**	**(16 046)**	**11 178**
Total comprehensive income for the financial year 2016				(9 294)	(9 294)
Transactions with equity holders of the Company					
Share base payment				480	480
Increase of share capital			9 330		9 330
Transaction costs on share capital issued			(811)		(811)
Conversion of convertible notes					
			8 519	(8 814)	(295)
Balance at 31 December 2016	**2 691**		**33 052**	**(24 860)**	**10 884**

For further information on equity transactions see Note 15. Equity and reserves.

FINANCIAL STATEMENTS

Notes

NOTE 1
1. Summary of significant accounting policies

1.1 Corporate information

Faron Pharmaceuticals Ltd. (hereafter "Faron" or "Company") is a Finnish limited liability company organized under the laws of Finland and domiciled in Turku, Finland. The Company's registered address is Joukahaisenkatu 6 B, 20520 Turku, Finland.

The former parent company of Faron Pharmaceuticals Ltd., Faron Holding Ltd., merged into Faron Pharmaceuticals Ltd. as at 31 December 2013. Faron has no interests in other entities. The shares of Faron Pharmaceuticals Ltd. are held by multiple shareholders.

Faron Pharmaceuticals Ltd. is a privately owned clinical stage drug discovery and development company. Currently Faron has three major drug development projects focusing on:

- acute trauma
- inflammatory diseases; and
- cancer growth and spread.

Faron's lead product FP-1201, also known as Traumakine, which passed successfully a phase I/II trial in the UK to treat vascular leakage in ARDS[1] patients, moved to a pan-European pivotal phase III study (INTEREST –study) during 2015. INTEREST recruited its first patient in late December 2015. Faron has been granted an orphan drug status for the treatment of ARDS with interferon-beta by the EU Commission and European Medicines Agency (EMA) under the registration number EU/3/07/505. Faron has also been granted several patents both in USA, Europe and Japan, and has several pending applications in other territories for the use of interferon-beta to treat various ischemic conditions.

Faron's second product FP-1305, also known as Clevegen, is in pre-clinical stage and will be taken into clinical trials aiming to prove its safety and efficacy in reduction of tumour immunosuppression and macrophage activation. Also for Clevegen Faron has been granted several patents both in USA, Europe and Japan, and has several pending applications in other territories for the molecule, the antibody as well as other key characteristics related to their use and efficacy.

In its meeting on 28 March 2017 the Board of Directors of Faron Pharmaceuticals Ltd. approved the publishing of these financial statements. According to the Finnish Limited Liability Companies' Act, shareholders have the right to approve or reject the financial statements in the Annual General Meeting held after the publication of the financial statements.

The principal accounting policies applied in the preparation of these financial statements are set out below.

1.2 Basis of preparation

These are Faron's third full year financial statements prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union (and as published by the International Accounting Standards Board (IASB) and in force as at 31 December 2016. In the EU IFRS are standards and their interpretations adopted in accordance with the procedure laid down in regulation (EC) No 1606/2002 of the European Parliament and of the Council. Faron has consistently applied these policies to all the years presented, unless otherwise stated. The Company has not applied any standard, interpretation or amendment thereto before its effective date.

Faron's date of transition to IFRS is 1 January 2012. The Company has applied IFRS 1 *First-time Adoption of International Financial Reporting Standards* in preparing these financial statements. Until 31 December 2011 Faron's separate financial statements have been prepared in accordance with Finnish Accounting Standards (FAS).

The financial statements are prepared under the historical cost convention, except as disclosed in the accounting policies below.

The financial year of Faron is the calendar year ending 31 December. The figures in the financial statements are presented in thousands of euro unless otherwise stated. All figures presented have been rounded, and consequently the sum of individual figures may deviate from the presented aggregate figure.

The Company has not had any other comprehensive income in those years presented in these financial statements.

Faron's financial statements are prepared on a going concern basis. It is the intention of the Company to continue the development of the products to the point where they can be either licensed at attractive terms to internationally active pharmaceutical companies who have the means to further develop these products, or to develop the products in-house

until receipt of marketing approval from the relevant regulatory agencies. After such approval, Faron would either seek to form partnerships with global, regional or local pharmaceutical companies that have the necessary marketing and distribution capabilities and resources or take the approved product to the markets itself. In the case of partnership, Faron would typically grant geographically limited licenses to products in exchange for contractually agreed payments, license fees and royalties on future product sales. In some cases, one element of such agreements may include a collaboration in which Faron will also receive funding for R&D services provided at a cost plus basis. In case of choosing to market the product itself, Faron would need to secure necessary funding to cover the costs of taking the product through the approval, pricing and regional registering process in addition to required marketing costs. In absence of collaboration agreement such funding would mainly come in form of equity funding.

In addition to its normal R&D and corporate activities, Faron seeks, as a clinical stage drug discovery and development company, to advance the development of its lead compounds through clinical trials. The Company conducts these either together with development partners or by itself. In both cases these activities require substantial amounts of funds. Faron primarily relies upon financing its activities through equity financing, license agreements, and public R&D loans and grants.

The preparation of financial statements under IFRS requires management to make judgments, estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosure of contingent assets and liabilities at the end of the reporting period as well as the reported amounts of income and expenses during the reporting period. These estimates and assumptions are based on historical experience and other justified assumptions that are believed to be reasonable under the circumstances at the end of the reporting period and the time when they were made. Although these estimates are based on management's best knowledge of current events and actions, actual results may ultimately differ from those estimates. The estimates and underlying assumptions are reviewed on an on-going basis and when preparing financial statements. Changes in accounting estimates may be necessary if there are changes in the circumstances on which the estimate was based, or as a result of new information or more experience. Such changes are recognised in the period in which the estimate is revised. The key assumptions about the future and key sources of estimation uncertainty that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next 12 months are described in more detail in chapter 1.20.

1.3 Foreign currency transactions and balances

The Company's presentation and functional currency is euro. Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the dates of the transactions or valuation where items are re-measured. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at period-end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the income statement within financial items.

1.4 Revenue recognition

Pharmaceutical companies collect revenues in many ways depending on the stage of the drug development process. The Company's main sources of revenue have been upfront payments (one-off license payments), revenues from product sales and milestone payments. Revenue is recognised when the amount of revenue can be measured reliably; when it is probable that the future economic benefits will flow to the company; and when specific criteria have been met for each of the group's activities as described below.

1.4.1 Revenue from sales of goods

Revenue from the sale of goods is recognised when the significant risks, rewards and actual control usually associated with ownership of the goods have been transferred to the buyer. From 2013 to 2016 Faron has generated revenues from sales of interferon-beta.

1.4.2 Recognition of revenue from upfront payments

Upfront license fees, including signing fees, are usually received when a license is granted. They are deferred and recognised as revenue over the relevant contract period on a basis that is consistent with the services delivered over the relevant contract period.

1.4.3 Recognition of revenue from milestone payments

Revenue associated with performance milestones is recognised based on achievement of the deliverables as defined in the respective agreements. Refundable milestone payments are recorded as deferred income and recognized as revenue at the point of time when the underlying performance obligations have been fulfilled. Non-refundable milestone payments are recognised as revenue when:

- customer has verifiably accepted that the milestone has been reached
- Faron has no further performance obligations related to the milestone in question; and
- there is a reasonable assurance that these receivables can and will be collected.

1.5 Other operating income

Other operating income includes income from activities outside the ordinary business of Faron, such as recognition government grants, service charge income and gains from disposals of non-current assets.

1.6 Research and development costs

All costs related to research activities are presented under the caption research and development expenses in the income statement. Research and development expenses include salaries and other expenditure directly attributable to Faron's research and development activities. Furthermore, costs attributable to supporting the research and development activities, such as rental expenses for facilities, are included. Research and development expenses are directly related to the development phases of Faron's projects and may therefore fluctuate strongly from year to year.

No internal development expenses related to Company's unapproved product candidates have yet been capitalized as management considers that the uncertainties inherent in developing pharmaceutical products prohibits the capitalization of internal development expense as an intangible asset until marketing approval has been received from the relevant regulatory agencies.

Costs incurred on internal development projects are recognised as intangible assets as of the date that the internal development project meets the criteria for recognition. See 1.12.2 Intangible assets.

1.7 Employee benefits

Faron's employee benefits currently consist of short-term employee benefits and post-employment benefits (defined contribution pension plans).

Short-term employee benefits, i.e. salaries, social security contributions, paid annual leave and sick leave, bonuses and non-monetary benefits, are accrued in the year in which the related service is provided. A liability is recognised for the amount expected to be paid if Faron has a present legal or constructive obligation to pay this amount as a result of past service provided by the employee and the obligation can be estimated reliably.

A defined contribution plan is a pension plan under which Faron pays fixed contributions into a separate external entity. Faron has no legal or constructive obligations to pay further contributions if the fund does not hold sufficient assets to pay all employees the benefits relating to employee service in the current and prior periods. The contributions are recognised as employee benefit expense when they are due. Prepaid contributions are recognised as an asset to the extent that a cash refund or a reduction in the future payments is available.

1.8 Share based payments

Share-based incentive programs under which board members and employees have the option to purchase shares in the Company (equity-settled share-based payment arrangements) are measured at the equity instrument's fair value at the grant date.

The cost of equity-settled transactions is determined by the fair value at the date of grant using the Black-Scholes valuation model. The cost is recognized together with a corresponding increase in equity over the period in which the performance and service conditions are fulfilled, the vesting period. The fair value determined at the grant date of the equity-settled share-based payment is expensed on a straight line basis.

No expense is recognized for grants that do not ultimately vest. The assumptions and best estimates for calculating the fair value of share-based payment transactions are disclosed in the notes.

1.9 Operating result

IFRS allow the use of additional line items and subtotals in the income statement. Faron has defined operating result to be a relevant subtotal in understanding the Company's financial performance. In Faron, operating result is the net sum, which is formed by adding other operating income to revenue and then deducting research and development expenses as well as administrative expenses. All other items of the income statement are presented below the operating result.

1.10 (Loss) per share

Basic loss per share is calculated by dividing the net loss attributable to shareholders by the weighted average number of ordinary shares in issue during the year, excluding ordinary shares purchased by the Company and held as treasury shares, if any.

Diluted loss per share is calculated by adjusting the weighted average number of ordinary shares outstanding assuming conversion of all dilutive potential ordinary shares.

1.11 Income taxes

The income tax expense for the period consists of current and deferred taxes. Tax is recognised in the income statement, except for the income tax effects of items recognised in other comprehensive income or directly in equity, which is similarly recognised in other comprehensive income or equity. The current income tax charge is calculated on the basis of the tax rates and laws enacted or substantively enacted in the countries where Faron operates and generates taxable income. Management establishes provisions where appropriate on the basis of amounts expected to be paid to the tax authorities. Deferred tax is provided using the liability method on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the financial statements. However, deferred tax is not accounted for if it arises from initial recognition of an asset or liability in a transaction other than a business combination that at the time of the transaction affects neither accounting nor taxable profit nor loss. Faron's major temporary differences arise from tax losses carried forward and research expenditure incurred not yet deducted for tax purposes.

Deferred tax liability tax is generally provided for in full. Deferred tax assets are recorded up to the amount that represents probable taxable income received in the future and against which temporary differences can be utilized. The amount and probability of the utilization of deferred tax assets are reviewed at the end of each reporting period.

Deferred taxes are determined using tax rates (and laws) enacted or substantively enacted by the balance sheet date in the respective countries and are expected to apply when the related deferred tax asset is realized or the deferred tax liability is settled.

1.12 Equipment and intangible assets

1.12.1 Equipment

Currently Faron does not own any land or buildings. Equipment that Faron owns comprises mainly office equipment and personal computers. Equipment is stated at historical cost less depreciation and any impairment losses. Historical cost includes expenditure that is directly attributable to the acquisition of the items. Repairs and maintenance costs are expensed as incurred.

Depreciation is calculated using the straight-line method to allocate each item's cost to its residual value over its estimated useful life.

The depreciation expense is included in the costs of the functions using the asset.

1.12.2 Intangible assets

Faron's intangible assets include patents and internally developed intellectual property ("documentation-related assets"). An intangible asset is recognised only if it is probable that the future economic benefits attributable to the asset will flow to Faron and the cost of the asset can be measured reliably. All other expenditure is expensed as incurred. These intangible assets are initially recognised at cost. Cost comprises the purchase price and all costs directly attributable to bringing the asset ready for its intended use. Subsequently intangible assets are carried at cost less amortization and any accumulated impairment losses.

Internally generated intangible assets arising from development are recognised if, and only if, all the criteria for recognition are fulfilled:

- it is technically feasible to complete the intangible asset so that it will be available for use;
- there is an ability to use or sell the intangible asset;
- it can be demonstrated how the intangible asset will generate probable future economic benefits,
- adequate technical, financial and other resources to complete the development and to use or sell the intangible asset are available; and
- the expenditure attributable to the intangible asset during its development can be reliably measured.

The internally developed documentation asset is related to the re-development of the active pharmaceutical ingredient, API ("API documentation") The development activities and documentation relate to stability testing of a drug substance (API), that is sellable as such, but the usage value of which improves as the prolonged stability is proven and documented. In addition to its own use, Faron may also, for a fee, license the documentation to companies that can utilise documentation in their own drug candidate approval and registration documentation. Provision of such access does in no way limit Faron's ability to use the documentation in its own application processes or ability to give such access to additional users.

Intangible assets are amortised over their expected or known useful lives on a straight-line basis beginning from the point they are available for use. The estimated useful life is the lower of the legal duration and the economic useful life. The estimated useful lives of intangible assets are regularly

reviewed. The estimated useful life for intangible assets is currently 10 years. The effect of any adjustment to useful lives is recognised prospectively as a change of accounting estimate. Intellectual property-related costs for patents are part of the expenditure for the research and development projects.

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at the end of each financial year.

Internal research costs are those costs incurred for the purpose of gaining new scientific or technical knowledge and understanding. Such costs are always expensed as incurred. Internal development costs are those costs incurred for the application of research findings or other knowledge to plan and develop new products for commercial production. As the drug product development projects undertaken by Faron are subject to technical feasibility, regulatory approval and other uncertainties, these criteria are considered to be met only after Faron has filed its submission to the regulatory authority for final approval after which all subsequent development costs will be capitalized. Before this trigger point all drug product related development costs are typically expensed as incurred. Faron has not capitalized any drug product related development expenditure as the related criteria have not been met yet. Development costs expensed in prior financial years are not capitalized at a later date.

1.13 Impairment of non-financial assets

Assets that are subject to depreciation/amortisation are reviewed for impairment whenever there are any indications that the carrying amount may not be recoverable. As a clinical stage drug discovery and development company Faron pays attention on the following factors, among others: changes in the legal framework covering patents, rights or licences, change in the useful lives of similar assets, relationship with other intangible or tangible assets and, other factors that indicate that the value of a tangible or an intangible asset has been impaired.

Intangible assets that have an indefinite useful life or intangible assets not ready for use are not subject to amortization and are tested for impairment annually or whenever events or changes in circumstances indicate that the carrying amount may not be recoverable.

An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and value in use. The value in use represents the discounted future net cash flows expected to be derived from an asset. Any reductions are reported in the income statement as an impairment loss.

1.14 Government grants

Faron has received government grants from the EU (Commission's FP7 program).

Grants from governments or similar organizations to support certain projects are accounted for as grants related to income. They are initially recognised at their fair value. Those grants are deferred and recognised in the income statement over the period necessary to match them with the costs that they are intended to compensate, when management has reasonable assurance that the grant will be received and Faron will comply with the conditions attached to that grant. Such grants are presented as other operating income.

Grants for the acquisition of equipment and intangible assets would be deducted from the cost of the asset in question. So far Faron has not received any such grants.

If, at the balance sheet date, the conditions are believed to be fulfilled and the related grant payments are outstanding, grant receivables are shown in the balance sheet.

1.15 Inventories

Inventories are stated at the lower of cost and net realizable value. Cost is determined using average cost method instead of FIPO –method. The change of method had no impact on the inventory value. The cost of finished goods comprises purchase price and other directly attributable costs. Net realisable value is the estimated selling price in the ordinary course of business, less applicable variable selling expenses.

Inventories consist of GMP[2] manufactured drug ingredient API (active pharmaceutical ingredient), acquired primarily for research and development purposes to be processed into IMP (investigational medicinal product). However, it also has alternative use, i.e. the ingredient is traded by other companies and consequently may be sold in the market. Faron has sold API over the reporting periods to pharmaceutical companies.

1.16 Financial assets

Faron's financial assets consist principally of cash and cash equivalents.

The classification of a financial asset depends on the purpose for which the financial asset was acquired. Management determines the classification of its financial assets at initial recognition.

Cash and cash equivalents are recognised at cost. They include cash in hand and bank balances if they are readily convertible to known amounts of cash, are not subject to significant changes in value and have a maturity of three months or less from the date of acquisition. Any bank overdrafts are shown within borrowings in current financial liabilities.

Receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market nor held by the Company for trading. Trade receivables and other financial receivables are included in this category. They are included in current assets, except for maturities greater than 12 months after the end of the reporting period.

Trade receivables are amounts due from customers for signing fees, milestone payments or services performed (including reimbursable costs) in the ordinary course of business. Trade receivables are carried at the original invoice amount less allowances made for doubtful receivables, discounts and rebates and similar allowances, when applicable. Impairment is recognised on doubtful receivables based on individual assessment of potential identified credit risk where there is objective evidence that Faron will not be able to collect all amounts due. Credit losses are recognised in the income statement and presented under costs allocated to functions. Interest income is recognised using the effective interest method and recorded in financial income.

Financial assets are derecognised when Faron loses the rights to receive the contractual cash flows on the financial asset or it transfers substantially all the risks and rewards of ownership outside Faron.

1.17 Financial liabilities and equity

Faron classifies an instrument, or its component parts, on initial recognition as a financial liability or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability and an equity instrument

1.17.1 Bank borrowings

Borrowings are initially recognised at fair value, less any directly attributable transaction costs. Subsequently borrowings are carried at amortised cost using the effective interest method.

Borrowings are presented as current liabilities unless Faron has an unconditional right to defer settlement of the liability for at least 12 months after the end of the reporting period. Borrowings (or part of the liability) is not derecognised until the liability has ceased to exist, that is, when the obligation identified in a contract has been fulfilled or cancelled or is no longer effective.

Fees paid on the establishment of loan facilities are recognised as transaction costs of the loan to the extent that it is probable that some or all of the facility will be drawn down. In this case, the fee is deferred until the draw-down occurs. To the extent there is no evidence that it is probable that some or all of the facility will be drawn down, the fee is capitalised as a pre-payment for liquidity services and amortised over the period of the facility to which it relates.

1.17.2 Government loans

Faron has three government loans with a below-market rate of interest from Tekes (The Finnish Funding Agency for Technology and Innovation). Two of the loans have been withdrawn before the date to transition to IFRS (i.e. prior to 1 January 2012). Based on the exemption under IFRS 1, Faron has measured the government loans using the previous FAS book value as the carrying amount of the loan and as such has not accounted for the below-market grant separately. Subsequently, these loans are carried at amortised cost using the effective interest rate.

In January 2016 the Company raised first instalment of a new €1.5 million Tekes development loan for funding of the pre-clinical development of Clevegen. As the third loan was draw down after the date to transition to IFRS (i.e. after 1 January 2014) it is therefore treated according to IAS 20 and IAS 39. The benefit of a government loan at a below market rate of interest is treated as a government grant and accounted for in accordance with IAS 20.

The loan component is recognized and measured in accordance with IAS 39 initially at fair value and subsequently at amortised cost over the loan period by using the effective interest method. The benefit of the below market rate is measured as the difference between the initial carrying value of the loan, i.e. the fair value, and the proceeds received from the government. Government grants are recognised as profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grants are intended to compensate.

1.17.3 Convertible notes

Faron analyses the contractual terms and substance of convertible notes to classify each instrument, or its component parts, as a financial liability or an equity instrument.

If the instrument does not contain contractual obligation to deliver cash or other financial assets, and it can be converted to fixed amount of the Company's shares, it is classified as equity. If the conversion option is to variable amount of the Company's shares, and it includes contractual obligation to deliver cash, the instrument is a liability that contain embedded derivatives, and it is classified as a financial liability at fair value through profit or loss in its entirety.

If the instrument is classified as equity, it is recognised at cost and it is not re-measured subsequently. If the instrument is classified as a financial liability at fair value through profit or loss, it is measured initially and subsequently at fair value, and

fair value changes are recognised in the income statement as finance income or costs in the period in which they occur. On conversion to equity, the liability is transferred to equity.

As of 31 December 2016, Faron had no outstanding convertible loans.

1.17.4 Equity

Ordinary shares are classified as equity. Incremental costs directly attributable to the issue of new shares are shown in equity as a deduction, net of tax, from the proceeds of the share issue. The portion of costs attributable to the issuance of new shares to the stock market in September 2015, or are otherwise not incremental and directly attributable to issuing new shares, are recorded as an expense in the income statement.

Reserve for invested unrestricted equity is credited with other equity inputs as well as that part of the subscription price of the shares that according to the explicit decision is not to be credited to the share capital.

1.18 Leases

Faron as a lessee

Leases of equipment, where Faron has substantially all the risks and rewards of ownership, are classified as finance leases. Assets leased under finance leases are capitalized at the inception of the lease at the lower of the fair value of the leased property and the present value of the minimum lease payments. Lease obligations are included in current and non-current financial liabilities based on their maturity, net of finance charges. The interest element of the payments is expensed. An asset recognised under a finance lease is depreciated over its useful life. Faron's assets leased under finance leases were insignificant during the financial years presented.

Leases where a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Payments made under operating leases are charged to the income statement on a straight-line basis over the lease term.

1.19 Provisions and contingent liabilities

A provision is recognised when Faron has a present legal or constructive obligation as a result of past events, it is probable that an outflow of resources will be required to settle the obligation, and a reliable estimate of the amount can be made. Faron had no provisions at the end of the reporting periods presented in these financial statements.

A contingent liability is a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence of uncertain future events not wholly within the control of the entity. Such present obligation that probably does not require settlement of a payment obligation and the amount of which cannot be reliably measured is also considered to be a contingent liability. Contingent liabilities are disclosed in the notes to the financial statements.

1.20 Critical accounting estimates and management judgments made in applying accounting policies

1.20.1 Revenue recognition

Due to the nature of the pharmaceutical development business, Faron's collaboration and licence contracts are complex and these contracts often require significant analysis and judgement by management in order to determine the appropriate method of revenue recognition.

Contracts may consist of multiple components with the underlying services and goods delivered at different times over a contract's lifetime representing separate earnings processes. Revenue is allocated to the separate components on a relative fair value basis and revenue is recognized when the criteria for revenue recognition is met for each component. Non-refundable milestones are recognized as revenue when the milestone has been achieved and the Company does not have future obligations related to that milestone. This is normally when the Company is informed by the contract party that the milestone has been achieved. Any milestone payments that have been received but for which earnings process has not been completed are reported as deferred revenue in the balance sheet/statement of financial position and recognized as revenue when the service/goods has been delivered and there are no remaining obligations or contingencies. For some transactions this may result in recognizing cash receipts initially as deferred income and then released to income over subsequent financial years on the basis of meeting the conditions further specified in each individual agreement.

1.20.2 Research and development expenses

Faron follows IFRS guidance to determine whether development costs qualify for capitalization. This determination requires significant judgement. When an internal development project fulfils the criteria for capitalization, costs incurred are capitalized from that point forward. The in-process development project is then tested for impairment annually and whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. It is Faron's view that drug product related development expenses may not be capitalized until marketing approval has been received from

the relevant regulatory agencies, as this is considered to be the first point at which it may be concluded that that future revenues can be generated.

According to management's judgement, the internally developed documentation asset that is related to the re-development of the active pharmaceutical ingredient, API ("API documentation"), fulfils the criteria of IFRS for capitalizing costs of internally developed intangible assets despite the nature of the Company's operations where capitalization criteria is traditionally met at the receipt of regulatory approval. The development activities and documentation relate to stability testing of a drug substance (API) that is sellable as such, even though it is primarily used in the development process. The usage value of the drug substance improves as the prolonged stability is proven and documented. In addition to its own use, Faron may also, for a fee, license the documentation to companies that can utilise documentation in their drug candidate approval and registration documentation. The costs of this internally developed intangible asset have been capitalized as of the criteria for capitalization was fulfilled.

1.20.3 Deferred taxes

Recognition and measurement of deferred tax assets and deferred tax liabilities include management estimates, especially for deferred tax assets arising from tax losses carried forward. Deferred tax assets are recognised for deductible temporary differences to the extent that it is probable that taxable profit will be available against which deductible temporary differences can be utilized. Various internal and external factors may have favourable or unfavourable effects on the deferred tax assets and liabilities. These factors include, but are not limited to, available tax strategies, changes in tax laws, regulations and/or rates dealing with e.g. recoverability periods for tax loss carry-forwards, changing interpretations of existing tax laws or regulations, future levels of research and development spending and changes in overall levels of pre-tax earnings. Such changes that arise could impact the assets and liabilities recognised in the balance sheet in future periods. All tax liabilities and assets are reviewed at the end of the reporting period and changes are recognised in the income statement. Faron has not recorded any deferred tax assets on tax losses carried forward.

1.20.4 Inventories

Measurement of inventories includes some management estimates. Inventories are measured at lower of cost and net realizable value. Net realizable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale. Net realizable value is used in testing the recoverable amount of inventories in order to avoid the inventories being carried in excess of amount expected to be realized from their sale or use.

Management has assessed, that GMP[3] manufactured drug ingredient also fulfils the criteria of IFRS to be classified as inventory. Even though it has been acquired mainly for research and development purposes to be processed into API (active pharmaceutical ingredient) and it is not currently Faron's core business to actively market the ingredient, as it also has alternative use, i.e. the ingredient is traded by other companies and Faron has also traded API, management has recorded the API in its inventory.

1.20.5 Adoption of new and amended standards and interpretations applicable in future financial years

New and forthcoming IFRS standards, effective 1 January 2016 or period thereafter

In preparing these financial statements, Faron has followed the same accounting policies as in the annual financial statements for 2015 except for the effect of changes required by the adoption of the following new standards, interpretations and amendment to existing standards and interpretations on 1 January 2016.

Clarification of Acceptable Methods of Depreciation and Amortisation – Amendments to IAS 16 and IAS 38 (Effective date 1 January 2016)

The amendments clarify that a revenue-based method of depreciation or amortisation is generally not appropriate.

The IASB has amended IAS 16 Property, Plant and Equipment to clarify that a revenue-based method should not be used to calculate the depreciation of items of property, plant and equipment.

IAS 38 Intangible Assets now includes a rebuttable presumption that the amortisation of intangible assets based on revenue is inappropriate. This presumption can be overcome if either

- The intangible asset is expressed as a measure of revenue (ie where a measure of revenue is the limiting factor on the value that can be derived from the asset), or
- It can be shown that revenue and the consumption of economic benefits generated by the asset are highly correlated.

None of the above-listed annual improvements had any effect on the financial statements for 2016.

Annual Improvements to IFRSs 2012-2014 cycle (Effective date 1 January 2016) The latest annual improvements clarify:

- IFRS 5 – when an asset (or disposal group) is reclassified from 'held for sale' to 'held for distribution' or vice versa, this does not constitute a change to a plan of sale or distribution and does not have to be accounted for as such;
- IFRS 7 – specific guidance for transferred financial assets to help management determine whether the terms of a servicing arrangement constitute 'continuing involvement' and, therefore, whether the asset qualifies for derecognition;
- IFRS 7 – that the additional disclosures relating to the offsetting of financial assets and financial liabilities only need to be included in interim reports if required by IAS 34
- IAS 19 – that when determining the discount rate for post-employment benefit obligations, it is the currency that the liabilities are denominated in that is important and not the country where they arise
- IAS 34 – what is meant by the reference in the standard to 'information disclosed elsewhere in the interim financial report'; entities taking advantage of the relief must provide a cross-reference from the interim financial statements to the location of that information and make the information available to users on the same terms and at the same time as the interim financial statements.

None of the above-listed annual improvements had any effect on the financial statements for 2016.

Disclosure Initiative - Amendments to IAS 1 (Effective date 1 January 2016)

The amendments to IAS 1 Presentation of Financial Statements are made in the context of the IASB's Disclosure Initiative, which explores how financial statement disclosures can be improved. The amendments provide clarifications on a number of issues, including:

- Materiality – an entity should not aggregate or disaggregate information in a manner that obscures useful information. Where items are material, sufficient information must be provided to explain the impact on the financial position or performance.
- Disaggregation and subtotals – line items specified in IAS 1 may need to be disaggregated where this is relevant to an understanding of the entity's financial position or performance. There is also new guidance on the use of subtotals.
- Notes – confirmation that the notes do not need to be presented in a particular order.
- OCI arising from investments accounted for under the equity method – the share of OCI arising from equity-accounted investments is grouped based on whether the items will or will not subsequently be reclassified to profit or loss. Each group should then be presented as a single line item in the statement of other comprehensive income.

According to the transitional provisions, the disclosures in IAS 8 regarding the adoption of new standards/accounting policies are not required for these amendments.

None of the above-listed annual improvements had any effect on the financial statements for 2016.

Forthcoming requirements of IFRS standards, interpretations and amendments

IFRS 9 Financial Instruments and associated amendments to various other standards (Effective date 1 January 2018)

IFRS 9 "Financial Instruments" replaces the multiple classification and measurement models in IAS 39 and it will bring changes to classification and measurement of financial assets their impairment assessment hedge accounting.

A debt instrument is measured at amortised cost only if the objective of the business model is to hold the financial asset for the collection of the contractual cash flows, and the contractual cash flows under the instrument solely represent payments of principal and interest.

All other debt and equity instruments, including investments in complex debt instruments and equity investments, must be recognised at fair value. All fair value movements on financial assets are taken through the statement of profit or loss, except for equity investments that are not held for trading, which may be recorded in the statement of profit or loss or in reserves (without subsequent recycling to profit or loss). In addition debt instruments can be classified at fair value through other comprehensive income according to entity's business model.

As of the date of these financial statements Faron is still to assess the impacts of the standard.

IFRS 15 Revenue from contracts with customers and associated amendments to various other standards (Effective date 1 January 2018)

The IASB has issued a new standard for the recognition of revenue. This will replace IAS 18 which covers contracts for goods and services and IAS 11 which covers construction contracts.

The new standard is based on the principle that revenue is recognised when control of a good or service transfers to a customer – so the notion of control replaces the existing notion of risks and rewards.

A new five-step process must be applied before revenue can be recognised:

- identify contracts with customers
- identify the separate performance obligation
- determine the transaction price of the contract
- allocate the transaction price to each of the separate performance obligations, and
- recognise the revenue as each performance obligation is satisfied. Key changes to current practice are:

The Company is still to assess the impacts of the standard.

IFRS 16 Leases (effective for financial years beginning on or after 1 January 2019)

IFRS 16 will affect primarily the accounting by lessees and will result in the recognition of almost all leases on balance sheet. The standard removes the current distinction between operating and financing leases and requires recognition of an asset (the right to use the leased item) and a financial liability to pay rentals for virtually all lease contracts. An optional exemption exists for short-term and low-value leases.

The income statement will also be affected because the total expense is typically higher in the earlier years of a lease and lower in later years. Additionally, operating expense will be replaced with interest and depreciation, so key metrics like EBITDA will change.

Operating cash flows will be higher as cash payments for the principal portion of the lease liability are classified within financing activities. Only the part of the payments that reflects interest can continue to be presented as operating cash flows.

The accounting by lessors will not significantly change. Some differences may arise as a result of the new guidance on the definition of a lease. Under IFRS 16, a contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

The Company is still to assess the impacts of the standard.

Recognition of Deferred Tax Assets for Unrealised Losses – Amendments to IAS 12 (effective for financial years beginning on or after 1 January 2017)

Amendments made to IAS 12 in January 2016 clarify the accounting for deferred tax where an asset is measured at fair value and that fair value is below the asset's tax base. Specifically, the amendments confirm that:

- A temporary difference exists whenever the carrying amount of an asset is less than its tax base at the end of the reporting period.
- An entity can assume that it will recover an amount higher than the carrying amount of an asset to estimate its future taxable profit.
- Where the tax law restricts the source of taxable profits against which particular types of deferred tax assets can be recovered, the recoverability of the deferred tax assets can only be assessed in combination with other deferred tax assets of the same type.
- Tax deductions resulting from the reversal of deferred tax assets are excluded from the estimated future taxable profit that is used to evaluate the recoverability of those assets.

The Company is still to assess the impacts of the standard.

Disclosure Initiative – Amendments to IAS 7(effective for financial years beginning on or after 1 January 2017).

Going forward, entities will be required to explain changes in their liabilities arising from financing activities. This includes changes arising from cash flows (e.g. drawdowns and repayments of borrowings) and non-cash changes such as acquisitions, disposals, accretion of interest and unrealised exchange differences.

Changes in financial assets must be included in this disclosure if the cash flows were, or will be, included in cash flows from financing activities. This could be the case, for example, for assets that hedge liabilities arising from financing liabilities.

Entities may include changes in other items as part of this disclosure, for example by providing a 'net debt' reconciliation. However, in this case the changes in the other items must be disclosed separately from the changes in liabilities arising from financing activities.

The information may be disclosed in tabular format as reconciliation from opening and closing balances, but a specific format is not mandated.

The Company is still to assess the impacts of the standard.

Sale or contribution of assets between an investor and its associate or joint venture – Amendments to IFRS 10 and IAS 28 (effective date has not been established yet, not yet endorsed by EU).

The IASB has made limited scope amendments to IFRS 10 Consolidated financial statements and IAS 28 Investments in associates and joint ventures. The amendments clarify the accounting treatment for sales or contribution of assets between an investor and its associates or joint ventures. They confirm that the accounting treatment depends on whether the non-monetary assets sold or contributed to an associate or joint venture constitutes a 'business' (as defined in IFRS 3 Business Combinations).

Where the non-monetary assets constitute a business, the investor will recognise the full gain or loss on the sale or contribution of assets. If the assets do not meet the definition of a business, the gain or loss is recognised by the investor only to

the extent of the other investor's investors in the associate or joint venture. The amendments apply prospectively.

The Company is still to assess the impacts of the standard.

Clarifications to IFRS 15 Revenue from Contracts with Customers (effective date 1 January 2018, not yet endorsed by EU)

The amendments comprise clarifications of the guidance on identifying performance obligations, accounting for licenses of intellectual property and the principal versus agent assessment (gross versus net revenue presentation). New and amended illustrative examples have been added for each of these areas of guidance. The IASB has also included additional practical expedients related to transition to the new revenue standard.

The Company is still to assess the impacts of the standard .

Annual improvements to IFRSs 2014-2016 cycle (effective date 1 January 2017, not yet endorsed by EU).

These annual improvements clarify:

- IFRS 12 – that the disclosure requirements in IFRS 12, other than those relating to summarised financial information for subsidiaries, joint ventures and associates, apply to an entity's interests in other entities that are classified as held for sale or discontinued operations in accordance with IFRS 5.

IAS 28 – that an entity has an investment-by-investment choice for measuring investees at fair value in accordance with IFRS 9 by a venture capital organisation, or a mutual fund, unit trust or similar entities including investment linked insurance funds. Additionally, an entity that is not an investment entity may have an associate or joint venture that is an investment entity. IAS 28 permits such an entity the choice to retain the fair value measurements used by that investment entity associate or joint venture when applying the equity method. The amendments clarify that this choice is also available on an investment-by-investment basis.

The Company is still to assess the impacts of the standard.

'Insurance Contracts' – Amendments to IFRS 4 (effective date 1 January 2018, not yet endorsed by EU).

The amendment provides exceptions in applying IFRS 9 with IFRS 4 Insurance Contracts when entity has issued insurance contracts.

The Company is still to assess the impacts of the standard.

"Share-based Payment Transactions' – Amendments to IFRS 2 (effective date 1 January 2018, not yet endorsed by EU).

Clarifies how to account for certain types of share-based payment transactions and provide requirements on the accounting for:

- the effects of vesting and non-vesting conditions on the measurement of cash-settled share-based payments;
- share-based payment transactions with a net settlement feature for withholding tax obligations; and
- a modification to the terms and conditions of a share-based payment that changes the classification of the transaction from cash-settled to equity-settled

The Company is still to assess the impacts of the standard.

IFRIC 22: Foreign Currency Transactions and Advance Considerations 2 (effective date 1 January 2018, not yet endorsed by EU).

IFRIC 22 provides requirements about which exchange rate to use in reporting foreign currency transactions (such as revenue transactions) when payment is made or received in advance.

The Company is still to assess the impacts of the standard.

Transfers of Investment Property – Amendments to IAS 40 (effective date 1 January 2018, not yet endorsed by EU).

Clarification. The amendment was made to reinforce the principle for transfers into, or out of, investment property in respect of properties under construction or development.

The Company is still to assess the impacts of the standard.

[1] Acute Respiratory Distress Syndrome, ARDS.
[2] GMP = Good Manufacturing Practice.
[3] GMP = Good Manufacturing Practice.

NOTE 2
2.1 Principles of financial risk management

Faron's activities expose it to a variety of financial risks as follows:

- liquidity risk
- credit risk, and
- market risk

Faron's overall risk management seeks to minimise potential adverse effects on the Company's financial performance. Risk management is carried out by the financial management of Faron. The financial management identifies, evaluates and hedges financial risks. So far Faron has not used derivative financial instruments to hedge any risk exposures. Faron's risk management focuses on liquidity and market risks.

Liquidity risk

Liquidity risk is the risk that Faron will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset.

Management forecasts the Company's liquidity requirements to ensure it has sufficient cash to meet operational needs. Such forecasting takes into consideration Faron's financing plans and expected cash flow. In 2016, Company issued new shares to institutional investors on AIM market and received new equity, less direct costs, to the amount of EUR 8,519 thousands. This new capital significantly reduced the liquidity risk for the Company in the near future.

In 2012 the European Commission awarded a EUR 5,963 thousand grant to the Faron network ("Consortium") to support the FP-1201-lyo clinical phase III program ("Traumakine"). The Consortium consists of the European Commission as a granting agency, Faron as a coordinator and three other participating partners of the Traumakine program; University College London Hospital (UCLH), University Sapienza Roma and University of Turku. The first pre-payment for the Consortium under the grant was received in 2013, amounted to EUR 2,299 thousand, and Faron recognised EUR 660 thousand as other operating income. The second Consortium pre-payment, EUR 1,018 thousand was received at the end of 2014 and Faron recognised EUR 111 thousand as other operating income. In 2015, Faron recognised EUR 701 thousand as other operating income.The third pre-payment, EUR 1,781 thousand was received in 2016, and Faron recognised EUR 1,502 thousand as other operating income. In conjunction to each pre-payment Faron has forwarded each Consortium member their respective shares of pre-payments.

During 2016 the Company negotiated a further two year extension to the loan and an equal postponement of the installments of the first R&D loan from Tekes, for which the first installment was due in 2016. Tekes provided Faron with an additional two years to make in respect to first installment which is now therefore due in 2018. Faron also has had a committed credit limit available, up to EUR 800 thousand, which was ended in 31 December 2015. The management believes that this credit limit can be reopened if required.

These above mentioned funds and financing sources, in addition to expected milestone payments from Maruish in 2017 and income from other commercial agreements, will enable Faron to fund its operating expenses as planned during 2017.

A) Goverment loans (R&D loans from Tekes)

The Finnish Funding Agency for Technology and Innovation (Tekes) has granted three loans to the Company. The total amount of the first two loans had been drawn down by the Company by the end of the year 2011. Both loans are government loans with a below-market rate of interest. The total loan periods are 10 years from the draw-down. The interest rate for these loans is the base rate set by the Finnish Ministry of Finance less 1%, however, the interest rate will not fall below a 3% minimum. Repayment of these loans shall be initiated after 5 years, thereafter loan principals shall be paid back in equal installments over the remaining loan period. In certain circumstances Tekes may, at its own discretion, extend the loan terms, convert the loans into capital loans or exempt the Company from repayment following the general terms of the loans. The loans do not include any covenants. The Company has negotiated with Tekes four year extension to the first loan and an equal postponement of the installments. The first instalment of the third loan have been drawn down during 2016.

B) Convertible notes

Faron issued convertible notes in 2014 to strengthen its financial position. These convertible notes were classified in equity, because they contained contractual oblication to deliver cash to the holder only in an event of liquidation of Faron, and the actual conversion rate determined in the contract was fixed. The loan was fully converted to shares in January 2015.

C) Loans

Stated in euro	2016 €'000	2017 €'000	2018 €'000	2019 €'000	Later years €'000	Total €'000
Contractual maturity of loans and their interest payments at 31 Dec 2016						
Non-current financial liabilities						
Government loans						
Repayment of loans	0	93	338	338	1 847	2 617
Interest expenses	26	26	24	20	55	150
Current financial liabilities						
Government loans, current portion						
Interest expenses						
Bank overdraft facility						
Trade payables	1824					1 824
	1850	**119**	**362**	**358**	**1 902**	**4 591**

The Company intends to finance the repayment of the loans from future cash sources including among others milestone payments from existing agreements, equity issuances and revenue from future lisencing agreements. The loans contain a provision, that if the projects related to the loans would turn out to be unsuccesfull the lender can forgive the loans either partially or fully.

Credit risk

Credit risk is the risk that one party to a financial instrument will cause a financial loss for Faron by failing to discharge an obligation.

Credit risk arises from cash and cash equivalents as well as credit exposures to external parties, including amounts to be invoiced and outstanding receivables.

Currently Faron does business with only few external counterparties, which all are licensees of Company's technology and products. Over the coming years, funding (milestone payments and reimbursable research expenses) from licensees remain important to Faron's product development programs and are considered the main area of credit risk. However, this risk is partly mitigated by the fact that Faron's current licensees are large and internationally reputable pharmaceutical companies that are financially solid. These collaborations are normally governed by contractual relationships that typically address and describe remedies for situations in which interests of Faron and the partner are not longer in line.

Faron's cash and cash equivalents are invested primarily in saving and deposit accounts with original maturities of three months or less. These accounts generate a very small amount of interest income. The banks that Faron works with have good (Moody's Aaa) credit ratings.

The Company has not incurred any credit losses over the reporting periods 2012-2016, and management does not expect losses from non-performance by counterparties. Therefore, at present, credit risk is limited.

Faron has historically had very little trade receivables by year-end 2012-2015, In the year ended 31 Dec 2016 the trade receivables were EUR 579 thousand and they are all from Maruishi and one client which is a very large international pharmaceuticals company. There has not been any irregularities in the payments of these clients. All the trade receivables are due in 30 days. Thus no further ageing analysis of trade receivables is presented.

Market risk

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk:

- currency risk
- interest rate risk; and
- other price risk

A) Currency risk

Currency risk is the risk that the fair value or future cash flows of a financial instrument, e.g. a trade receivable, will fluctuate because of changes in foreign exchange rates.

Faron's functional currency is the euro and Faron is exposed to foreign exchange risk arising from currency exposure, currently mainly with respect to the Japanese Yen and English Pound. The Company receives payments from its main licence partner Maruishi (based in Japan) in Japanese Yen. However, the impact of the foreign exchange risk arising from the Yen exposure is not considered significant in average.

Due to the commencement of the Ph III clinical trials with a UK -based Clinical Research Organisation as main service provider, the Companys' sterling denominated expensess and trade payables have become significant. The Company converted most of the pound -denominated IPO -proceeds into euros immediatelly after the IPO, but held- and still holds - a sizeable amounts of pounds on its pound -bank accounts. This forms a natural hedge against euro-pound exchange rate changes, as the funds held in pounds roughly match with the estimated pound expenses during 2017. As a result of the sizeable pound -holdings, the depreciation of english pound against euro had a negative effect on the financial statements. As the exchange rate may move also to other direction during 2017, the management believes that natural hedge strategy best protects the Company from adverse exchange rate changes and this protection overweights short term currency rate losses.

Other foreign currency denominated trade receivables (and trade payables, if any) are small and short term in nature.The borrowings and other liabilities of Faron are denominated in euro. As the currency exposure and risk is considered significant, the Company established a natural hedging policy to manage the foreign exchange risk against the functional currency of the Company.

B) Interest rate risk

Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.

The Company's interest rate risk arises from long-term borrowings. Faron's borrowings are denominated in euro. The non-current borrowings issued at fixed rates expose the Company to fair value interest rate risk. Interest rate is partially offset by cash held at variable rates which, on the other hand, expose Faron to cash flow interest rate risk. Given that most of the borrowings are government loans with a below-market rate of interest, cash and cash equivalents are very short term, the impact of interest rate risk on Faron is currently minor, and consequently Faron does not hedge the interest rate risk.

2.2 Capital management

Faron's objectives when managing capital are to safeguard the Company's ability to continue as a going concern and to maintain an optimal capital structure to reduce the cost of capital. The total amount of equity as recognised in the balance sheet is seen and managed as capital by Faron. In order to maintain or adjust the capital structure, Faron may issue new shares or other equity, liability or compound instruments, or sell assets to reduce debt.

To advance the drug development programs into commercialised pharmaceutical products requires significant financial resources. Faron relies on its ability to fund its operations through three major sources of financing:

1) Equity financing: Faron's funding is partly organised through equity financing. Management monitors liquidity on the basis of the amount of funds. These are reported to the Board regularly.

2) Commercialisation, collaboration and licensing agreements: by entering into said agreements with larger pharmaceutical companies Faron is entitled to receive upfront and milestone-dependent payments from these partners. Activities in the area of business development are targeted at securing such agreements. These activities are integral part of the duties of the management and are monitored by the Board of Directors, which ultimately decides on entering into such agreements.

3) Research and development grants and loans: In addition to the sources of funding described above. Faron also relies on different sources of R&D grants and loans. Various regional, national or EU level institutions provide these funds with the aim of fostering economic and technological progress in the region in which Faron operates. Such funds have been historically available to Faron at substantial levels. Faron is in regular contact with the funding agencies. The availability of such funds in the future cannot be guaranteed.

Faron's Board of Directors approves the operational plans and budget. The Board regularly follows up the implementation of these plans and the financial status.

2.3 Fair value estimation

Some of Faron's accounting policies and disclosures require the measurement of fair values. For Faron this applies primarily to financial assets and liabilities.

For financial instruments that are measured in the balance sheet at fair value, IFRS requires disclosure of fair value measurements by level of the fair value measurement hierarchy. Fair value hierarchy is based on the source of inputs used in determining fair values (used in the valuation techniques) as follows:

- Level 1: fair values are based on quoted prices (unadjusted) in active markets for identical assets or liabilities
- Level 2: fair values are based on market rates and prices, discounted future cash flows etc. Thus inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly (that is, as prices) or indirectly (that is, derived from prices) are used.
- Level 3: for assets and liabilities in level three, there is no reliable market source available and thus fair value measurement cannot be based on observable market data (unobservable inputs).

When measuring the fair value of an asset or a liability, Faron uses market observable data as far as possible.

NOTE 3
Revenue

In 2015 revenue consisted of milestone income from Maruishi and sales of API reference material as well as analyse material sales. In 2016 revenue consisted of sale of API and sale of clinical material to Maruishi.

NOTE 4
Segment reporting

Faron is a late clinical stage biotechnology company. It's operations have been focused on the development of its main drug candidate, Traumakine. Faron's chief operating decision maker has been identified as the Chief Executive Officer (CEO).

The CEO manages Faron as one integrated business and hence Faron has one operating and reportable segment. Faron's country of operation is Finland.

NOTE 5
Other operating income

Stated in euro	2016 €'000	2015 €'000
Grants from EU	1 502	701
Grant component of goverment loans	237	
Other items	4	
Total other operating income	1 742	701

In 2012 the European Commission awarded a EUR 5,963 thousand grant to the Faron network ("Consortium") to support the FP-1201-lyo clinical phase III program ("Traumakine"). The Consortium consists of the European Commission as a granting agency, Faron as the funds receiving and further distributing coordinator and three other participating partners of the Traumakine program; University College London Hospital (UCLH), University Sapienza Roma and University of Turku. The first pre-payment for the Consortium under the grant was received in 2013, amounted to EUR 2,299 thousand, and Faron recognised EUR 660 thousand as other operating income. The second Consortium pre-payment, EUR 1,018 thousand was received at the end of 2014 and Faron recognised EUR 111 thousand as other operating income. In 2015, Faron recognised EUR 701 thousand as other operating income.The third pre-payment, EUR 1,781 thousand was received in 2016, and Faron recognised EUR 1,502 thousand as other operating income. In conjunction to each pre-payment Faron has forwarded each Consortium member their respective shares of pre-payments.

According to IFRS 39 below-market level goverment loans must be divided into Fair-value -component and Grant component. Thus the Tekes -loans raised during 2016 have been decomposed and the grant component of 237 thousand euro is recorded in Other operating income.

The Other items are 4 thousand euro legal costs returned to the Company.

NOTE 6

Employee benefit expense

Stated in euro	2016 €'000	2015 €'000
Salaries	(1 636)	(940)
Contributions to defined contribution post-employment plans	(219)	(115)
Social security contributions	(90)	(63)
Share based payments	(480)	(474)
Total employee benefit expenses	**(2 426)**	**(1 591)**
Average number of personnel		
Finland	10	6
Total	**10**	**6**

For further information on management remuneration see Note 21 related party transactions. Share based payments are further explained in Note 16.

NOTE 7

Depreciation and amortisation

Stated in euro	2016 €'000	2015 €'000
Depreciation and amortisation allocated to functions		
Research and development	(161)	(175)
Administration	(7)	(9)
Total depreciation and amortisation	(168)	(184)
Depreciation and amortisation by asset categories		
Machinery and equipment	(7)	(9)
Total depreciation	(7)	(9)
Intangible assets		
Patents	(71)	(65)
Other intangible assets	(90)	(90)
IFRS depreciation adjustment		(20)
Total amortisation	(161)	(175)
Total depreciation and amortisation	**(168)**	**(184)**

The Company has not recorded any impairment losses for the years ended 31 December 2012 to 2016.

NOTE 8
Financial income and expenses

Faron has received three goverment loans for research and development purposes with below-market interest rate from Tekes (The Finnish Funding Agency for Technology and Innovation). Two of theses loans were drawn down before the date to transition to IFRS (i.e. prior to 1 January 2014). Thus, based on the exemption under IFRS 1, Faron has measured the government loans using the previous FAS carrying amount as the carrying amount of the loan. Subsequently, both loans are carried at amortized cost using the effective interest rate. The total loan periods are 10 years from the draw-down. The interest rate for these loans is the base rate set by the Finnish Ministry of Finance less 1%, however, the interest rate will not fall below a 1% minimum. Repayment of these loans shall be initiated after 5 years, thereafter loan principals shall be paid back in equal installments over the remaining loan period. In certain circumstances Tekes may, at its own discretion, extend the loan terms, convert the loans into capital loans or exempt the Company from repayment following the general terms of the loans. The loans do not include any covenants. The Company has negotiated with Tekes four years extension to the first loan and an equal postponement of the installments and a years extension to the first loan and an equal postponement of the installments. Therefore the first instalment of the first loan is due in April 2018 and for the second loan in February 2019.

The third Tekes loan has been partially drawn down during 2016. Its loan period is also 10 years from first draw down with first repayment after 5 years. Therefore the first instalment of the third loan is due in April 2022. In all other material respact the terms of the third loan are identical to those of the first two loans. As the third loan was draw down after the date to transition to IFRS (i.e. after 1 January 2014) and therefore it is treated according to IAS 20 and IAS 39. The benefit of a government loan at a below market rate of interest is treated as a government grant and accounted for in accordance with IAS 20.

The loan component is recognized and measured in accordance with IAS 39 initially at fair value and subsequently at amortised cost over the loan period by using the effective interest method. The benefit of the below market rate is measured as the difference between the initial carrying value of the loan, i.e. the fair value, and the proceeds received from the government. Government grants are recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grants are intended to compensate.

Other significant financial expense items are the exchange rate losses when transfering GBP to Euro, when issuing the new shares entering London stock exchange, expenses on loan guarantees, interest on convertible loans and credit limit interest from bank.

See also Note 2 Financial risk management.

Stated in euro	2016 €'000	2015 €'000
Financial income		
Interest from bank balances		
Interest from account receivables	0	0
Exchage rate profit	0	
Total financial income	0	0
Financial expenses		
Interest on government loans (Tekes)	(19)	(18)
Interest on bank loans	(5)	(19)
Interest on accounts payables	(1)	(1)
Exchange rate losses	(333)	(247)
Bank guarentee costs and provisions	(2)	(9)
Other financial expenses	(1)	(17)
Total financial expenses	(361)	(311)
Total financial income and expenses	**(361)**	**(311)**

NOTE 9

Income taxes

Stated in euro	2016 €'000	2015 €'000
Withholding tax	(75)	(42)
Total income taxes	(75)	(42)

Taxes paid in the year ended 31 December 2015 and 2016 relate to milestone payment from Maruishi and signing fee from PharmBio.

Stated in euro	2016 €'000	2015 €'000
Reconciliation of effective tax rate The Finnish corporate tax rate applied was 20%.		
Loss before income tax	(9 294)	(6 188)
Tax using Faron's domestic corporate tax rate	1 859	1 238
Current-year losses for which no deferred tax asset is recognised	(1 859)	(1 238)
Taxes in the income statement		

Items for which Faron has not recognised a deferred tax asset		
R&D expenses not yet deducted in taxation[1)]	2 816	2 816
The tax losses carried forward approved by tax authorities[2)]	13 928	5 434
Deductible temporary differences for which no deferred assets have been recognised	16 744	8 250

[1)] Faron has incurred research and development costs in the financial years ended 31 December 2010 and 2011 that have not yet been deducted in its taxation. The amount can be deducted over an indefinite period with amounts that the Company may freely decide.

[2)] These losses expire over the years 2019 to 2025. The amount presented for the year ended 31 December 2016 does not include the deductible temporary difference arisen from the net loss for the financial year 2016 as the related loss has not yet been approved by tax authorities by the time of preparation of these financial statements.

The related deferred tax assets have not been recognised in the balance sheet due to the uncertainty as to whether they can be utilised.

NOTE 10
Loss per share

Basic

Basic loss per share is calculated by dividing the loss attributable to equity holders of the Company by the weighted average number of ordinary shares in issue during the year.

Stated in euro	2016 €'000	2015 €'000
Loss attributable to equity holders of the Company (EUR 1,000)	(9 294)	(6 188)
Weighted average number of ordinary shares in issue	23 979 650	20 686 854
Basic (and dilutive) loss per share, EUR	(0,39)	(0,30)
Weighted-average number of ordinary shares		
Issued ordinary shares at 1 January	23 111 704	15 456 250
Effect of shares issued	867 945	5 230 604
Weighted-average number of ordinary shares at 31 December	23 979 650	20 686 854

Diluted

Diluted lossper share is calculated by adjusting theweighted average number of ordinary shares outstanding to assume conversion of all dilutive potential ordinary shares.

Stated in euro	2016 €'000	2015 €'000
Loss attributable to equity holders of the Company (EUR 1,000)	(9 294)	(6 188)
Interest adjustment		9
Convertible loan interest adjusted loss attrib to equity holders	(9 294)	(6 179)
Diluted weighted average number of ordinary shares in issue	23 979 650	20 686 854
Basic loss per share, EUR	(0,39)	(0,30)
Weighted-average number of ordinary shares		
Issued ordinary shares at 1 January	23 111 704	15 456 250
Effect of shares issued	867 945	5 230 604
Weighted-average number of ordinary shares at 31 December	23 979 650	20 686 854
Dilution effect of convertible loans'		-
Diluted weighted-average number of ord. shares at 31 December	23 979 650	20 686 854

NOTE 11
Machinery and equipment and intangible assets

Machinery and equipment

Stated in euro	2016 €'000	2015 €'000
Cost		
Balance at 1 January		
Cost	39	2
Additions		37
Disposals		
Transfers		
Balance at 31 December	39	39
Accumulated depreciation / amortisation and impairment		
Balance at 1 January	(11)	(1)
Depreciation / amortisation (Note 7)	(7)	(9)
Balance at 31 December	(18)	(11)
Net book value at 1 January	**28**	**0**
Net book value at 31 December	**21**	**28**

Patents

Stated in euro	2016 €'000	2015 €'000
Cost		
Balance at 1 January		
Cost	716	646
Additions	92	70
Disposals		
Transfers		
Balance at 31 December	809	716
Accumulated depreciation / amortisation and impairment		
Balance at 1 January	(434)	(369)
Depreciation / amortisation (Note 7)	(71)	(65)
Balance at 31 December	(505)	(434)
Net book value at 1 January	**283**	**277**
Net book value at 31 December	**304**	**283**

Documentation assets in process

Stated in euro	2016 €'000	2015 €'000
Cost		
Balance at 1 January		
Cost	907	907
Additions		
Disposals		
Transfers		
Balance at 31 December	907	907
Accumulated depreciation / amortisation and impairment		
Balance at 1 January	(188)	
Depreciation / amortisation (Note 7)	(90)	(188)
Balance at 31 December	(278)	(188)
Net book value at 1 January	**719**	**907**
Net book value at 31 December	**629**	**719**

Total intangible assets

Stated in euro	2016 €'000	2015 €'000
Cost		
Balance at 1 January		
Cost	1 623	1 553
Additions	92	70
Disposals		
Transfers		
Balance at 31 December	1 716	1 623
Accumulated depreciation / amortisation and impairment		
Balance at 1 January	(622)	(369)
Depreciation / amortisation (Note 7)	(161)	(253)
Balance at 31 December	(783)	(622)
Net book value at 1 January	**1 001**	**1 184**
Net book value at 31 December	**933**	**1 001**

Total machinery and equipment and intangible assets

Stated in euro	2016 €'000	2015 €'000
Cost		
Balance at 1 January		
Cost	1 662	1 555
Additions	92	107
Disposals		
Transfers		
Balance at 31 December	1 754	1 662
Accumulated depreciation / amortisation and impairment		
Balance at 1 January	(632)	(370)
Depreciation / amortisation (Note 7)	(168)	(262)
Balance at 31 December	(800)	(632)
Net book value at 1 January	**1 029**	**1 185**
Net book value at 31 December	**954**	**1 029**

Finance leases

On 31 December 2016 the company had finance leases a total of 49 thousand euros.

The Interest charges related to the financial leases are recorded in the financial expenses. See note 8.

Documentation assets

The cost of the documentation arisen in conjunction to the development work of Faron is recorded in intangible assets. This documentation consists of API documentation1 (see Note 1, 1.10.2 Intangible assets for further details).

Faron has completed these assets in 2014.

Orphan drug status

Faron has been granted an orphan drug status for the treatment of ALI/ARDS with interferon beta by the European Commission and the European Medicines Agency (EMA) under the registration number EU/3/07/505. The orphan drug status granted by the EMA entitles the holder an exclusive right for the marketing and sales of a drug within the European Union for 10 years as from the grant date of the approval. This status is transferable. No costs related to this status have been capitalised. Thus the orphan drug status represents an off-balance sheet asset.

NOTE 12
Inventories

Stated in euro	2016 €'000	2015 €'000
Pre-payment of unfinnished products	952	
Finished goods	499	649
Inventories total	1 451	649

Inventories consists of pre-payments of unfinnished materials and finnished goods. The unfinnished materials consists of an on-going production lot of active pharmaceutical ingredient (API) used in production of FP-1201-lyo. The finnished goods consists of deep-frozen bags of API which have a limited expiry time but which can be extended by conducting additional stability studies.

The cost of inventories recognised as an expense and included in the line item "Cost of sales" amounted to EUR 100,000 (2016: zero; 2015: zero).

The Company has not recorded any impairment losses in years from 2012 to 2016.

NOTE 13
Current receivables

Stated in euro	2016 €'000	2015 €'000
Trade receivables	579	37
Prepayments	1 250	1 248
Accrued items	134	17
Other receivables	1 441	772
Total trade and other receivables	**3 404**	**2 074**

The majority of prepayments relate to the Clinical Service Agreement with the clinical research organisation (CRO), which is the main service provider for the INTEREST Study. The other receivables consist mainly of the EU FP7 grant income as described in Note 4.

NOTE 14
Cash and cash equivalents

Stated in euro	2016 €'000	2015 €'000
Bank balances	11 478	11 068
Total cash and cash equivalents	11 478	11 068

NOTE 15
Equity and reserves

Equity and reserves	Number of shares (pcs)	Share capital (1,000 €)	Reserve for invested non-restricted equity (1,000 €)	Total (1,000 €)
In issue at 1 January 2013	1 453 380	1 296	5 328	6 624
Conversion of convertible notes to	3 688	120	0	120
Issued for merger consideration	1 000 000	0	0	0
Cancelled in merger	-1 000 000	0	0	0
31 December 2013	1 457 068	1 416	5 328	6 744
Share issues, issued for cash	35 424	1 275	0	1 275
Issue of convertible equity instrument	0	0	1 126	1 126
Warrants issue	53 133	0	0	0
31 December 2014	1 545 625	2 691	6 453	9 144
Share base payments	0	0		0
Convertible issue	78 166			0
Share issues for cash	302 764		5 050	5 050
Total	1 926 555			0
Split 1:10	19 265 550			0
Emission of new shares	3 846 154		13 030	13 030
31 December 2015	23 111 704	2 691	24 533	27 224
Share base payments	0	0		0
Emission of new shares	3 200 000		8 519	8 519
31 December 2016	26 311 704	2 691	33 052	35 743

Faron Pharmaceuticals Ltd. has one class of shares. The shares amounted to 23,111,704 at 1 January 2016. The following increases were made during 2016:

By a resolution of a Board Meeting held on 21 September 2016 made pursuant to an authority granted to the Board of Directors at the Annual General Meeting held on 26 May 2016, the Company resolved to issue a total of 3,200,000 Ordinary Shares.

The company was listed on the London Stock Exchange in November 2015. The share has no nominal value. Each share entitles the holder to one vote at the Annual General Meeting. All shares entitle holders to an equal dividend.

At the 31 December 2016 Faron's share capital, entered in the Finnish trade register, amounted to EUR 2,691 thousand. The number of Ordinary Shares at 31 December 2015 was 26,311,704.

Details on the management shareholding are disclosed in Note 21. Transactions with Related Parties.

Nature and purpose of reserves

Share capital

The subscription price of a share received by the company in connection with share issues is recorded to the share capital, unless it is provided in the share issue decision that a part of the subscription price is to be recorded in the fund for invested non-restricted equity. The proceeds received by Faron from the conversion of the convertible bonds have been credited to share capital.

Fund for invested non-restricted equity

The fund for invested non-restricted equity includes other equity investments, for which part of the subscription price of the shares according to the related decision is not to be credited to the share capital and issuance of convertible capital loans.

Faron has not paid any dividends over the years.

NOTE 16
Share options

The Company adopted its 2015 option plan on 15 September 2015 ("Option Plan") as described in full in the Company's Admission Document. Under the Option Plan, options may be granted in four different tranches (A, B, C and D), each of which may be subscribed for and exercised in different periods. Each option will entitle the holder of the option to subscribe for one ordinary share in the Company. An aggregate maximum number of 1,600,000 options may be granted under this plan, such aggregate being made up of a maximum of 400,000 "A" Options, the subscription period for which ended on 9 May 2016 (exercisable between 9 May 2016 and 30 September 2021), a maximum of 400,000 "B" Options to be subscribed for between 8 October 2016 and 30 September 2019 (exercisable between 8 October 2016 and 30 September 2021), a maximum of 400,000 "C" Options to be subscribed for between 8 October 2017 and 30 September 2019 (exercisable between 8 October 2017 and 30 September 2021), and a maximum of 400,000 "D" Options to be subscribed for between 8 October 2018 and 30 September 2019 (exercisable between 8 October 2018 and 30 September 2021).

The terms of the 2015 option plan require that the option holder remain in the Company's service until the beginning of the subscription period. The exercise price for Ordinary Shares based on "A" Options is €3.71 and the exercise price for Ordinary Shares based on "A" Options is €2.90. The exercise price for ordinary shares based on tranches "C" and "D" Options shall be determined by the Euro equivalent to the average share price of the publicly traded ordinary shares of the Company on AIM between 1 July and 30 September of 2017 and 2018 respectively.

Faron has no legal or constructive obligation to repurchase or settle the options in cash, accordingly, the arrangements have been classified as equity settled share-based payments.

Transactions during 2016

Option under the 2015 Option Plan

Option tranche	A	B	C	D	Total	Average exercise price in €
Status	Granted	Granted	Allocated*	Allocated*		
Outstanding at 1 Jan.	250 000	250 000	250 000	250 000	1 000 000	3.31
Amount	150 000	150 000	0	0	300 000	3.31
Forfeited	0	0	0	0	0	
Exercised	0	0	0	0	0	
Outstanding at 31 Dec.	**400 000**	**400 000**	**250 000**	**250 000**	**1 300 000**	**3.31**

*Subscription for these options is conditional on the Director/employee remaining in their role at the time of commencement of the relevant subscription period.

Warrants

Warrant tranche	A	B	Total	Average exercise price in €
Status	Granted	Granted		
Outstanding at 1 Jan.	0	0	0	
Granted	109 800	41 600	151 400	1.68
Forfeited	0	0	0	
Exercised	0	0	0	
Outstanding at 31 Dec.	**109 800**	**41 600**	**151 400**	**1.68**

The Company has granted warrants over 151,400 ordinary shares in 2015. The warrants are divided into two tranches: in the first tranche, 109,800 warrants with a subscription price of €1.55 (“A Warrants”), and in the second tranche, 41,600 warrants with a subscription price of €2.01 (“B Warrants”). Any “A” Warrants shall be exercised during the subscription period commencing on 2 November 2015 and ending on 7 May 2018. Any “B” Warrants shall be exercised during the subscription period commencing on 2 November 2015 and ending on 28 May 2018.

Calculation of the share-based payment expense in the income statement

Accounting for share-based payments under IFRS 2 requires Faron to take into account all the options and warrants, both granted and allocated. In the calculation of the share-based payment expense the options and warrants were treated as one pool.

The estimated average fair value of options and warrants granted and allocated during the period was € 0.96 per option.

Out of 1,451,400 granted and allocated options and warrants, 951,400 were exercisable as at 31 December 2016. None were exercised by year end 2016. The maximum number of ordinary shares which could be issued in the event of all options under the 2015 option plan being allocated, subscribed for and exercised together with exercise of the outstanding warrants outstanding, amounts to 1,751,400 shares.

The grant date fair value of the options were determined using the Black-Scholes valuation model.The significant inputs into the model were share price, exercise price, volatility and the annual risk-free interest rate as shown in the table below.

Plan and month of grant/ allocation	Years of vesting	Contractual months remaining	Share price €	Estimated excercise price €	Volatility	Risk-free interest rate
A Options - Sept 2015	2015-2021	57	2.88	3.71	50-53%	0.01%.
B Options - Sept 2015	2016-2021	57	2.78	2.90	50-53%	0.01%
C Options - Sept 2015	2017-2021	57	2.69	4.51	50%	0.01%
D Options - Sept 2015	2018-2021	57	2.69	4.96	50%	0.01%
Warrants A - Sept 2015	2015-2018	17	2.69	1.55	50%	0.01%
Warrants B - Sept 2015	2015-2018	14	2.69	2.01	50%	0.01%

The total expense recognised in the income statement for share options is EUR 480,256 in 2016. 2015 is Companies first year to issue options.

Accounting for share-based payments under IFRS 2 requires Faron management to use judgment in determining whether a transactions settled in entity's own equity instruments include share-based payments. In addition, management uses judgment in determining the attribution model in the financial statements, including, for example, estimates of future forfeitures. Measuring the fair value of equity instruments granted requires management to use judgment on appropriate inputs into option pricing model, e.g. share price at grant date, volatility and interest rates.

NOTE 17
Non-current financial liabilities and other liabilities

Stated in euro	2016 €'000	2015 €'000
Interest-bearing financial liabilities		
Tekes loan	2 033	1 446
Convertible notes		
Total non-current financial liabilities	**2 033**	**1 446**
Other non-current liability		
Total other non-current liabilities		
Total non-current liabilities	**2 033**	**1 446**

The "Prepayments" above contains the residual of the EU grant prepayments paid to Company in 2014, 2015 and 2016 deducted with the amounts that are recorded as Other operational income. (See Note 5, Other operational income). In addition the Prepayments include the 750 thousand euro signing fee paid by PharmBio.

Further information on Faron's financial liabilities and related arrangements is presented in Note 2. Financial risk management. See also Note 18. Current financial liabilities and other liabilities below.

NOTE 18
Current financial liabilities and other liabilities

Stated in euro	2016 €'000	2015 €'000
Interest-bearing financial liabilities		
Convertible notes		
Goverment loans (current portion)	93	245
Bank overdraft facility		
	93	245
Non-interest-bearing financial liabilities		
Trade payables	1 874	436
	1 874	436
Other liabilities		
Prepayment	1 718	973
Accrued expenses	620	515
Other liabilities	65	29
	2 403	1 517
Total current financial liabilities and other liabilities	**4 371**	**2 197**

The item "Prepayments" above comprises portions of the awarded EU grant, received in 2013 and 2014. For further information, see Note 5. Other operating income.

For the years 2014 and 2015 the major item under "Accrued expenses" are personnel related (short-term employee benefits). In 2014 in addition to the before mentioned, the accrued interest of the convertible notes were a major portion of the accrued expenses.

NOTE 19
Carrying amounts and fair values of financial liabilities by measurement categories

During the years presented in these financial statements Faron mainly had financial instruments classified as financial liabilities measured at amortised cost. Fair value information of those measured at fair value is included in note 2.3. The carrying amounts of Faron's financial liabilities are considered to equal their fair values.

Faron has elected to apply the exemption provided under IFRS 1 to both goverment loans (Tekes), drawn in 2008 and 2010. The loans are stated at the carrying amount measured using the previous GAAP. The carrying amount is presented below. The third Tekes loan has been partially drawn down during 2016. As the third loan was draw down after the date to transition to IFRS (i.e. after 1 January 2014) and therefore it is treated according to IAS 20 and IAS 39. See note 8. for more details

Stated in euro	2016 €'000	2015 €'000
Carrying amount[1]	2 126	1 691

[1] Includes both the non-current and current portions

NOTE 20
Contingencies and commitments

Stated in euro	2016 €'000	2015 €'000
Corporate mortgages	800	800
	800	800

The corporate mortage was a guarantee for the EUR 800,000 credit limit. The credit limit was not renewed after it expired on 31 December 2015.

Operating lease – Faron as a lessee

The future aggregate minimum lease payments under non-cancellable operating leases are as follows

Stated in euro	2016 €'000	2015 €'000
No later than 1 year	144	82
Later than 1 year and no later than 5 years	261	14
Later than 5 years		
Total	405	96

Faron leases equipment under non-cancellable operating leases. The lease terms at the time of the start of the lease agreement are between 3 and 4 years.

The operating facilities used currently are leased under long-term operating lease.

NOTE 21
Transactions with related parties

Related parties of the Company

Faron's related party comprise of the following:

- A&B (HK) Company Limited, an investment company existing under the laws of Hong Kong having significant influence in Faron Pharmaceuticals Oy, given their shareholding of 12.9%, as at 31 December 2015.
- Marko Salmi, a private person having significant influence over Faron Pharmaceuticals Oy, given his shareholding of 12.9%, as at 31 December 2016.
- Board of Directors; and
- the Company's key management personnel (see below)

Faron had no interests in other entities at the end of the reporting periods presented in these financial statements.

Key management personnel

The Company's key management personnel consist of the following:

- members of the Board of Directors
- Management Team comprising CEO Markku Jalkanen, PhD; VP Ilse Piippo, MD, MSc (Pharm), Operations director. Mikael Maksimow, PhD, Medical director Matti Karvonen, MD, PhD and CFO Yrjö Wichmann, MSc (Econ)

Stated in euro	2016 €'000	2015 €'000
Remuneration of key management personnel*		
Salaries and other short-term employee benefits	832	769
Share based payment	274	122
Post-employment benefits (defined contribution plans)		
Total	**1 106**	**891**

Stated in euro	2016 €'000	2015 €'000
Remuneration to the Board of Directors **		
Salaries and other short-term benefits	258	124
Share based payment	38	155
Total	**296**	**279**

*Presented information for the Management Includes the executive directors of the Board

**Presented information for the Board includes only non-executive directors.

Management and Board shareholding

Management* shareholding, 31 December 2016	
Number of shares (pcs)	2 965 170
Shareholding, percentage	11,3%
Board shareholding, 31 December 2016**	
(excluding the shareholding of CEO and CFO)	
Number of shares (pcs)	1 607 489
Shareholding, percentage	6.1%
Total number of shares outstanding at 31 December 2016 (pcs)	26 311 704

*Presented information for the Management Includes the executive directors of the Board

**Presented information for the Board includes only non-executive directors.

Transactions with related parties

Faron has not carried out any transactions with related parties in the financial years presented in these financial statements, except that the former parent company of Faron Pharmaceuticals Ltd., Faron Holding Ltd., merged into its subsidiary Faron Pharmaceuticals Ltd. on 31 December 2013.

NOTE 22
Events after the balance sheet date

On 1 March 2017, Faron announced that the Company raised €5.8 million before expenses by way of the placing of 1,422,340 ordinary shares at the Issue Price of 350 pence per share.

Results and dividends

The Statement of Comprehensive Income for the year is set out on page 44.
The Company's loss for the financial year after taxation and other comprehensive losses was € 9,293,930.28 (2015:€6,187,917.23).

The Directors do not recommend the payment of a dividend (2015: nil).

Board signatures

Turku, 28 March 2017

Frank Armstrong, Chairman

Markku Jalkanen

Juho Jalkanen

Yrjö Wichmann

Jonathan Knowles

Huaizheng Peng

Leopoldo Zambeletti

Matti Manner

The Auditor's Note

Our auditor's report has been issued today

Turku, 28 March 2017

PricewaterhouseCoopers

Kalle Laaksonen
Authorized Public Accountant

Auditor's Report (Translation of the Finnish Original)

To the Annual General Meeting of Faron Pharmaceuticals Ltd.

Report on the Audit of the Financial Statements

Opinion

In our opinion, the financial statements give a true and fair view of the company's financial performance and financial position in accordance with International Financial Reporting Standards (IFRS) as adopted by the EU.

What we have audited

We have audited the financial statements of Faron Pharmaceuticals Ltd (business identity code 2068285-4) for the year ended 31 December 2016. The financial statements comprise the balance sheet, income statement, statement of comprehensive income, statement of changes in equity and statement of cash flow and notes to the financial statements.

Basis for Opinion

We conducted our audit in accordance with good auditing practice in Finland. Our responsibilities under good auditing practice are further described in the Auditor's Responsibilities for the Audit of Financial Statements section of our report.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Independence

We are independent of the company in accordance with the ethical requirements that are applicable in Finland and are relevant to our audit, and we have fulfilled our other ethical responsibilities in accordance with these requirements.

Responsibilities of the Board of Directors and the Managing Director for the Financial Statements

The Board of Directors and the Managing Director are responsible for the preparation of financial statements that give a true and fair view in accordance with International Financial Reporting Standards (IFRS) as adopted by the EU. The Board of Directors and the Managing Director are also responsible for such internal control as they determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the Board of Directors and the Managing Director are responsible for assessing the company's ability to continue as going concern, disclosing, as applicable, matters relating to going concern and using the going concern basis of accounting. The financial statements are prepared using the going concern basis of accounting unless there is an intention to liquidate the company or cease operations, or there is no realistic alternative but to do so.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance on whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with good auditing practice will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

As part of an audit in accordance with good auditing practice, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the company's internal control.

- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.

- Conclude on the appropriateness of the Board of Directors' and the Managing Director's use of the going concern basis of accounting and based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the company to cease to continue as a going concern.

- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events so that the financial statements give a true and fair view.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

Other Reporting Requirements

Other Information

The Board of Directors and the Managing Director are responsible for the other information. The other information comprises of the strategic report, director's report, director´s remuneration report and the statement of director´s responsibilities. Our opinion on the financial statements does not cover the other information.

In connection with our audit of the financial statements, our responsibility is to read the reports mentioned above and, in doing so, consider whether the information included in the reports are materially inconsistent with the financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated.

In our opinion the information given in the strategic report, director's report, director´s remuneration report and the statement of director´s responsibilities are prepared are consistent with the financial statements.

If, based on the work we have performed, we conclude that there is a material misstatement in the reports mentioned above, we are required to report that fact. We have nothing to report in this regard.

Turku 28th of March 2017
PricewaterhouseCoopers Oy
Authorised Public Accountants

Kalle Laaksonen
Authorised Public Accountant (KHT)

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