

Company Number 05375156

VERONA PHARMA PLC
ANNUAL REPORT AND ACCOUNTS
YEAR ENDED 31 DECEMBER, 2016

VERONA PHARMA PLC

CONTENTS

	Page
Directors, secretary and advisers	2
Highlights for the year	3-4
Corporate statement	5-6
Chairman and Chief Executive Officer's joint statement	7-9
Strategic report	10-13
Directors' report	14-19
Corporate governance report	20
Independent auditors' report	21-23
Consolidated Statement of Comprehensive Income	24
Consolidated Statement of Financial Position	25
Company Statement of Financial Position	26
Consolidated Statement of Cash Flows	27
Company Statement of Cash Flows	28
Consolidated Statement of Changes in Equity	29
Company Statement of Changes in Equity	30
Notes to the financial statements	31-62

VERONA PHARMA PLC
DIRECTORS, SECRETARY AND ADVISERS

Directors	David Ebsworth (Non-Executive Chairman) Jan-Anders Karlsson (Chief Executive Officer) Ken Cunningham Rishi Gupta (appointed 29 July, 2016) Patrick Humphrey Mahendra Shah (appointed 29 July, 2016) Andrew Sinclair (appointed 29 July, 2016) Vikas Sinha (appointed 12 September, 2016) Anders Ullman
Company Secretary	Ben Harber
Registered Office	One Central Square Cardiff CF10 1FS
Company Number	05375156
Auditors	PricewaterhouseCoopers LLP 3 Forbury Place 23 Forbury Road Reading Berkshire RG1 3JH
Nominated Adviser and Broker	N+1 Singer One Bartholemew Lane London EC2N 2AX
Solicitors	Taylor Wessing LLP 5 New Street Square London EC4A 3TW
Principal Banker	Royal Bank of Scotland 130 Jermyn Street London SW1Y 4UR
Registrars	Computershare Investor Services plc PO Box 82, The Pavilions Bridgewater Road Bristol BS99 7NH

2016 CLINICAL AND DEVELOPMENT HIGHLIGHTS

- Reported positive results from “add-on” Phase 2a study with RPL554 in COPD patients. Data continues to suggest the drug could be meaningful for the treatment of COPD:
 - RPL554 produced a highly significant ($P < 0.001$) and a clinically meaningful additional (>50%) bronchodilation on top of the administered standard of care bronchodilators, salbutamol or ipratropium bromide.
 - The bronchodilatory effects seen when RPL554 was added to each of the two bronchodilators were significantly ($P < 0.001$) larger than those of either salbutamol or ipratropium bromide alone, which were in turn all significantly greater than placebo.
 - When RPL554 was added to each of salbutamol or ipratropium bromide caused a significant reduction ($p = 0.0002$ and $p = 0.004$ respectively) in trapped air in the lung (residual volume) as compared to salbutamol or ipratropium bromide alone, suggesting that RPL554 treatment may reduce dyspnea, a major debilitating symptom of COPD.
 - Consistent with previous studies, RPL554 was well tolerated both alone and when added to either of the two bronchodilators:
 - No effect on vital signs or ECG parameters.
 - No gastro-intestinal adverse events recorded.
- Reported positive results from a Phase 2a dose finding study with RPL554 in asthmatic patients:
 - Nebulised RPL554 demonstrated a dose-dependent bronchodilator response in asthma patients; the FEV₁ response as compared to placebo was highly statistically significant ($p < 0.0001$) at all doses tested.
 - The maximum bronchodilator effect of RPL554 in this study was comparable to the effect observed with the supramaximal dose (7.5mg) of nebulised salbutamol used in the study.
 - Wide dose range (0.4 to 24mg) examined; suggests RPL554 potentially has a large safety margin.
 - RPL554 did not elicit any serious adverse events or adverse events of concern at any dose:
 - Fewer adverse events recorded with RPL554 than with nebulised salbutamol.
 - No gastro-intestinal adverse events or cardiovascular events of concern.
- Data from first Phase 1 study with RPL554 supporting the Company’s view that RPL554 could become an important, novel and complementary inhaled medicine for the treatment of respiratory diseases such as COPD, cystic fibrosis and asthma presented at American Thoracic Society (ATS) 2016 International Conference in USA:
 - Studies continue to demonstrate the bronchodilator properties of RPL554.
 - Formulation is better tolerated than the earlier solution formulation prototype, with no maximum tolerated dose observed even at 16 times the active bronchodilator dose.
 - New formulation is suitable for twice daily dosing.
- Formulation provides for a longer pulmonary residence time, lower peak plasma exposure and longer half-life in blood than the earlier formulation suggesting a more pronounced effect locally in the lung and comparatively less effects in other organs in the body.

2016 OPERATIONAL AND FINANCIAL HIGHLIGHTS

- Raised gross proceeds of £44.7m from a placing of 1.56bn units at a price of 2.873 pence per unit (31.1m units at a price of £1.4365 per unit after taking account of the 50-for-1 share consolidation) with each unit comprising one new ordinary share and one warrant to purchase 0.4 of an ordinary share.
- Appointed Mr. Rishi Gupta, Dr. Mahendra Shah, Dr. Andrew Sinclair, and Mr. Vikas Sinha as Non-Executive Directors of the Board.
- Appointed Mr. Piers Morgan as Chief Financial Officer.
- Loss after tax of £5.02m (2015: £7.49m) reflecting tight cost control and a lower level of R&D spend especially on clinical studies during the year.
- Loss per share of 0.30 pence (2015: 0.74 pence). After taking account of the 50-for-1 share consolidation approved by Shareholders at the General Meeting on 8 February, 2017 the loss per share for the year ended 31 December, 2016 would be 14.98p (2015: 37.10p).
- Net cash outflows from operating activities during the year of £5.59m (2015: £6.36m) reflecting clinical progress, with cash and cash equivalents as at 31 December, 2016 increasing to £39.79m (2015: £3.52m).
- Announced plans to conduct a registered initial public offering in the United States. The number of shares and price of the proposed offering have not yet been determined. The proposed offering is expected to commence in the first half of 2017, after the U.S. Securities and Exchange Commission completes its review process of the registration statement relating to the proposed offering and subject to market and other conditions.

POST PERIOD

- Initiation of a Phase 2a study to evaluate in approximately 30 COPD patients the addition of nebulised RPL554 to tiotropium, a commonly used long-acting bronchodilator for COPD.
- On 8 February, 2017 shareholders approved a 50-for-1 share consolidation of the Company's shares. The consolidation took place after the period covered by these financial statements and therefore the financial statements have not been adjusted to take account of the share consolidation.

**VERONA PHARMA PLC
CORPORATE STATEMENT
FOR THE YEAR ENDED 31 DECEMBER, 2016**

We are a clinical stage biopharmaceutical company focused on developing and commercialising innovative therapeutics for the treatment of respiratory diseases with significant unmet medical needs. Our product candidate, RPL554, is a first in class, inhaled, dual inhibitor of the enzymes phosphodiesterase 3 and 4, or PDE3 and PDE4, that acts as both a bronchodilator and an anti-inflammatory agent in a single compound. We believe RPL554 has the potential to be the first novel class of bronchodilator in over 40 years. We have completed eight Phase 1 and 2a clinical trials for RPL554, with 282 subjects enrolled. In our clinical trials, treatment with RPL554 has been observed to result in statistically significant improvements in lung function as compared to placebo and has shown clinically meaningful and statistically significant improvements in lung function when added to two commonly used bronchodilators as compared to either bronchodilator administered as a single agent. RPL554 also has shown anti-inflammatory effects and been well tolerated in our clinical trials, and has not been observed to result in the gastrointestinal or other side effects commonly associated with the only PDE4 inhibitor currently on the market for the treatment of COPD.

We are developing RPL554 for the treatment of patients with chronic obstructive pulmonary disease, or COPD. We believe there is an urgent and unmet medical need for new and more effective treatments for COPD to reduce the number and burden of symptoms, reduce acute periods of worsening symptoms, or exacerbations, and establish a consistent and durable treatment response. We are also developing RPL554 for the treatment of cystic fibrosis, or CF, a fatal inherited disease where we believe the bronchodilatory and anti-inflammatory effects of RPL554 may be beneficial. We believe RPL554, if approved, has the potential to become an important and novel treatment and standard of care for COPD and CF patients. We may also explore, alone or with a collaborator, the development of RPL554 to treat asthma and other respiratory diseases.

We are developing RPL554 in a nebulised formulation for the maintenance treatment of COPD patients and for the treatment of CF. We also are developing RPL554 in a nebulised formulation as an add-on therapy to short acting bronchodilators and other commonly used therapies for the treatment of hospitalised patients with acute exacerbations of COPD.

To evaluate RPL554 in a nebulised formulation for the maintenance treatment of COPD, we plan to commence a Phase 1 single-dose pharmacokinetic, or PK, trial in 12 healthy volunteers in 2017 and a four-week Phase 2b dose ranging clinical trial in approximately 400 patients by the end of 2017. A PK trial involves the study of the process of bodily absorption, distribution, metabolism and excretion of a drug. In February 2017 we also commenced a Phase 2a clinical trial evaluating RPL554 in approximately 30 patients with COPD as an add-on therapy to tiotropium, a commonly used long acting bronchodilator. We expect to report top line data from this trial in the fourth quarter of 2017. We also intend to commence in 2018 a Phase 2 clinical trial for RPL554 for the treatment of acute exacerbations of COPD in approximately 150 patients. In addition, we plan to commence a Phase 2a single dose PK and pharmacodynamics, or PD, trial in 2017 evaluating RPL554 in approximately ten CF patients. A PD trial involves the study of the biochemical and pharmacological effects of a drug and its mechanism of action, including the correlation of the drug's actions and effects with its mechanism of action. The results of this clinical trial will support dose selection for a proof of concept Phase 2b trial in approximately 100 patients with CF.

In addition to our nebulised formulation of RPL554, we are developing RPL554 in both dry powder inhaler, or DPI, and metered dose inhaler, or MDI, formulations for the maintenance treatment of COPD. We may explore the development of RPL554 in these formulations for the treatment of asthma and other respiratory diseases.

According to the World Health Organization, over one billion people suffer from chronic respiratory diseases. Among the most common of these afflictions is COPD, which is a progressive respiratory disease for which there is no cure. COPD damages the airways and the lungs and leads to shortness of breath, impacting a person's ability to perform daily activities. In some cases, patients experience acute exacerbations, which are estimated to cause approximately 1.5 million emergency department visits, 687,000 hospitalisations and 129,000 deaths per year in the United States alone.

VERONA PHARMA PLC
CORPORATE STATEMENT
FOR THE YEAR ENDED 31 DECEMBER, 2016

According to the World Health Organization, COPD is the third leading cause of death globally, with 210 million people worldwide suffering from the disease. Global sales of drugs currently indicated for COPD are expected to be \$10.6 billion in 2016 and are expected to grow to \$15.6 billion in 2019.

According to the Cystic Fibrosis Foundation, more than 30,000 people in the United States and more than 70,000 people worldwide are living with CF and approximately 1,000 new cases of CF are diagnosed each year. CF is the most common fatal inherited disease in the United States and Europe. CF causes impaired lung function and is commonly associated with repeat and persistent lung infections due to the inability to clear thickened phlegm, or mucus, from the lung. This condition often results in frequent exacerbations and hospitalisations. There is no cure for CF and the median age of death for CF patients is 37 years. CF is considered a rare, or orphan, disease by both the U.S. Food and Drug Administration, or FDA, and the European Medicines Agency, or EMA.

By inhibiting PDE3 and PDE4, RPL554 increases the levels of two critical intracellular messengers, resulting in bronchodilatory and anti-inflammatory effects. RPL554 also stimulates the cystic fibrosis transmembrane conductance regulator, or CFTR, which is an ion channel in the epithelial cells lining the airways. Mutations in the CFTR protein result in poorly or non-functioning ion channels, which cause CF and are potentially important in COPD. Dual inhibition of PDE3 and PDE4 has been observed to be more effective than inhibition of either PDE alone at relaxing airway smooth muscle cells and suppressing the activation and functions of pro-inflammatory cells residing in the lung, both of which are recognised to play a significant role in COPD and CF.

In our clinical trials, RPL554 has shown rapid onset and durable bronchodilation in healthy subjects and patients with COPD when inhaled from a nebuliser. In addition, RPL554 has been observed to be complementary and additive when administered as an add-on therapy to other currently marketed bronchodilators. Our most recent clinical trial of RPL554 was a Phase 2a clinical trial in 36 patients with COPD. Our primary objective in this clinical trial was to evaluate the improvement in lung function, as measured by the maximal volume of air a person can forcefully exhale in one second, or FEV1, and the duration of action of RPL554. We evaluated RPL554 administered as a single agent as compared to placebo and two commonly used bronchodilators, albuterol, also known as salbutamol and marketed as Ventolin, and ipratropium, marketed as Atrovent. We also evaluated RPL554 administered as an add-on therapy to either albuterol or ipratropium, in each case as compared to albuterol or ipratropium alone. We observed that RPL554 administered as a single agent produced statistically significant improvements in lung function, as measured by FEV1, as compared to placebo, with a p value of less than 0.001. P value is a conventional statistical method for measuring the statistical significance of clinical results. A p value of 0.05 or less represents statistical significance, meaning that there is a less than 1 in 20 likelihood that the observed results occurred by chance. We also observed clinically meaningful and statistically significant improvement in lung function, as measured by FEV1, when RPL554 was administered as an add-on therapy to standard doses of albuterol and ipratropium as compared to standard doses of either bronchodilator alone. In this clinical trial, we observed the effect size, or peak improvement minus placebo improvement, was 51% higher for the add-on therapy of RPL554 with albuterol as compared to albuterol alone, and 66% higher in the add-on therapy of RPL554 with ipratropium as compared to ipratropium alone. In addition, we observed RPL554 administered as an add-on therapy to either albuterol or ipratropium resulted in a statistically significant reduction in time of onset of bronchodilation as compared to albuterol or ipratropium alone.

We have worldwide commercialisation rights for RPL554. We have raised £74.6m in gross proceeds from investors since our listing on AIM in 2006, of which £44.7m was raised in our most recent private placement of equity securities in July 2016 with a number of European and U.S. based healthcare specialist investment firms. Members of our management team and board of directors have extensive experience in large pharmaceutical and biotechnology companies in respiratory product development from drug discovery through commercialisation and have played important roles in the development and commercialisation of several approved respiratory treatments, including Symbicort, Daliresp/Daxas, Spiriva and Flutiform.

**VERONA PHARMA PLC
CHAIRMAN AND CHIEF EXECUTIVE OFFICER'S JOINT STATEMENT
FOR THE YEAR ENDED 31 DECEMBER, 2016**

FINANCIALS

The operating loss for the year ended 31 December, 2016 was £7.02m (2015: £8.97m) and the loss after tax for the year ended 31 December, 2016 was £5.02m (2015: £7.49m).

Research and development costs for the year ended 31 December, 2016 were £4.52 m (2015: £7.27m), a decrease of £2.75m. The decrease was attributable to a £3.6m decrease in clinical trial expenses related to the completion of our Phase 2a clinical trials of RPL554 in late 2015 and early 2016, a £0.4m decrease in pre-clinical research and related costs and a £0.2m decrease in patent-related costs and expenses, which were partially offset by a £0.7m increase in research and development personnel costs and a £0.7m increase in contract manufacturing and associated costs.

General and administrative costs for the year ended 31 December, 2016 were £2.50m (2015: £1.71m), an increase of £0.79m. The majority of this increase was attributable to a £0.2m increase in personnel costs, a £0.3m increase in professional service fees and expenses, and a £0.2m increase in other facility and office related costs, all attributable to the growth of the organisation as we prepare to expand our team in preparation for the next stage in the Company's development, which is expected to include the IPO and initiating larger clinical studies.

Finance income for the year ended 31 December, 2016 was £1.84m (2015: £0.04m). The increase in Finance income was primarily due to a decrease in the fair value of the warrant liability of £1.07m caused by changes in the underlying assumptions for measuring the liability of the warrant, including the price and volatility of Verona shares, as well as the unwinding of the expected life of the warrant.

Finance expense for the year ended 31 December, 2016 was £0.79m (2015: £0.07m). The increase was primarily due to the inclusion of the proportion of expenses incurred as part of the July Placement which related to the issue of the warrants, and which are recorded as a Finance expense (the remainder of the July Placement expenses related to the equity issued and were recorded as a charge against share premium), as well as an increase in the calculated value of the assumed contingent obligation resulting from the Vernalis agreement.

Taxation for the year ended 31 December, 2016 amounted to a credit of £0.95m (2015: £1.51m), a decrease in the credit amount of £0.56m. The credits are obtained at a rate of 14.5% of 230% of our qualifying research and development expenditure, and the decrease in the credit amount was primarily attributable to our decreased expenditure on research and development.

As at 31 December, 2016 the Company had approximately £39.8m in cash and cash equivalents (2015: £3.5m).

CORRECTION OF ERRORS IN 2015 GROUP AND COMPANY COMPARATIVE FIGURES

Certain errors in historic financial information have been identified and corrected in the 2015 Group and Company comparative figures. Further details are set out in note 2.2 of these financial statements.

MANAGEMENT AND STAFF

The Company continued to strengthen its Board and Management team during the year.

Mr. Rishi Gupta joined the Board in July 2016. Since 2002, Mr. Gupta has held various positions at OrbiMed Advisors LLC, a global healthcare investment firm, where he is currently a Private Equity Partner. Mr. Gupta currently is a member of the board of directors of Symbiomix Therapeutics, LLC, Dimension Therapeutics, Inc., Avitide, Inc. and Turnstone Biologics Inc. Mr. Gupta received an A.B. in biochemical sciences from Harvard College and a J.D. from the Yale Law School.

Dr. Mahendra Shah joined the Board in July 2016. Since March 2010, Dr. Shah has served as a Managing Director of Vivo Capital, a healthcare investment firm. Dr. Shah is also the founder and Executive Chair of Semnur Pharmaceuticals, Inc., a specialty pharmaceutical company. Dr. Shah serves as a member of the board of directors of Fortis Inc., Crinetics Pharmaceuticals, Inc., Essentialis Therapeutics LLC, and Impel Neuropharma, Inc. In addition, Dr. Shah serves on the board of directors of private companies in the

**VERONA PHARMA PLC
CHAIRMAN AND CHIEF EXECUTIVE OFFICER'S JOINT STATEMENT
FOR THE YEAR ENDED 31 DECEMBER, 2016**

biopharmaceutical and biotechnology industries. Dr. Shah received his Ph.D. in industrial pharmacy from St. John's University and a Master's Degree in Pharmacy from L.M. College of Pharmacy in Gujarat, India.

Dr. Andrew Sinclair joined the Board in July 2016. Since 2008, Dr. Sinclair has held various positions at Abingworth LLP, a life sciences investment group, where he is currently a Partner and Portfolio Manager. Dr. Sinclair received a Ph.D. in chemistry and genetic engineering at the BBSRC Institute of Plant Science, Norwich, and a B.Sc. in microbiology from King's College London. He is a member of the Institute of Chartered Accountants in England and Wales.

Mr. Vikas Sinha joined the Board in September 2016. From 2005 to December 2016, Mr. Sinha served as the Chief Financial Officer of Alexion Pharmaceuticals, Inc., a biotechnology company. Mr. Sinha holds a master's degree in business administration from the Asian Institute of Management. He is also a qualified chartered accountant from the Institute of Chartered Accountants of India and a Certified Public Accountant in the United States.

The Company appointed Mr. Piers Morgan as Chief Financial Officer in September 2016. From November 2015 to September 2016, Mr. Morgan was an independent consultant. From May 2014 to November 2015, Mr. Morgan was the Chief Executive Officer of C4X Discovery plc, a biotechnology company. Prior to C4X, Mr. Morgan co-founded uniQure N.V., a biotechnology company in Amsterdam, where he served as Chief Financial Officer from December 2009 to May 2014. Mr. Morgan is a member of the Institute of Chartered Accountants in England and Wales. He replaced Mr. Biresch Roy who had previously stepped down from the Board and left the Company.

OUTLOOK

We intend to become a leading biopharmaceutical company focused on the treatment of respiratory diseases with significant unmet medical needs. The key elements of our strategy to achieve this goal include:

- Rapidly advance the development of nebulised RPL554 for the maintenance treatment of COPD. We intend to develop RPL554 for the maintenance treatment of COPD. To evaluate RPL554 in a nebulised formulation for the maintenance treatment of COPD, we plan to commence a Phase 1 single-dose PK trial in 12 healthy volunteers in 2017 and a four-week Phase 2b dose ranging clinical trial for RPL554 in this indication in approximately 400 patients with COPD by the end of 2017. In February 2017 we commenced a Phase 2a clinical trial evaluating RPL554 in approximately 30 patients with COPD as an add-on therapy to tiotropium. We expect to report top line data from this trial in the fourth quarter of 2017.
- Rapidly advance the development of nebulised RPL554 for the treatment of acute exacerbations of COPD. We also are developing RPL554 as an add-on therapy to short acting bronchodilators and other commonly used therapies for the treatment of hospitalised patients with acute exacerbations of COPD. We plan to commence a Phase 2 clinical trial for RPL554 for this indication in approximately 150 patients in 2018.
- Develop RPL554 for the treatment of CF. We plan to commence a Phase 2a single dose trial with RPL554 in approximately ten CF patients to evaluate the PK and PD profile and tolerability of RPL554, as well as examine the effect on lung function and inflammatory biomarkers. The results of this trial will help with dose selection for a proof of concept Phase 2b trial in approximately 100 patients with CF.
- Develop DPI and MDI formulations of RPL554. In addition to our nebulised formulation of RPL554, we are developing RPL554 in both DPI and MDI formulations for the maintenance treatment of COPD. We believe the development of DPI and MDI formulations has the potential to significantly increase the market opportunity for RPL554, if approved, for the maintenance treatment of COPD. In addition, we may explore the development of RPL554 in these formulations for the treatment of asthma and other respiratory diseases.
- Pursue development of RPL554 in other forms of respiratory disease. We believe that RPL554's properties as an inhaled, dual inhibitor of PDE3 and PDE4 give it broad potential applicability in the treatment of other respiratory diseases. We may explore development of RPL554 to treat other forms of respiratory disease following development of RPL554 for the treatment of COPD and CF.

**VERONA PHARMA PLC
CHAIRMAN AND CHIEF EXECUTIVE OFFICER'S JOINT STATEMENT
FOR THE YEAR ENDED 31 DECEMBER, 2016**

- Seek strategic collaborative relationships. We may seek strategic collaborations with market leading biopharmaceutical companies to develop and commercialise RPL554. We believe these collaborations could provide significant funding to advance the development of RPL554 while allowing us to benefit from the development or commercialisation expertise of our collaborators.
- Acquire or in license product candidates for the treatment of respiratory diseases. We plan to leverage our respiratory disease expertise to identify and in license or acquire additional clinical stage product candidates that we believe have the potential to become novel treatments for respiratory diseases with significant unmet medical needs.

We would like to thank the staff and Board members for all their contributions and shareholders for their continued support during a successful year.

Dr. David Ebsworth
Chairman

27 February, 2017

Dr. Jan-Anders Karlsson
Chief Executive Officer

27 February, 2017

The Directors present their strategic report together with the audited consolidated financial statements, audited company financial statements and auditors' report for the year ended 31 December, 2016.

Principal activity

The Company was incorporated on 24 February, 2005. On 18 September, 2006 the Company successfully acquired all the shares of Rhinopharma Limited, a private company incorporated in Canada, and changed its name to Verona Pharma plc (the "Company" or the "Parent"). On 12 December, 2014, the Company established a U.S subsidiary, Verona Pharma Inc., in the state of Delaware. The Parent, Rhinopharma Limited and Verona Pharma Inc. are collectively referred to as the "Group".

The principal activity of the Group is the development of novel, "first-in-class" drugs for the treatment of chronic respiratory diseases, such as chronic obstructive pulmonary disease (COPD), cystic fibrosis and asthma.

Review of the business and future prospects

The Chairman and Chief Executive Officer's joint statement describes the Group's activities, strategy and future prospects. The Directors' report describes the Group's results for the year ended 31 December, 2016.

Key performance indicators ("KPIs")

The key performance indicators for the Group are as follows:

1. Development milestones – this operational KPI is used by the Board to monitor the performance of the Group's drug candidates through the planned clinical studies. Key development milestones achieved in 2016 include:
 - Completed a series of clinical trials with a novel proprietary suspension formulation for nebulisation of the lead compound RPL554 - a "first-in-class", dual PDE3/PDE4 inhibitor with both bronchodilator and anti-inflammatory activities for treatment of respiratory diseases:
 - a Phase I/IIa Single Ascending Dose /Multiple Ascending Dose (SAD/MAD) study in 80 healthy subjects and in 32 COPD patients in UK (study 007).
 - a Phase IIa dose-finding study in 29 asthma patients in UK and Sweden (study 008).
 - a Phase IIa study examining the effect of adding RPL554 to standard doses of common bronchodilator drugs in 30 COPD patients in UK (study 009).
 - Reported positive results from "add-on" Phase 2 study with RPL554 in COPD patients. Data continues to suggest drug could be meaningful new addition, alone or in combination, for the treatment of COPD:
 - Primary objective of study met; RPL554 produced a highly significant ($P \leq 0.001$) and a clinically meaningful additional (>50%) bronchodilation on top of the administered standard of care bronchodilators, salbutamol or ipratropium bromide.
 - The bronchodilator effects seen with the combinations were significantly ($P \leq 0.001$) larger than those of either salbutamol or ipratropium bromide alone, which were in turn all significantly greater than placebo.
 - Secondary objectives also met; the combination of RPL554 with salbutamol or ipratropium bromide caused a significant reduction ($p=0.0002$ and $p=0.004$ respectively) in trapped air in the lung (residual volume) as compared to salbutamol or ipratropium bromide alone, suggesting that RPL554 treatment may reduce dyspnea, a major debilitating symptom of COPD.
 - Consistent with previous studies, RPL554 was well tolerated both alone and in combination:
 - No effect on vital signs or ECG parameters.
 - No gastro-intestinal adverse events recorded.

- Reported positive results from dose finding study with RPL554 in asthmatic patients:
 - Primary objective of study met; nebulised RPL554 demonstrated a dose-dependent bronchodilator response in asthma patients; the response was highly statistically significant ($p < 0.0001$) at all doses tested.
 - The maximum bronchodilator effect of RPL554 in this study was comparable to the effect observed with the supramaximal dose (7.5mg) of nebulised salbutamol used in the study.
 - Large dose range (0.4 to 24mg) examined; suggests RPL554 potentially has a large safety margin.
 - RPL554 did not elicit any serious adverse events or adverse events of concern at any dose:
 - Fewer adverse events recorded with RPL554 than with nebulised salbutamol.
 - No gastro-intestinal adverse events or cardiovascular events of concern.
 - Data from first Phase 1 study with RPL554 supporting the Company's view that RPL554 could become an important, novel and complementary inhaled medicine for the treatment of respiratory diseases such as COPD, asthma and cystic fibrosis presented at American Thoracic Society (ATS) 2016 International Conference in USA:
 - Studies continue to demonstrate the excellent bronchodilator properties of RPL554.
 - Formulation is much better tolerated than the earlier solution formulation prototype, with no maximum tolerated dose observed even at 16 times the active bronchodilator dose.
 - New formulation is suitable for twice daily dosing.
 - Formulation provides for a longer pulmonary residence time, lower peak plasma exposure and longer half-life in blood than the earlier formulation suggesting a more pronounced effect locally in the lung and comparatively less effects in other organs in the body.
 - Published further data on RPL554 at the North America Cystic Fibrosis Conference and in a scientific journal, providing additional data demonstrating that it is an activator of the CFTR channel that is dysfunctional in cells from cystic fibrosis patients and responsible for the respiratory problems in these patients.
2. Cash flow: This financial KPI is used by the Board to monitor the Group's burn rate and the timing and requirement for future funding. The average monthly operating cash outflow (Cash used in operating activities) in 2016 was unchanged at £0.59m (2015: £0.59m), the stability in operating cash outflow over last year reflecting the decreased R&D activity, as a number of clinical trials were completed during the first half of the year, offset by the increase in expenditure including growth of the organisation as we expand our team in preparation for the next stage of the Company's development, which is expected to include initiating larger clinical studies as well as advisory costs associated with the July Placement and the preparation for the NASDAQ IPO. The net cash position at 31 December, 2016 was £39.79m. As at the date of approval of this report, based on current cost expectations and level of operations, it is estimated that the Group has funds allowing it to operate for more than 12 months and, in addition, to complete:
- a four-week Phase 2b dose-ranging clinical trial of nebulised RPL554 in approximately 400 COPD patients;
 - a Phase 2a clinical trial evaluating nebulised RPL554 in approximately 30 patients with COPD as an add-on therapy to tiotropium, a commonly used long-acting bronchodilator; and
 - a Phase 2a single-dose pharmacokinetic and pharmacodynamic clinical trial evaluating nebulised RPL554 in approximately 10 Cystic Fibrosis patients.

VERONA PHARMA PLC
STRATEGIC REPORT
FOR THE YEAR ENDED 31 DECEMBER, 2016

The following table depicts the potential indications for RPL554 and their current development status:

Indication	RPL554 Formulation	Pre-Clinical	Phase 1	Phase 2	Phase 3
Maintenance treatment of COPD	Nebulizer	▶			
Treatment of acute COPD	Nebulizer	▶			
CF	Nebulizer	▶			
Maintenance treatment of COPD	DPI/MDI	▶			
Treatment of Asthma	DPI/MDI	▶			

Risks Associated with Our Business

In common with other pharmaceutical development companies, the Group faces a number of risks and uncertainties. Internal processes are in place to help identify, manage and mitigate these risks. Please refer to the Financial Risk Management section in the Directors' report.

The main risks have been identified as follows:

- We have a limited operating history, have never generated any product revenue, have incurred significant operating losses since our inception, expect to incur significant operating losses for the foreseeable future and may never achieve or maintain profitability.
- We will need additional funding to complete the development and commercialisation of RPL554, if approved, and if we are unable to raise capital when needed, we could be forced to delay, reduce or eliminate our product development programs or commercialisation efforts.
- We depend heavily on the success of RPL554, our only product candidate, and we cannot give any assurance that RPL554 will receive regulatory approval for any indication, which is necessary before it can be commercialised.
- We may encounter regulatory changes that delay or impede our development and commercialisation efforts.
- We rely, and expect to continue to rely, on third parties to conduct our clinical trials and to manufacture our product candidates for pre-clinical and clinical testing, and those third parties may not perform satisfactorily, which could delay our product development activities.
- If we are unable to adequately protect our technology, or to secure and maintain freedom to operate or issued patents protecting our product candidates, others could preclude us from commercialising our technology and products or compete against us more directly.
- We face significant competition from other biotechnology and pharmaceutical companies.
- Our future growth and ability to compete depends on retaining our key personnel and recruiting additional qualified personnel.

On behalf of the Board

Dr. Jan-Anders Karlsson

Chief Executive

27 February, 2017

VERONA PHARMA PLC
DIRECTORS' REPORT
FOR THE YEAR ENDED 31 DECEMBER, 2016

The Directors present their report together with the audited consolidated financial statements, audited company statements and auditors' report for the year ended 31 December, 2016.

Results and dividends

The Group results for the year are set out on page 24. There was a loss for the year after taxation amounting to £5.02m (2015: loss of £7.49m), reflecting a planned decrease in research and development expenditure to £4.52m (2015: £7.27m). In view of the loss for the period, further planned expenditure on drug development and in the absence of distributable reserves the Directors cannot recommend the payment of a dividend.

Research and Development Activities

The Chairman and Chief Executive Officer's joint statement describes the Group's activities, strategy and future prospects.

Directors

The following Directors held office during the year:

Jan-Anders Karlsson
David Ebsworth
Ken Cunningham
Anders Ullman
Patrick Humphrey
Rishi Gupta (appointed 29 July, 2016)
Mahendra Shah (appointed 29 July, 2016)
Andrew Sinclair (appointed 29 July, 2016)
Vikas Sinha (appointed 12 September, 2016)
Biresh Roy (resigned from the Board on 11 January, 2016)

Directors' interests

The beneficial and non-beneficial interests in the Company's shares of the Directors and their families were as follows:

Name	Held at 31 December, 2015	Held at 31 December, 2016
David Ebsworth	4,199,774	5,214,227
Jan-Anders Karlsson	2,870,000	3,470,000
Ken Cunningham	Nil	Nil
Anders Ullman	Nil	Nil
Patrick Humphrey	Nil	Nil
Rishi Gupta	Nil	Nil
Mahendra Shah	Nil	Nil
Andrew Sinclair	Nil	Nil
Vikas Sinha	Nil	Nil

Interests are shown prior to taking into account the 50-for-1 share consolidation approved by shareholders on 8 February, 2017, after the period covered by these accounts.

VERONA PHARMA PLC
DIRECTORS' REPORT
FOR THE YEAR ENDED 31 DECEMBER, 2016

Share options

Share options held by Directors at 31 December, 2016 (before adjusting for the 50-for-1 share consolidation approved by shareholders on 8 February, 2017) were as follows:

	At beginning of period	Granted/ exercised or expired in period	At end of period	Exercise price (£)	Exercisable at end of period
J-A Karlsson	5,000,000	-	5,000,000	0.050 - 0.150	5,000,000
J-A Karlsson	5,000,000	-	5,000,000	0.040	5,000,000
J-A Karlsson	3,000,000	-	3,000,000	0.035	2,000,000
J-A Karlsson	15,000,000	-	15,000,000	0.025	-
J-A Karlsson	-	5,000,000	5,000,000	0.040	-
J-A Karlsson	-	5,000,000	5,000,000	0.060	-
J-A Karlsson	-	25,000,000	25,000,000	0.036	-
P Humphrey	1,000,000	-	1,000,000	0.040	1,000,000

No gains were realised by any Director from the exercise of share options in the Company during the year ended 31 December, 2016 (2015: £nil).

Report on Directors' remuneration and service contracts

The Remuneration Committee, consisting of two independent Non-Executive Directors and chaired by Dr. Ken Cunningham, meets at least once a year (or more frequently as required). The Committee is responsible for the remuneration of the Executive Director and the senior management team, including their benefits in kind, terms of employment and share options, as well as staff share option schemes. The remuneration of the Non-Executive Directors is determined by the Board as a whole, based on a review of current practices in other companies. The service contracts of the Executive Director for director services are subject to a three-month termination period. The employment contract with Dr. Jan-Anders Karlsson is in his own name and the contract specifies a termination period of twelve months.

The Committee aims to provide remuneration packages that are sufficient to attract, retain and motivate high-calibre Executive Directors and senior management who can deliver the Company's strategic objectives, reflecting the individual's experience and role within the Company. The Committee recognises that remuneration packages should be appropriately structured to include fixed and variable pay elements and a mixture of short, medium and long-term incentives in order to align the actions and interests of Executive Directors with those of shareholders. To achieve this objective, the Committee takes account of shareholder views on remuneration policy and information on remuneration paid by other companies of a similar size and comparable industry sector in the UK and internationally. The Committee has engaged the services of an external adviser, Mercer Consulting (a division of Marsh & McLellan) to provide such information and to advise the Committee on its remuneration policy.

Details of the Directors' emoluments for the year are set out below. An annual cash bonus is awarded on the achievement of stretch objectives that support the Company's corporate goals and business strategy together with goals in relation to personal performance. Goals typically include progress in clinical development programs, capital and cash management, pipeline development, partnering and investor relations. Jan-Anders Karlsson, CEO, was awarded a £230,000 bonus in 2016 representing 92% of target bonus against 2016 objectives.

The CEO is required to invest a significant proportion of his after-tax bonus in purchasing shares in the Company and is required to build and retain a significant holding in the Company equivalent to at least 100% of his base salary. Share option awards are made at the discretion of the Committee and are designed to encourage strong corporate performance. Awards typically vest over a three-year period. Share options granted to the CEO in 2016 vest 50% two years after the date of grant and 50% three years after the date of grant. The Committee imposes performance conditions for share options by setting the exercise price at a premium to the share price at the date of grant.

VERONA PHARMA PLC
DIRECTORS' REPORT
FOR THE YEAR ENDED 31 DECEMBER, 2016

Directors' emoluments

	Base Salary	Incremental payment for additional services	Bonus	Employer's NI/Benefit	Employer's Pension	Share-based payment	Other	2016 Total	2015 Total
	£	£	£	£	£	£	£	£	£
Executive									
Jan-Anders Karlsson ¹	220,833	-	230,000	62,722	13,250	281,479	12,002	820,286	570,407
Biresch Roy ²	93,872	-	-	15,531	5,632	(25,571)	3,737	93,201	288,306
Claire Poll ³	-	-	-	-	-	-	-	-	109,760
Non-Executive									
David Ebsworth	80,000	44,000	-	9,921	-	-	-	133,921	122,921
Patrick Humphrey	30,000	-	-	3,021	-	707	-	33,728	35,107
Ken Cunningham ⁴	30,000	-	-	3,021	-	-	-	33,021	9,858
Anders Ullman ⁵	30,000	-	-	3,021	-	-	-	33,021	9,858
Rishi Gupta ⁶	12,500	-	-	-	-	-	-	12,500	-
Mahendra Shah ⁷	12,500	-	-	-	-	-	-	12,500	-
Andrew Sinclair ⁸	12,500	-	-	950	-	-	-	13,450	-
Vikas Sinha ⁹	9,083	-	-	-	-	-	-	9,083	-
Trevor Jones ¹⁰	-	-	-	-	-	-	-	-	33,312
Stuart Bottomley ¹¹	-	-	-	-	-	-	-	-	33,313
	531,288	44,000	230,000	98,187	18,882	256,615	15,739	1,194,711	1,212,842

1. In addition to the amounts disclosed above, in August 2016, following completion of the July Placement, a bonus of £154,530 was paid in relation to 2015; the bonus was not accrued for in the 2015 financial statements.
2. Resigned 11 January, 2016. In addition to the amounts disclosed above, in August 2016, following completion of the July Placement, a bonus of £17,640 was paid in relation to performance in 2015; the bonus was not accrued for in the 2015 financial statements.
3. Retired from the Board 10 September, 2015
4. Appointed 10 September, 2015
5. Appointed 10 September, 2015
6. Appointed 29 July, 2016
7. Appointed 29 July, 2016
8. Appointed 29 July, 2016
9. Appointed 12 September, 2016
10. Retired from the Board 10 September, 2015
11. Retired from the Board 10 September, 2015

VERONA PHARMA PLC
DIRECTORS' REPORT
FOR THE YEAR ENDED 31 DECEMBER, 2016

Pensions

Verona Pharma plc operates a defined contribution pension scheme open to all Executive Directors and employees.

Political and charitable contributions

There were no political or charitable contributions made by the Company during the year ended 31 December, 2016.

Significant shareholders

The Company has been notified, in accordance with Chapter 5 of the FCA's Disclosure and Transparency Rules, of the under noted interests in its ordinary shares as at 27 February, 2017 of 3% shareholders and above:

	Number of Ordinary shares	% of Share Capital
Novo A/S	6,464,065	12.6%
Vivo Capital	6,309,847	12.3%
OrbiMed Advisers	4,669,847	9.1%
New Enterprise Associates	4,424,065	8.6%
Abingworth	3,510,553	6.8%
Aviva plc and subsidiaries	3,285,974	6.4%
Edmond de Rothschild Investment Partners	2,212,033	4.3%
Tekla Capital Management	2,212,033	4.3%
The Wales Life Sciences Investment Fund LP	2,110,000	4.1%
Fidelity International	1,805,944	3.5%

Shareholdings are stated after taking account of the 50-for-1 share consolidation approved by shareholders at the General Meeting on 8 February, 2017.

Future developments

The Chairman and Chief Executive Officer's joint statement describes the Group's activities, strategy and future prospects.

Statement of Directors' responsibilities

The directors are responsible for preparing the Annual Report, the Directors' Remuneration Report and the financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare financial statements for each financial year. Under that law the directors have prepared the Group and parent company financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union. Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the Group and the Company and of the profit or loss of the Group for that period. In preparing these financial statements, the directors are required to:

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

VERONA PHARMA PLC
DIRECTORS' REPORT
FOR THE YEAR ENDED 31 DECEMBER, 2016

The Directors 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 the Group and enable them to ensure that the financial statements and the Directors' Remuneration Report comply with the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation. They are also responsible for safeguarding the assets of the Company and the Group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The Directors are responsible for the maintenance and integrity of the Company's website www.veronapharma.com. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

The Directors consider that the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the Company's performance, business model and strategy.

Each of the Directors, whose names and functions are listed in this Directors' Report, confirm that, to the best of their knowledge:

- the Group and Company financial statements, which have been prepared in accordance with IFRSs as adopted by the EU, give a true and fair view of the assets, liabilities, financial position and loss of the group; and
- the Chairman and Chief Executive Officer's joint statement includes a fair review of the development and performance of the business and the position of the Group, and the Strategic Report contains a description of the principal risks and uncertainties that it faces.

Corporate Governance

The Corporate Governance report describes the corporate governance of the Group.

Post Balance Sheet Events

Since the balance sheet date of 31 December, 2016, the Company has initiated a Phase 2a combination study to evaluate in approximately 30 COPD patients the addition of nebulised RPL554 to tiotropium, a commonly used long-acting bronchodilator for COPD.

On 8 February, 2017 shareholders approved a 50-for-1 share consolidation of the Company's shares. The consolidation took place after the period covered by these financial statements and therefore the financial statements have not been adjusted to take account of the share consolidation, save that earnings per share information has been retrospectively adjusted to reflect the consolidation as if it had occurred at the beginning of the earliest period presented.

Financial risk management

The Group's activities have exposed it to a variety of financial risks: market risk (including currency risk and interest rate risk), credit risk, and liquidity risk. The Group's overall risk management programme is focused on preservation of capital and the unpredictability of financial markets and has sought to minimise potential adverse effects on the Group's financial performance and position. Further details are set out in note 3.1 to the financial statements.

Disclosure of information to Auditors

So far as the Directors are aware:

1. there is no relevant audit information of which the Company's auditors are unaware; and
2. the Directors have taken all steps that they ought to have taken to make themselves aware of any relevant audit information and to establish that the auditors are aware of that information.

**VERONA PHARMA PLC
DIRECTORS' REPORT
FOR THE YEAR ENDED 31 DECEMBER, 2016**

Auditors

In accordance with Section 489 of the Companies Act 2006, a resolution proposing that PricewaterhouseCoopers be re-appointed as auditors of the Company and that the Directors be authorised to fix their remuneration will be proposed at the Annual General Meeting.

Annual General Meeting

A notice of Annual General Meeting of the Company will be sent out in due course, setting out time, date and location of the meeting, together with the resolutions relating to the business which the Company proposes to conduct at such meeting.

On behalf of the Board.

Dr. Jan-Anders Karlsson
Chief Executive

27 February, 2017

Board of Directors

The Board meets at regular intervals, normally no less than six times a year. The Board is responsible for approving company policy and strategy. At the end of 2016 the Board consisted of nine members, with Dr. Jan-Anders Karlsson as an executive director and Dr. David Ebsworth, Dr. Patrick Humphrey, Dr. Ken Cunningham, Dr. Anders Ullman, Mr. Rishi Gupta, Dr. Mahendra Shah, Dr. Andrew Sinclair and Mr. Vikas Sinha as non-executive directors. The Chairman of the Board is Dr. David Ebsworth and the Company's business is run by Dr. Jan-Anders Karlsson (CEO).

Internal control

The Board is responsible for maintaining a strong system of internal control to safeguard shareholders' investment and the Group's assets and to review its effectiveness. The system of internal control is designed to provide reasonable, but not absolute, assurance against material misstatement or loss and to mitigate operational risks.

An Audit Committee has been established; it is chaired by Mr. Vikas Sinha, and with Dr. David Ebsworth and Dr. Andrew Sinclair as members. The Committee meets at least twice a year and is responsible for ensuring that the financial performance of the Group is properly monitored and reported on, as well as meeting the auditors and reviewing any reports prepared by auditors.

At the present time, the size of the Group does not justify an internal audit function. The key features of the Group's system of internal control are as follows:

- the Company is headed by an effective Board, which leads and controls the Group;
- there is a clear division of responsibilities in running the Board and running the Group's business;
- the Board includes a balance of executive and non-executive directors; and
- the Board receives and reviews on a timely basis financial and operating information appropriate to being able to discharge its duties.

The Company has also established a Remuneration Committee and a Nominations and Corporate Governance Committee. The Remuneration Committee is chaired by Dr. Ken Cunningham and with Mr. Rishi Gupta, Dr. David Ebsworth and Dr. Patrick Humphrey as members. The Nominations and Corporate Governance Committee is chaired by Dr. David Ebsworth and with Dr. Mahendra Shah and Dr. Patrick Humphrey as members. Each Committee meets at least once a year. The Nominations and Corporate Governance Committee is responsible for overseeing the Company's corporate governance capability, including evaluating the structure, size and composition of the Board and succession planning of Board members and senior management.

Going concern

The Board has a reasonable expectation that the Group has adequate resources to continue in operational existence for the foreseeable future. The Board will continue to monitor the progress of the development of its programmes and the financial position in order to ensure that the Group continues to have sufficient funding to continue in business. For this reason, the Board continues to adopt the going concern basis in preparing the financial statements.

Communication with shareholders

The Board has a strong commitment to the maintenance of good investor relations with its shareholders, and the Directors will make themselves available to answer questions at the Annual General Meeting. Shareholders are encouraged to contact the Company via email or telephone if they have any questions.

Independent auditors' report to the members of Verona Pharma plc

Report on the financial statements

Our opinion

In our opinion:

Verona Pharma plc's group financial statements and company financial statements (the "financial statements") give a true and fair view of the state of the group's and of the company's affairs as at 31 December 2016 and of the group's loss and the group's and the company's cash flows for the year then ended;

the group financial statements have been properly prepared in accordance with International Financial Reporting Standards ("IFRSs") as adopted by the European Union;

the company financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union and as applied in accordance with the provisions of the Companies Act 2006; and

the financial statements have been prepared in accordance with the requirements of the Companies Act 2006.

What we have audited

The financial statements, included within the Annual Report and Accounts ("Annual Report"), comprise:

the Consolidated Statement of Financial Position as at 31 December 2016;

the Company Statement of Financial Position as at 31 December 2016;

the Consolidated Statement of Comprehensive Income for the year then ended;

the Consolidated Statement of Cash Flows for the year then ended;

the Company Statement of Cash Flows for the year then ended;

the Consolidated Statement of Changes in Equity for the year then ended;

the Company Statement of Changes in Equity for the year then ended; and

the notes to the financial statements, which include a summary of significant accounting policies and other explanatory information.

The financial reporting framework that has been applied in the preparation of the financial statements is IFRSs as adopted by the European Union and, as regards the company financial statements, as applied in accordance with the provisions of the Companies Act 2006, and applicable law.

In applying the financial reporting framework, the directors have made a number of subjective judgements, for example in respect of significant accounting estimates. In making such estimates, they have made assumptions and considered future events.

**INDEPENDENT AUDITORS' REPORT
TO THE MEMBERS OF VERONA PHARMA PLC
FOR THE YEARS ENDED 31 DECEMBER, 2015 AND 2016**

Opinions on other matters prescribed by the Companies Act 2006

In our opinion, based on the work undertaken in the course of the audit:

- the information given in the Strategic Report and the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements; and
- the Strategic Report and the Directors' Report have been prepared in accordance with applicable legal requirements.

In addition, in light of the knowledge and understanding of the group, the company and their environment obtained in the course of the audit, we are required to report if we have identified any material misstatements in the Strategic Report and the Directors' Report. We have nothing to report in this respect.

Other matters on which we are required to report by exception

Adequacy of accounting records and information and explanations received

Under the Companies Act 2006 we are required to report to you if, in our opinion:

- we have not received all the information and explanations we require for our audit; or
- adequate accounting records have not been kept by the company, or returns adequate for our audit have not been received from branches not visited by us; or
- the company financial statements are not in agreement with the accounting records and returns.

We have no exceptions to report arising from this responsibility.

Directors' remuneration

Under the Companies Act 2006 we are required to report to you if, in our opinion, certain disclosures of directors' remuneration specified by law are not made. We have no exceptions to report arising from this responsibility.

Responsibilities for the financial statements and the audit

Our responsibilities and those of the directors

As explained more fully in the Statement of Directors' Responsibilities set out on pages 17 and 18, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view.

Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland) ("ISAs (UK & Ireland)"). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

This report, including the opinions, has been prepared for and only for the company's members as a body in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and for no other purpose. We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

**INDEPENDENT AUDITORS' REPORT
TO THE MEMBERS OF VERONA PHARMA PLC
FOR THE YEARS ENDED 31 DECEMBER, 2015 AND 2016**

What an audit of financial statements involves

We conducted our audit in accordance with ISAs (UK & Ireland). An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of:

- whether the accounting policies are appropriate to the group's and the company's circumstances and have been consistently applied and adequately disclosed;
- the reasonableness of significant accounting estimates made by the directors; and
- the overall presentation of the financial statements.

We primarily focus our work in these areas by assessing the directors' judgements against available evidence, forming our own judgements, and evaluating the disclosures in the financial statements.

We test and examine information, using sampling and other auditing techniques, to the extent we consider necessary to provide a reasonable basis for us to draw conclusions. We obtain audit evidence through testing the effectiveness of controls, substantive procedures or a combination of both.

In addition, we read all the financial and non-financial information in the Annual Report to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report. With respect to the Strategic Report and Directors' Report, we consider whether those reports include the disclosures required by applicable legal requirements.

Sam Taylor (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
Reading
27 February 2017

VERONA PHARMA PLC
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEARS ENDED 31 DECEMBER, 2015 AND 2016

	Notes	Restated Year ended 31 December, 2015	Year ended 31 December, 2016
		£	£
Research and development costs		(7,268,847)	(4,521,820)
General and administrative costs		(1,705,944)	(2,498,349)
Operating loss	7	(8,974,791)	(7,020,169)
Finance income	9	44,791	1,841,282
Finance expense	9	(72,291)	(793,690)
Loss before taxation		(9,002,291)	(5,972,577)
Taxation — credit	11	1,509,448	954,184
Loss for the year		(7,492,843)	(5,018,393)
Other comprehensive income:			
Exchange differences on translating foreign operations		3,784	42,559
Total comprehensive loss attributable to owners of the Company		<u>(7,489,059)</u>	<u>(4,975,834)</u>
Loss per ordinary share — basic and diluted (pence)	5	(0.74)	(0.30)
<i>Loss per ordinary share — basic and diluted (pence) after giving effect to the 50-for-1 share consolidation approved by shareholders on 8 February, 2017</i>	5	(37.10)	(14.98)

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

VERONA PHARMA PLC
CONSOLIDATED STATEMENT OF FINANCIAL POSITION
AS OF 31 DECEMBER, 2015 AND 2016

	Notes	Restated As of 31 December, 2015	As of 31 December, 2016
		£	£
ASSETS			
Non-current assets:			
Property, plant and equipment.....	15	13,163	13,838
Intangible assets	16	1,813,756	1,876,684
Goodwill.....	17	441,000	441,000
		<u>2,267,919</u>	<u>2,331,522</u>
Current assets:			
Prepayments and other receivables.....	12	513,300	2,958,587
Current tax receivable		1,534,788	1,067,460
Cash and cash equivalents	13	3,524,387	39,785,098
		<u>5,572,475</u>	<u>43,811,145</u>
Total assets		<u><u>7,840,394</u></u>	<u><u>46,142,667</u></u>
EQUITY AND LIABILITIES			
Capital and reserves attributable to equity holders:			
Share capital	18	1,009,923	2,568,053
Share premium		26,650,098	58,526,502
Share-based payment reserve		1,525,897	2,101,790
Accumulated loss		(23,752,204)	(28,728,038)
Total equity		<u>5,433,714</u>	<u>34,468,307</u>
Current liabilities:			
Trade and other payables.....	14	1,798,682	2,823,489
Tax payable – US operations.....		14,057	126,063
Derivative financial instrument	22	-	7,922,603
Total current liabilities		<u>1,812,739</u>	<u>10,872,155</u>
Non-current liabilities:			
Assumed contingent obligation	21	593,941	802,205
Total non-current liabilities		<u>593,941</u>	<u>802,205</u>
Total equity and liabilities		<u><u>7,840,394</u></u>	<u><u>46,142,667</u></u>

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

The financial statements on pages 24 to 62 were approved by the Company's board of Directors on 27 February, 2017 and signed on its behalf by:

Dr. Jan-Anders Karlsson
Chief Executive Officer of the Company.

Company number: 05375156

VERONA PHARMA PLC
COMPANY STATEMENT OF FINANCIAL POSITION
AS OF 31 DECEMBER, 2015 AND 2016

	Notes	Restated As of 31 December, 2015 £	As of 31 December, 2016 £
ASSETS			
Non-current assets:			
Property, plant and equipment	15	13,163	13,838
Intangible assets	16	1,813,756	1,876,684
Goodwill	17	441,000	441,000
Investment	10	79,593	242,557
		<u>2,347,512</u>	<u>2,574,079</u>
Current assets:			
Prepayments and other receivables	12	513,829	2,953,358
Current tax receivable		1,534,788	1,067,460
Cash and cash equivalents		3,523,140	39,733,658
		<u>5,571,757</u>	<u>43,754,476</u>
Total assets		<u><u>7,919,269</u></u>	<u><u>46,328,555</u></u>
EQUITY AND LIABILITIES			
Capital and reserves attributable to equity holders:			
Share capital	18	1,009,923	2,568,053
Share premium		26,650,098	58,526,502
Share-based payment reserve		1,525,897	2,101,790
Accumulated loss		<u>(23,778,496)</u>	<u>(28,742,983)</u>
Total equity		<u><u>5,407,422</u></u>	<u><u>34,453,362</u></u>
Current liabilities:			
Trade and other payables	14	1,917,906	3,150,385
Derivative financial instrument	22	—	7,922,603
Total current liabilities		<u><u>1,917,906</u></u>	<u><u>11,072,988</u></u>
Non-current liabilities:			
Assumed contingent obligation	21	593,941	802,205
Total non-current liabilities		<u><u>593,941</u></u>	<u><u>802,205</u></u>
Total equity and liabilities		<u><u>7,919,269</u></u>	<u><u>46,328,555</u></u>

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

The financial statements on pages 24 to 62 were approved by the Company's board of Directors on 27 February, 2017 and signed on its behalf by:

Dr. Jan-Anders Karlsson
Chief Executive Officer of the Company.

Company number: 05375156

VERONA PHARMA PLC
CONSOLIDATED STATEMENT OF CASH FLOWS
FOR THE YEARS ENDED 31 DECEMBER, 2015 AND 2016

	Restated Year ended 31 December, 2015	Year ended 31 December, 2016
	£	£
Cash used in operating activities:		
Loss before taxation	(9,002,291)	(5,972,577)
Finance income	(44,791)	(1,841,282)
Finance expense	72,291	793,690
Share-based payment charge	398,943	575,893
Decrease / (increase) in prepayments and other receivables	57,633	(1,808,832)
Increase in trade and other payables	1,274,370	1,067,595
Depreciation of property, plant and equipment	9,689	10,051
Loss on disposal of property, plant and equipment	—	2,625
Loss on disposal of intangible assets	134,532	8
Amortisation of intangible assets	43,428	51,571
Cash used in operating activities	(7,056,196)	(7,121,258)
Cash inflow from taxation	699,519	1,533,287
Net cash used in operating activities	(6,356,677)	(5,587,971)
Cash flow from investing activities:		
Interest received	50,592	86,542
Purchase of plant and equipment	(1,193)	(13,351)
Payment for patents and computer software	(141,878)	(114,506)
Net cash used in investing activities	(92,479)	(41,315)
Cash flow from financing activities:		
Gross proceeds from issue of shares and warrants	—	44,750,364
Transaction costs on issue of shares and warrants	—	(2,910,461)
Transaction costs on upcoming Global Offering	—	(636,455)
Net cash generated from financing activities	—	41,203,448
Net (decrease) / increase in cash and cash equivalents	(6,449,156)	35,574,162
Cash and cash equivalents at the beginning of the year	9,969,759	3,524,387
Effect of exchange rates on cash and cash equivalents	3,784	686,549
Cash and cash equivalents at the end of the period	3,524,387	39,785,098

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

VERONA PHARMA PLC
COMPANY STATEMENT OF CASH FLOWS
FOR THE YEARS ENDED 31 DECEMBER, 2015 AND 2016

	Restated Year ended 31 December, 2015	Year ended 31 December, 2016
	£	£
Cash used in operating activities:		
Loss before taxation	(9,037,581)	(6,048,360)
Finance income	(44,791)	(1,841,282)
Finance expense	72,291	793,690
Share-based payment charge	319,352	412,929
Decrease / (increase) in prepayments and other receivables	57,103	(1,803,072)
Increase in trade and other payables	1,393,593	1,232,258
Depreciation of property, plant and equipment	9,689	10,051
Loss on disposal of property, plant and equipment	—	2,625
Loss on disposal of intangible assets	134,532	8
Amortisation of intangible assets	43,428	51,571
Cash used in operating activities	(7,052,384)	(7,189,582)
Cash inflow from taxation	699,519	1,551,419
Net cash used in operating activities	(6,352,865)	(5,638,163)
Cash flow from investing activities:		
Interest received	50,591	86,542
Purchase of plant and equipment	(1,193)	(13,351)
Payment for patents and computer software	(141,876)	(114,507)
Net cash used in investing activities	(92,478)	(41,316)
Cash flow from financing activities:		
Gross proceeds from issue of shares and warrants	—	44,750,364
Transaction costs on issue of shares and warrants	—	(2,910,461)
Transaction costs on upcoming Global Offering	—	(636,455)
Net cash generated from financing activities	—	41,203,448
Net (decrease) / increase in cash and cash equivalents	(6,445,343)	35,523,969
Cash and cash equivalents at the beginning of the year	9,968,483	3,523,140
Effect of exchange rates on cash and cash equivalents	—	686,549
Cash and cash equivalents at the end of the period	3,523,140	39,733,658

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

VERONA PHARMA PLC
CONSOLIDATED STATEMENT OF CHANGES IN EQUITY
FOR THE YEARS ENDED 31 DECEMBER, 2015 AND 2016

	Share Capital	Share Premium	Share- based Expenses	Total Accumulated Losses	Total Equity
	£	£	£	£	£
Balance at 1 January, 2015 (Restated)	1,009,923	26,650,098	1,126,954	(16,263,145)	12,523,830
Loss for the year	—	—	—	(7,492,843)	(7,492,843)
Other comprehensive income for the year:					
Exchange differences on translating foreign operations	—	—	—	3,784	3,784
Total comprehensive loss for the period	—	—	—	(7,489,059)	(7,489,059)
Share-based payments.....	—	—	398,943	—	398,943
Balance at 31 December, 2015 (Restated)	<u>1,009,923</u>	<u>26,650,098</u>	<u>1,525,897</u>	<u>(23,752,204)</u>	<u>5,433,714</u>
Balance at 1 January, 2016	1,009,923	26,650,098	1,525,897	(23,752,204)	5,433,714
Loss for the year	—	—	—	(5,018,393)	(5,018,393)
Other comprehensive income for the year:					
Exchange differences on translating foreign operations	—	—	—	42,559	42,559
Total comprehensive loss for the period	—	—	—	(4,975,834)	(4,975,834)
New share capital issued	1,555,796	34,151,439	—	—	35,707,235
Transaction costs on share capital issued.....	—	(2,325,035)	—	—	(2,325,035)
Share options exercised during the period	2,334	50,000	—	—	52,334
Share-based payments.....	—	—	575,893	—	575,893
Balance at 31 December, 2016	<u>2,568,053</u>	<u>58,526,502</u>	<u>2,101,790</u>	<u>(28,728,038)</u>	<u>34,468,307</u>

The currency translation reserve for 2015 and 2016 was not considered material and as such was not presented in a separate reserve but was included in the total accumulated losses reserve.

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

VERONA PHARMA PLC
COMPANY STATEMENT OF CHANGES IN EQUITY
FOR THE YEARS ENDED 31 DECEMBER, 2015 AND 2016

	Share Capital	Share Premium	Share- based Expenses	Total Accumulated Losses	Total Equity
	£	£	£	£	£
Balance at 1 January, 2015 (Restated)	1,009,923	26,650,098	1,126,954	(16,264,420)	12,522,555
Loss for the year.....	—	—	—	(7,514,076)	(7,514,076)
Other comprehensive income for the year:	—	—	—	—	—
Total comprehensive income for the year:	—	—	—	(7,514,076)	(7,514,076)
Share based payments recognised as expense	—	—	319,352	—	319,352
Share based payments recognised as investment	—	—	79,591	—	79,591
Balance at 31 December, 2015 (Restated)	1,009,923	26,650,098	1,525,897	(23,778,496)	5,407,422

	Share Capital	Share Premium	Share- based Expenses	Total Accumulated Losses	Total Equity
	£	£	£	£	£
Balance at 1 January, 2016	1,009,923	26,650,098	1,525,897	(23,778,496)	5,407,422
Loss for the year.....	—	—	—	(4,964,487)	(4,964,487)
Other comprehensive income for the year:	—	—	—	—	—
Total comprehensive income for the year:	—	—	—	(4,964,487)	(4,964,487)
New share capital issued	1,555,796	34,151,439	—	—	35,707,235
Transaction costs on share capital issued	—	(2,325,035)	—	—	(2,325,035)
Share options exercised during the period.....	2,334	50,000	—	—	52,334
Share based payments recognised as expense	—	—	412,929	—	412,929
Share based payments recognised as investment.....	—	—	162,964	—	162,964
Balance at 31 December, 2016	2,568,053	58,526,502	2,101,790	(28,742,983)	34,453,362

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

VERONA PHARMA PLC
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEARS ENDED 31 DECEMBER, 2015 AND 2016

1. General information

Verona Pharma plc (the “Company”) and its subsidiaries (together, the “Group”) are a clinical-stage biopharmaceutical group focused on developing and commercialising innovative therapeutics for the treatment of respiratory diseases with significant unmet medical needs.

The Company is a public limited company, which is listed on the Alternative Investment Market of the London Stock Exchange and incorporated and domiciled in the United Kingdom.

The Company has two subsidiaries, Verona Pharma, Inc. and Rhinopharma Limited (“Rhinopharma”), both of which are wholly owned.

On 8 February, 2017 the Company effected a 50-for-1 consolidation of its shares. Prior to the consolidation the total number of issued shares as at 31 December, 2016 would read as 2,568,053,160 shares and after the consolidation this number would read as 51,361,063 shares. Earnings per share information has been retrospectively adjusted to reflect the consolidation as if it had occurred at the beginning of the accounting period.

2. Accounting policies

A summary of the principal accounting policies, all of which have been applied consistently throughout the year, is set out below.

2.1 Basis of preparation

The consolidated financial statements of the Group have been prepared in accordance with International Financial Reporting Standards (“IFRS”) as issued by the European Union and the Companies Act 2006 applicable to companies reporting under IFRS. The consolidated financial statements have been prepared under the historical cost convention, with the exception of derivative financial instruments which have been measured at fair value.

The preparation of financial statements in conformity with IFRS requires the use of certain critical accounting estimates. It also requires management to exercise its judgement in the process of applying the Group’s accounting policies. The areas involving a higher degree of judgement or complexity, or areas where assumptions and estimates are significant to the consolidated financial statements are disclosed in note 4.

Going concern

During the year ended 31 December, 2016, the Group had a loss of £5,018 thousand (2015: £7,493 thousand). As of 31 December, 2016, the Group had net assets of £34,468 thousand (2015: £5,434 thousand) of which £39,785 thousand (2015: £3,524 thousand) was cash and cash equivalents.

The operation of the Group is currently being financed from funds that the Company raised from share placings. On July 29, 2016, the Company raised gross proceeds of £44.7 million from a placing, subscription and open offer (the “July Placement”). These funds are expected to be used primarily to support the development of RPL554 in chronic obstructive pulmonary disease (“COPD”) as well as corporate and general administrative expenditures.

The Directors believe that the Group has sufficient funds to complete the current clinical trials, to cover corporate and general administration costs and for it to comply with all commitments for at least 12 months from the end of the reporting period and, accordingly, are satisfied that the going concern basis remains appropriate for the preparation of these consolidated financial statements.

VERONA PHARMA PLC
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEARS ENDED 31 DECEMBER, 2015 AND 2016

2. Accounting policies (continued)

Business combination

The Group applies the acquisition method to account for business combinations regardless of whether equity instruments or other assets are acquired. The consideration transferred for the acquisition of a subsidiary is the fair value of the assets transferred, the liabilities incurred to the former owners of the acquiree and the equity interests issued by the Group. The consideration transferred includes the fair value of any asset or liability resulting from a contingent consideration arrangement and the fair value of any pre-existing equity interest in the subsidiary. The excess of the cost of acquisition over the fair value of the Group's share of the identifiable net assets acquired is recorded as goodwill. Goodwill arising on acquisitions is capitalised and is subject to an impairment review, both annually and when there are indications that the carrying value may not be recoverable.

Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date. Acquisition-related costs are expensed as incurred and included in administrative expenses.

Basis of consolidation

These consolidated financial statements include the accounts of Verona Pharma plc and its wholly owned subsidiaries Verona Pharma, Inc. and Rhinopharma. The acquisition method of accounting was used to account for the acquisition of Rhinopharma.

Inter-company transactions, balances and unrealised gains on transactions between Group companies are eliminated.

Verona Pharma Inc. and Rhinopharma adopt the same accounting policies as the Company.

2.2 Correction of errors in 2015 Group and Company comparative figures

Acquisition of Rhinopharma Limited

On September 19, 2006, the Group acquired Rhinopharma for a total consideration of £1,520 thousand payable in ordinary shares. Net assets of £51 thousand were recorded as part of the acquisition, resulting in excess consideration of £1,469 thousand, which was classified in its entirety as goodwill in the statement of financial position.

During 2016, the Group identified an error relating to the accounting for this acquisition. After further due diligence it has been identified that the excess consideration should have been recorded as an in-process research and development intangible ("IP R&D") and a corresponding deferred tax liability should have been recorded in relation to this intangible. In addition, there was a financial liability in relation to an assumed contingent obligation that Rhinopharma held with Vernalis plc ("Vernalis") that was not identified and fair valued at the date of the acquisition. The intangible asset and the financial liability should have been recognised at fair value on the acquisition date. The impact of these to the Group and Company as of the time of the acquisition was as follows:

- Reclassification from goodwill to IP R&D of £1,469 thousand;
- Recognition of a deferred tax liability of £441 thousand; and
- Recognition of goodwill of £441 thousand.

The assumed contingent obligation was deemed to be insignificant at the acquisition date and therefore not recognised.

Subsequent to the business combination the following should have been applied:

Goodwill and IP R&D are not amortised as explained in the accounting policy in note 2.8 and should be annually tested for impairment. The cash generating unit ("CGU") has been tested for impairment annually and no impairment has been recorded.

VERONA PHARMA PLC
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEARS ENDED 31 DECEMBER, 2015 AND 2016

2. Accounting policies (continued)

The assumed contingent obligation is subsequently carried at amortised cost using the effective interest method. Further, since 2006, a corresponding deferred tax asset has been recognised in relation to Verona Pharma plc losses which offset the deferred tax liability.

The financial statements have been restated retrospectively for these errors. The entries to the 2015 opening Consolidated Statement of Financial Position as of 1 January, 2015 are:

- an IP R&D asset of £1,469 thousand;
- an assumed contingent obligation of £522 thousand;
- a decrease in goodwill of £1,028 thousand; and
- a reduction in accumulated loss of £81 thousand.

The entries to the Consolidated Statement of Financial Position on 31 December, 2015 as a result of the errors identified, are:

- an IP R&D asset of £1,469 thousand;
- an assumed contingent obligation of £594 thousand;
- a decrease in goodwill of £1,028 thousand; and
- a reduction in accumulated loss of £81 thousand.

As a consequence the net impact on the Consolidated Statement of Comprehensive Income for 2015 is:

- a £72 thousand finance expense in respect of the movement in the value of the assumed contingent obligation. Further details are set out in note 21 to these consolidated financial statements.

The following tables set forth a summary of the restatements performed:

1 January, 2015

<u>Financial statement element</u>	<u>Pre restatement £'000</u>	<u>Correction amount</u>	<u>Post restatement £'000</u>
Intangibles — IP R&D	—	1,469	1,469
Assumed contingent obligation	—	(522)	(522)
Goodwill	1,469	(1,028)	441
Accumulated loss.....	15,733	81	15,814

31 December, 2015

<u>Financial statement element</u>	<u>Pre restatement £'000</u>	<u>Correction amount</u>	<u>Post restatement £'000</u>
Intangibles — IP R&D	—	1,469	1,469
Assumed contingent obligation	—	(594)	(594)
Goodwill	1,469	(1,028)	441
Accumulated loss.....	23,096	81	23,177
Finance expense.....	—	72	72

The business within Rhinopharma was hived up to the Company immediately after the acquisition of Rhinopharma by the Group. The hive-up was accounted for in the Company's separate financial statements using the acquisition values for Rhinopharma. Therefore the error relating to the initial business combination accounting is also reflected in the separate financial statements of the Company.

VERONA PHARMA PLC
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEARS ENDED 31 DECEMBER, 2015 AND 2016

2. Accounting policies (continued)

Reclassifications

During the period, five reclassifications have been made to the 31 December, 2015 primary statements as follows:

- Taxation recoverable amounting to £1,535 thousand has been reclassified from prepayments and other receivables to current tax receivable (for both Group and Company).
- Computer software with a net book value of £1 thousand has been reclassified from property, plant and equipment to intangible assets (for both Group and Company).
- Exchange differences arising on translating foreign operations have been reclassified from research and development to other comprehensive gains due to an error in the prior period amounting to £4 thousand (for the Group only).
- Transfers of previously expensed share-based payment charges upon lapse of options between the share-based payment reserve and the total accumulated losses have been reclassified amounting to £503 thousand (both for Group and Company).
- US taxation payable amounting to £14 thousand has been reclassified from trade and other payables to tax payable - US operations (for the Group only).

The following table sets forth a reconciliation of Group accumulated loss before restatements and reclassifications to the accumulated loss following the restatements and reclassifications.

1 January, 2015

	Group £'000	Company £'000
Accumulated loss before restatements/reclassification	15,733	15,750
Impact of business combination restatement	81	65
Accumulated loss following restatement above	<u>15,814</u>	<u>15,815</u>
Impact of reclassification from the share based payment reserve	449	449
Accumulated losses per the statement of changes in equity	<u>16,263</u>	<u>16,264</u>

31 December, 2015

	Group £'000	Company £'000
Accumulated loss before restatements/reclassification	23,096	23,138
Impact of business combination restatement	81	65
Accumulated loss following restatement above	<u>23,177</u>	<u>23,203</u>
Assumed contingent obligation income statement charge	72	72
Impact of reclassification from the share based payment reserve	503	503
Accumulated losses per the statement of changes in equity	<u>23,752</u>	<u>23,778</u>

2. Accounting policies (continued)

IAS 8 requires the disclosure of an opening balance sheet when an error has occurred before the earliest period presented. Management has judged that this disclosure gives sufficient information for a user to understanding the impact on the opening balance sheet. Management has also judged due to the nature of this adjustment, which is mainly a balance sheet gross up that not including the full opening balance sheet would not be misleading to the user.

2.3 Foreign currency translation

Items included in the Group's consolidated financial statements are measured using the currency of the primary economic environment in which the Group operates ("the functional currency"). The consolidated financial statements are presented in pounds sterling ("£"), which is the functional and presentational currency of the Company and the presentational currency of the Group.

Transactions in foreign currencies are recorded using the rate of exchange ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated using the rate of exchange ruling at the balance sheet date and the gains or losses on translation are included in the Consolidated Statement of Comprehensive Income. Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rates at the dates of the original transactions. Non-monetary items measured at fair value in a foreign currency are translated using the exchange rates at the date when the fair value was determined.

The assets and liabilities of foreign operations are translated into pounds sterling at the rate of exchange ruling at the balance sheet date. Income and expenses are translated at weighted average exchange rates for the period. The exchange differences arising on translation for consolidation are recognised in Other Comprehensive Income.

2.4 Cash and cash equivalents

Cash and cash equivalents includes cash in hand, deposits held at call with banks, and other short-term highly liquid investments with original maturities of three months or less.

2.5 Deferred taxation

Deferred tax is provided in full, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. Deferred tax is determined using tax rates (and laws) that have been enacted or substantially enacted by the balance sheet date and expected to apply when the related deferred tax is realised or the deferred liability is settled.

Deferred tax assets are recognised to the extent that it is probable that the future taxable profit will be available against which the temporary differences can be utilised.

2.6 Research and development costs

Capitalisation of expenditure on product development commences from the point at which technical feasibility and commercial viability of the product can be demonstrated and the Group is satisfied that it is probable that future economic benefits will result from the product once completed. No such costs have been capitalised to date, given the early stage of the Group's product candidate development.

Expenditure on research and development activities that do not meet the above criteria is charged to the Consolidated Statement of Comprehensive Income as incurred.

VERONA PHARMA PLC
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEARS ENDED 31 DECEMBER, 2015 AND 2016

2. Accounting policies (continued)

2.7 Property, plant and equipment

Property, plant and equipment are stated at cost, net of depreciation and any provision for impairment. Cost includes the original purchase price of the asset and the costs attributable to bringing the asset to its working condition for its intended use. Depreciation is calculated so as to write off the cost less their estimated residual values, on a straight-line basis over the expected useful economic lives of the assets concerned. The principal annual periods used for this purpose are:

Computer hardware	3 years
Office equipment	5 years

2.8 Intangible assets and goodwill

(a) Goodwill

Goodwill arises on the acquisition of subsidiaries and represents the excess of the consideration transferred over the fair value of the identifiable net assets acquired.

(b) Patents

Patent costs associated with the preparation, filing, and obtaining of patents are capitalised and amortised on a straight-line basis over the estimated useful lives of the patents of ten years.

(c) Computer software

Amortisation is calculated so as to write off the cost less estimated residual values, on a straight-line basis over the expected useful economic life of two years.

(d) In-process research & development

IP R&D assets acquired through business combinations which, at the time of acquisition, have not reached technical feasibility are recognised at fair value. The amounts are capitalised and are not amortised but are subject to impairment testing until completion, abandonment of the projects or when the research findings are commercialised through a revenue generating project. The Group determines whether intangible assets (including goodwill) are impaired on an annual basis and this requires the estimation of the higher of fair value less costs of disposal and value in use. Upon successful completion or commercialisation of the relevant project, IP R&D will be reclassified to developed technology. The Group will make a determination as to the then useful life of the developed technology, generally determined by the period in which the substantial majority of the cash flows are expected to be generated, and begin amortisation. In case of abandonment the asset will be impaired.

2.9 Impairment of intangible assets, goodwill and non-financial assets

Goodwill and intangible assets that have an indefinite useful life and intangible assets not ready to use are not subject to amortisation. These assets are tested annually for impairment or more frequently if impairment indicators exist. Non-financial assets that are subject to amortisation are reviewed for impairment 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 of disposal) and value in use.

For the purpose of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows, which are largely independent of the cash flows from other assets or group of assets (i.e. CGU).

2. Accounting policies (continued)

Goodwill is allocated to CGUs for the purpose of impairment testing. The allocation is made to those CGUs or groups of CGUs that are expected to benefit from the business combination in which the goodwill arose. The units or group of units are identified at the lowest level at which goodwill is monitored for internal management purposes, being the operating segments.

The Group is a single cash generating unit. Goodwill that arose on the acquisition of Rhinopharma has been thus allocated to this single CGU. IP R&D is tested for impairment at this level as well, since it is the lowest level at which independent cash flows can be identified.

Non-financial assets, other than goodwill, that have been previously impaired are reviewed for possible reversal of the impairment at each subsequent reporting date.

2.10 Employee Benefits

(a) Pension

The Group operates a defined contribution pension scheme for UK employees. Contributions payable for the year are charged to the Consolidated Statement of Comprehensive Income. The contributions are recognised as employee benefit expense when they are due. Differences between contributions payable in the year and contributions actually paid are shown as either accruals or prepayments in the Consolidated Statement of Financial Position. The Group has no further payment obligation once the contributions have been paid.

(b) Bonus plans

The Company recognises a liability and an expense for bonus plans if contractually obligated or if there is a past practice that has created a constructive obligation.

2.11 Share-based payments

The Group operates a number of equity-settled, share-based compensation schemes. The fair value of share-based payments under such schemes is expensed on a straight-line basis over the vesting period, based on the Group's estimate of shares that will eventually vest.

Where equity-settled transactions are entered into with third party service providers, fair value is determined by reference to the value of the services provided in lieu of payment. The expense is measured based on the services received at the date of receipt of those services and is charged to the Consolidated Statement of Comprehensive Income over the period for which the services are received and a corresponding credit is made to reserves. For other equity-settled transactions fair value is determined using the Black-Scholes model and requires several assumptions and estimates as disclosed in note 20.

For equity settled share-based payments where employees of subsidiary undertakings are rewarded with shares issued by the parent company, a capital contribution is recorded in the subsidiary with a corresponding increase in the investment by the parent company.

2.12 Provisions

Provisions are recognised when the Group 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 the amount can be reliably estimated. Provisions are measured at the present value of the expenditures expected to be required to settle the obligation using a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the obligation.

2. Accounting policies (continued)

2.13 Assumed contingent obligation related to the business combinations

On September 19, 2006, the Company acquired Rhinopharma for a total consideration of £1,520 thousand payable in ordinary shares. In addition, the Group assumed certain contingent obligations owed by Rhinopharma to Vernalis under an assignment and license agreement (the “assumed contingent consideration”) following the sale of IP by Vernalis to Rhinopharma. Pursuant to the agreement, Vernalis (i) assigned to the Company all of its rights to certain patents and patent applications relating to RPL554 and related compounds (the “Vernalis Patents”) and (ii) granted to the Company an exclusive, worldwide, royalty-bearing license under certain Vernalis know-how to develop, manufacture and commercialise products (the “Licensed Products”) developed using Vernalis Patents, Vernalis know-how and the physical stock of certain compounds.

The assumed contingent obligation comprises (a) a milestone payment on obtaining the first approval of any regulatory authority for the commercialisation of a Licensed Product; (b) low-to-mid single digit royalties based on the future sales performance of all Licensed Products; and (c) a portion equal to a mid-twenty percent of any consideration received from any sub-licensees for the Vernalis Patents and for Vernalis know-how.

On the date of acquisition the fair value of the assumed contingent obligation was estimated as the expected value of the milestone payment, royalty payments and sub-license payments, based on management’s estimate of the likely probability of success. The risk-weighted value of the assumed contingent arrangement was then discounted back to its net present value applying an effective interest rate of 12%. The initial fair value of the assumed contingent obligation as of 31 December, 2006 was deemed to be insignificant at the date of the acquisition, so it was not recorded.

The amount of royalties payable under the agreement is based on the future sales performance of certain products, and so the total amount payable is unlimited. The level of sales that may be achieved under the agreement is inherently uncertain and difficult to predict and the range of outcomes cannot be reliably estimated.

The value of this assumed contingent obligation is measured at amortised cost using the effective interest rate method, and is re-measured for changes in estimated cash flows, which may include charges based upon management’s assessment as to the timing or the probability of achieving the various outcomes which trigger payment, or due to the time value of money, or due to changes in exchange rates, which affect the expected value of future net sales made in foreign currencies. The assumed contingent obligation is accounted for as a liability, and any adjustments made to the value of the liability will be recognised in the Consolidated Statement of Comprehensive Income for the period.

2.14 Government and other grants

The Group may receive government, regional or charitable grants to support its research efforts in defined projects where these grants provide for reimbursement of approved costs incurred as defined in the respective grants. Income in respect of such grants would include contributions towards the costs of research and development. Income would be recognised when costs under each grant are incurred in accordance with the terms and conditions of the grant and the collectability of the receivable is reasonably assured. Government, regional and charitable grants relating to costs would be deferred and recognised in the Consolidated Statement of Comprehensive Income over the period necessary to match them with the costs they are intended to compensate. When the cash in relation to recognised government, regional or charitable grants is not yet received the amount is included as a receivable on the Consolidated Statement of Financial Position.

Where the grant income is directly related to the specific items of expenditure incurred, the income would be netted against such expenditure. Where the grant income is not a specific reimbursement of expenditure incurred, the Group would include such income under “Other income” in the Consolidated Statement of Comprehensive Income. Grants or investment credits may be repayable if the Group successfully commercialises a relevant program that was funded in whole or in part by the grant or investment credit within a particular timeframe. Prior to successful commercialisation, the Group would not make any provision for repayment.

2. Accounting policies (continued)

2.15 Financial instruments—initial recognition and subsequent measurement

Initial recognition

The Company classifies a financial instrument, or its component parts as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument.

The Company evaluates the terms of the financial instrument to determine whether it contains an asset, a liability or an equity component. Such components shall be classified separately as financial assets, financial liabilities or equity instruments.

A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

(a) Financial assets, initial recognition and measurement

All financial assets, such as receivables and deposits, are recognised initially at fair value plus transaction costs, for all financial assets not recorded at fair value through profit or loss. Financial assets carried at fair value through profit or loss are initially recognised at fair value, and transaction costs are expensed in the income statement.

(b) Financial liabilities, initial recognition and measurement

Financial liabilities are classified, at initial recognition, as financial liabilities at fair value through profit or loss, loans and borrowings, or payables, as appropriate. All financial liabilities are recognised initially at fair value and, in the case of loans and borrowings and payables, net of directly attributable transaction costs.

The Group's financial liabilities include trade and other payables and derivative financial instruments.

(c) Subsequent measurement

The measurement of financial assets and financial liabilities depends on their classification.

Financial liabilities at fair value through profit or loss include financial liabilities held for trading and financial liabilities designated upon initial recognition as at fair value through profit or loss. These are subsequently measured at fair value with any gains or losses recognised in profit or loss. All other financial liabilities are measured at amortised cost using the effective interest method.

Financial assets such as receivables and deposits are subsequently measured at amortised cost. The Group does not hold any financial assets at fair value through profit or loss or available for sale financial assets.

(d) Derivative financial instruments

Derivatives are initially recognised at fair value on the date a derivative contract is entered into and are subsequently re-measured at fair value at the end of each reporting date. The Company holds only one type of derivative financial instrument, the warrants, as explained in Note 2.16.

The full fair value of the derivative is classified as a non-current asset or liability when the item is more than 12 months and as a current asset or liability when the remaining maturity of the item is less than 12 months.

Changes in fair value of a derivative financial liability when related to a financing arrangement are recognised in the Consolidated Statement of Comprehensive Income within Finance income or Finance expense. Fair value gains or losses on derivatives used for non-financing arrangements are recognised in other operating income or expense.

2. Accounting policies (continued)

2.16 Warrants

Warrants issued by the Company to investors as part of a share subscription are compound financial instruments where the warrant meets the definition of a financial liability. A compound financial instrument is separated into its equity and financial liability component.

The financial liability component is initially measured at fair value in the Consolidated Statement of Financial Position. Equity is measured at the residual between the subscription price for the entire instrument and the liability component. Subsequently the financial liability component is subsequently remeasured depending on its classification. Equity is not subsequently remeasured.

2.17 Transaction costs

Qualifying transaction costs are often incurred in anticipation of an issuance of equity instruments and may cross reporting periods. The entity defers these costs on the balance sheet until the equity instrument is recognised. Deferred costs are subsequently reclassified as a deduction from equity when the equity instruments are recognised, to the extent that the costs are directly attributable to the equity transaction. If the equity instruments are not subsequently issued, the transaction costs are expensed. Any costs not directly attributable to the equity transaction are expensed.

Transaction costs that relate to the issue of a compound financial instrument are allocated to the liability and equity components of the instrument in proportion to the allocation of proceeds. Where the liability component is held at fair value through profit or loss, the transaction costs are expensed to the Consolidated Statement of Comprehensive Income. For liabilities held at amortised cost, transaction costs are deducted from the liability and subsequently amortised. The amount of transaction costs accounted for as a deduction from equity in the period is disclosed separately in accordance with IAS 1.

2.18 Investments in subsidiaries

Investments in subsidiaries are shown at cost less any provision for impairment.

2.19 New standards, amendments and interpretations adopted by the Group

The following amendment has been adopted by the Group for the first time for the financial year beginning on or after 1 January, 2016. It did not materially impact the Group's results:

- Annual Improvements 2014 (2012-2014 cycle)

2.20 New standards, amendments and interpretations issued but not effective for the financial year beginning 1 January, 2016 and not early adopted

A number of new standards and amendments to standards and interpretations have been issued but are not yet effective for annual periods beginning after 1 January, 2017 (noted below), and have not been adopted in preparing these consolidated financial statements.

- IFRS 9 "Financial instruments" (effective for annual periods beginning on or after 1 January, 2018)
- IFRS 15 "Revenue from contracts with customers" (effective for annual periods beginning on or after 1 January, 2018)
- IFRS 16 "Leases" (effective for annual periods beginning on or after 1 January, 2019)

IFRS 9 is not expected to have a material impact on the accounting for the assumed contingent obligation or the derivative financial instrument. IFRS 15 and 16 will have an immaterial impact on the financial statements of the Group as the Group is not currently revenue generating and does not have any leases of over one year.

VERONA PHARMA PLC
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEARS ENDED 31 DECEMBER, 2015 AND 2016

3. Financial Instruments

3.1 Financial Risk Factors

The Group's activities have exposed it to a variety of financial risks: market risk (including currency risk and interest rate risk), credit risk, and liquidity risk. The Group's overall risk management program is focused on preservation of capital and the unpredictability of financial markets and has sought to minimise potential adverse effects on the Group's financial performance and position.

(a) Currency risk

Foreign currency risk reflects the risk that the Group's net assets will be negatively impacted due to fluctuations in exchange rates. The Group has not entered into foreign exchange contracts to hedge against gains or losses from foreign exchange fluctuations. As of 31 December, 2016, cash and cash equivalents included €282 thousand, US \$13,110 thousand, and SEK 20 thousand, and accounts payable and accrued liabilities included balances of €211 thousand and US \$375 thousand.

Foreign currency denominated trade payables are short term in nature (generally 30 to 45 days). The Group has a US-operation, whose net assets are exposed to foreign currency translation risk.

(b) Credit risk

Credit risk reflects the risk that the Group may be unable to recover contractual receivables. The Group is still in the development stage; therefore, no policies are required at this time to mitigate this risk.

For banks and financial institutions, only independently rated parties with a minimum rating of "B+" are accepted. The Directors recognise that this is an area in which they may need to develop specific policies should the Group become exposed to further financial risks as the business develops.

As of 31 December, 2016 and 31 December, 2015, the majority of cash and cash equivalents were placed at the following banks:

	Year ended 31 December, 2015	Credit rating	Year ended 31 December, 2016	Credit rating
	£ thousands		£ thousands	
Banks				
Royal Bank of Scotland.....	63	A3	11,287	A3
Lloyds Bank.....	3,460	A1	28,447	A1
Wells Fargo ⁽¹⁾	1	Aa1	51	Aa2
Total.....	<u>3,524</u>		<u>39,785</u>	

⁽¹⁾ The Wells Fargo account holds the operating account for the Verona Pharma Inc. US operations.

(c) Management of capital

The Group considers capital to be its equity reserves. At the current stage of the Group's life cycle, the Group's objective in managing its capital is to ensure funds raised meet the research and operating requirements until the next development stage of the Group's suite of projects.

The Group ensures it is meeting its objectives by reviewing its Key Performance Indicators ("KPIs") to ensure the research activities are progressing in line with expectations, costs are controlled and unused funds are placed on deposit to conserve resources and increase returns on surplus cash held.

VERONA PHARMA PLC
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEARS ENDED 31 DECEMBER, 2015 AND 2016

3. Financial Instruments (continued)

(d) Interest rate risk

As of 31 December, 2016, the Group had cash deposits of £39,785 thousand (2015: £3,524 thousand). The rates of interest received during 2016 ranged between 0.0% and 0.5%. The Group's exposure to interest rate risk, which is the risk that the interest received will fluctuate as a result of changes in market interest rates on classes of financial assets and financial liabilities, was as follows:

	31 December, 2016	
	Floating interest rate	Fixed Interest rate
	£	£
Financial asset		
Cash deposits	11,338,225	28,446,873

(e) Liquidity risk

The Group prepares periodic working capital forecasts for the foreseeable future, allowing an assessment of the cash requirements of the Group, to manage liquidity risk. The following table provides an analysis of the remaining contractually agreed cash flows for the Group's non-derivative financial liabilities on an undiscounted basis, which therefore differs from both the carrying value and fair value. Balances due within 12 months equal their carrying value balances as the impact of discounting is not significant.

	LESS THAN 1 YEAR	BETWEEN 1 AND 2 YEARS	BETWEEN 2 AND 5 YEARS	OVER 5 YEARS ⁽¹⁾
	£	£	£	£
At 31 December, 2015				
Trade payables	1,108,991	—	—	—
Corporation tax payable – US operation	14,057	—	—	—
Trade payables due to related parties.....	172,955	—	—	—
Other payables	40,907	—	—	—
Total	<u>1,336,910</u>	<u>—</u>	<u>—</u>	<u>—</u>

⁽¹⁾ This table excludes a milestone payment, which may fall due under the assumed contingent obligation, of £5 million and sales based royalties.

	LESS THAN 1 YEAR	BETWEEN 1 AND 2 YEARS	BETWEEN 2 AND 5 YEARS	OVER 5 YEARS ⁽¹⁾
	£	£	£	£
At 31 December, 2016				
Trade payables	592,931	—	—	—
Corporation tax payable – US operation	126,063	—	—	—
Trade payables due to related parties.....	—	—	—	—
Other payables	180,567	—	—	—
Total	<u>899,561</u>	<u>—</u>	<u>—</u>	<u>—</u>

⁽¹⁾ This table excludes a milestone payment which may fall due under the assumed contingent obligation, of £5 million and sales based royalties.

VERONA PHARMA PLC
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEARS ENDED 31 DECEMBER, 2015 AND 2016

3. Financial Instruments (continued)

3.2 Fair value estimation

The carrying amounts of cash and cash equivalents, receivables, accounts payable, accrued liabilities and the assumed contingent obligation, approximate to fair value due to their short-term nature.

For financial instruments that are measured in the Consolidated Statement of Financial Position at fair value, IFRS 7 requires disclosure of fair value measurements by level of the following fair value measurement hierarchy:

- Quoted prices (unadjusted) in active markets for identical assets or liabilities (level 1);
- Inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly or indirectly (level 2); and
- Inputs for the asset or liability that are not based on observable market data (level 3).

For the year ended 31 December, 2016 and 2015 fair value adjustments to financial instruments through profit and loss resulted in the recognition of finance income of £1,068 thousand and £nil respectively.

The fair value of financial instruments that are not traded in an active market is determined by using valuation techniques. These valuation techniques maximise the use of observable market data where it is available and rely as little as possible on entity specific estimates. If all significant inputs required to ascertain the fair value of an instrument are observable, the instrument is included in level 2. If one or more of the significant inputs are not based on observable market data, the instrument is included in level 3. The carrying amount of a financial asset or financial liability is a reasonable approximation of the fair value and therefore information about the fair values of each class has not been disclosed.

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
	£	£	£	£
At 31 December, 2016				
Derivative financial instrument	—	—	7,922,603	7,922,603
Total	—	—	<u>7,922,603</u>	<u>7,922,603</u>

Movements in Level 3 items during the year ended 31 December, 2016 are as follows:

	<u>Derivative financial instrument</u>	<u>Total</u>
	£	£
At 1 January, 2016		
Initial recognition of derivative financial instrument	8,990,794	8,990,794
Fair value adjustments recognised in profit or loss	(1,068,191)	(1,068,191)
At 31 December, 2016	<u>7,922,603</u>	<u>7,922,603</u>

Further details relating to the derivative financial instrument are set out in notes 4 and 22 of these financial statements.

In determining the fair value of the derivative financial instrument the Company applied the Black Scholes model; key inputs include the share price at reporting date, estimations on timelines, volatility and risk-free rates. These assumptions and the impact of changes in these assumptions, where material, are disclosed in note 22.

4. Critical accounting estimates

The preparation of financial statements in conformity with IFRS requires the use of accounting estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of income and expenses during the reporting period. Although these estimates are based on management's best knowledge of current events and actions, actual results ultimately may differ from those estimates. IFRS also requires management to exercise its judgement in the process of applying the Group's accounting policies.

The areas involving a higher degree of judgement or complexity, or areas where assumptions and estimates are significant to the consolidated financial statements are as follows:

(a) Impairment of intangible assets

The Group is required to test goodwill and the IP R&D annually for impairment in accordance with the accounting policy in note 2.9. Goodwill and the IP R&D are tested for impairment at the Group level, which is viewed as a single CGU in accordance with the accounting policy in note 2.9.

The Group determines the recoverable amount of the single CGU and compares it to its carrying amount. Impairment is recognised when the carrying amount exceeds the recoverable amount of the CGU.

Determining the recoverable amount of the CGU, containing goodwill and IP R&D for impairment purposes requires estimation.

Since the Group is a single CGU, the entity measures its recoverable amount with reference to the market capitalisation of the Group, as an indication of the fair value less costs of disposal. Details of the Group's impairment assessment for the CGU containing goodwill and IP R&D are disclosed in notes 16 and 17.

(b) Share-based payments

The Group records charges for share-based payments. For option based share-based payments management estimates certain factors used in the option pricing model, including volatility, vesting date of options and number of options likely to vest. If these estimates vary from actual occurrence, this will impact the value of the equity carried in reserves. Further details of the Group's estimation of share-based payments are disclosed in note 20.

(c) Assumed contingent obligation

The Group has a material obligation for the future payment of royalties and milestones associated with contractual obligations on RPL554, a development product acquired as part of the acquisition of Rhinopharma. The estimation of the fair value of the assumed contingent obligation requires the selection of an appropriate valuation model at the date of acquisition, consideration as to the inputs necessary for the valuation model chosen, the estimation of the likelihood that the regulatory milestone will be achieved and fair value of the future cash flows (for further detail see note 21). The estimates for the assumed contingent obligation are based on a discounted cash flow model. Key assessments and judgements included in the calculation of deferred consideration are:

- development, regulatory and marketing risks associated with progressing the product to market approval in key target territories;
- market size and product acceptance by clinicians, patients and reimbursement bodies;
- gross and net selling price;
- costs of manufacturing, product distribution and marketing support;
- launch of competitive products; and
- discount rate and time to crystallisation of contingent consideration.

In accordance with IAS 39 ("Financial Instruments Recognition and Measurement" (para AG8)), when there is a change in the projected cash flows, the assumed contingent obligation will be remeasured with the change in

VERONA PHARMA PLC
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEARS ENDED 31 DECEMBER, 2015 AND 2016

4. Critical accounting estimates (continued)

value going through the Consolidated Statement of Comprehensive Income. The assumed contingent obligation is measured at amortised cost with the discount unwinding in the Consolidated Statement of Comprehensive Income throughout the year. Actual outcomes could differ significantly from the estimates made.

The value of the assumed contingent obligation as of 31 December, 2016 amounts to £802 thousand. (2015: £594 thousand. The increase in value of the assumed contingent obligation during 2016 amounted to £208 thousand (2015: £72 thousand) and was recorded as finance expense. Periodic remeasurement is triggered by changes in updated timelines of achieving commercialisation and updated probabilities of success resulting from clinical programmes. The discount percentage applied is 12 %.

(d) Valuation of the July 2016 warrants

The fair value is determined by applying the Black-Scholes valuation model and requires several assumptions and estimates as disclosed in note 4(d) and 22.

Pursuant to the July Placement, the Company issued 1,555,796,345 units to new and existing investors at the placing price of 2.8730p per unit. Each unit comprises one placing share and one warrant. The warrants entitle the investors to subscribe for in aggregate a maximum of 622,318,538 shares.

In accordance with IAS 32 and Company accounting policy as disclosed in note 2.17, the Company classified the warrants as a derivative financial liability to be presented on the Company's Consolidated Statement of Financial Position.

The fair value of these warrants is determined by applying the Black-Scholes model. Assumptions are made on inputs such as time to maturity, the share price, volatility and risk free rate, in order to determine the fair value per warrant. For further details please see note 22.

Transaction costs arising on the issues of these shares and warrants are allocated to the equity and warrant liability components in proportion to the allocation of proceeds.

5. Earnings per share

Basic loss per share of 0.30p (2015: 0.74p) for the Group is calculated by dividing the loss for the year ended 31 December, 2016 by the weighted average number of ordinary shares in issue of 1,674,970,686 as of 31 December, 2016 (2015: 1,009,923,481). Potential ordinary shares are not treated as dilutive as the entity is loss making and such shares would be anti-dilutive.

After giving effect to the 50-for-1 consolidation of shares (as described in Note 1) the above numbers would read as follows: Basic loss per share of 14.98p (2015: 37.10p) for the Group is calculated by dividing the loss for the year ended 31 December, 2016 by the weighted average number of ordinary shares in issue of 33,499,413 as of 31 December, 2016 (2015: 20,198,469).

6. Segmental reporting

During 2016, there has been a change to management's assessment of the operating and reporting segments of the Group and how the Chief Operating Decision Maker reviews management information. Management has concluded that the Group's activities now consist of one operating and reportable segment: Drug development. Previously management had two reporting segments: Clinical research for RPL554 and Basic research, which contained VRP700 and NAIP. During the year ended 31 December, 2015, the Group abandoned the development of the product candidates VRP700 and NAIP. As a consequence, management information is only prepared and reviewed for RPL554, resulting in a single operating and reportable segment.

All non-current assets are based in the United Kingdom.

VERONA PHARMA PLC
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEARS ENDED 31 DECEMBER, 2015 AND 2016

7. Operating loss

Group	Year ended 31 December, 2015	Year ended 31 December, 2016
	£	£
<i>Operating Loss is stated after charging:</i>		
Research and development costs:		
Employee benefits (note 8)	1,322,109	2,036,505
Amortisation of patents (note 16)	43,262	50,972
Loss on disposal of patents (note 16).....	134,532	8
Other research and development expenses	5,768,944	2,434,335
Total research and development costs	<u>7,268,847</u>	<u>4,521,820</u>
General and administrative costs:		
Employee benefits (note 8)	624,821	865,250
Legal and professional fees.....	608,447	884,040
Amortisation of computer software (note 16).....	166	599
Loss on disposal of property, plant and equipment (note 15).....	-	2,625
Depreciation of property, plant and equipment (note 15).....	9,689	10,051
Operating lease charge — land and buildings.....	156,632	168,763
Loss on variations in foreign exchange rate.....	20,732	139,091
Other general and administrative expenses.....	285,457	427,930
Total general and administrative costs.....	<u>1,705,944</u>	<u>2,498,349</u>
Operating loss	<u>8,974,791</u>	<u>7,020,169</u>

During the periods indicated, the Group obtained the services from and paid the fees of the Group's auditors and their associates as detailed below:

	Year ended 31 December, 2015	Year ended 31 December, 2016
	£	£
Audit of Verona Pharma plc and consolidated financial statements	25,000	80,000
Audit related services.....	—	525,000
IT services review.....	9,972	—
Total	<u>34,972</u>	<u>605,000</u>

For the year ended 31 December, 2016, audit related services include assurance reporting on historical financial information included in the Company's U.S. initial public offering registration statement that was confidentially filed with the U.S. Securities and Exchange Commission on November 23, 2016. As per 31 December, 2016 an amount of £466 thousand in relation to these services was booked in deferred IPO costs as they will be offset against share premium on completion of the plans to conduct a registered initial public offering in the United States (the "Global Offering") (see note 12).

VERONA PHARMA PLC
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEARS ENDED 31 DECEMBER, 2015 AND 2016

8. Directors' emoluments and staff costs

Group	Year ended 31 December, 2015	Year ended 31 December, 2016
The monthly average number of employees of the Group during the year:		
Research and Development	5	5
General and Administrative	3	2
Total.....	<u>8</u>	<u>7</u>

	Year ended 31 December, 2015	Year ended 31 December, 2016
	£	£
Aggregate emoluments of directors:		
Salaries and other short-term employee benefits	854,012	1,068,529
Incremental payment for additional services	89,051	44,000
Pension costs.....	<u>37,989</u>	<u>18,882</u>
Total directors' emoluments	981,052	1,131,411
Share-based payment charge	231,790	256,615
Directors' emoluments including share-based payment charge	<u>1,212,842</u>	<u>1,388,026</u>

	Year ended 31 December, 2015	Year ended 31 December, 2016
	£	£
Aggregate other staff costs:		
Wages and salaries.....	539,802	1,027,339
Social security costs.....	41,966	97,827
Incremental payment for additional services	-	57,917
Share-based payment charge	137,393	319,278
Pension costs.....	<u>14,927</u>	<u>11,368</u>
Total other staff costs	<u>734,088</u>	<u>1,513,729</u>

The Group operates a defined contribution pension scheme for U.K. employees and executive directors. The total pension cost during the year ended 31 December, 2016 was £30 thousand (2015: £53 thousand). There were no prepaid or accrued contributions to the scheme at 31 December, 2016.

VERONA PHARMA PLC
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEARS ENDED 31 DECEMBER, 2015 AND 2016

9. Finance income and expense

Group	Year ended 31 December, 2015	Year ended 31 December, 2016
	£	£
Finance income:		
Interest received on cash balances.....	44,791	86,542
Foreign exchange gain on translating foreign currency denominated bank balances	-	686,549
Fair value adjustment on derivative financial instruments (note 22)	-	1,068,191
Total finance income	44,791	1,841,282
	£	£
Finance expense:		
Transaction costs allocated to the issue of warrants (note 22)	-	585,425
Remeasurement of assumed contingent arrangement (note 21)	9,239	123,554
Unwinding of discount factor related to the assumed contingent arrangement (note 21)	63,052	84,711
Total finance expense	72,291	793,690

10. Investment in subsidiaries

The Company currently has two wholly owned subsidiaries, Rhinopharma Limited and Verona Pharma Inc.

	2015	2016
	£	£
Net book amount:		
At the start of the year	2	79,593
Capital contribution arising from share-based payments	79,591	162,964
Net book amount at the end of year	79,593	242,557

A capital contribution arises where share-based payments are provided to employees of subsidiary undertakings settled with equity to be issued by the Company.

The Company's investments comprise interests in Group undertakings, details of which are shown below:

<i>Name of undertaking</i>	<i>Verona Pharma Inc.</i>	<i>Rhinopharma Limited</i>
Country of incorporation	Delaware USA	British Columbia Canada
Description of shares held	\$0.001 Common stock	Without Par Value Common shares
Proportion of shares held by the Company	100%	100%

VERONA PHARMA PLC
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEARS ENDED 31 DECEMBER, 2015 AND 2016

10. Investment in subsidiaries (continued)

Verona Pharma Inc. was incorporated on the 12 December 2014 under the laws of the State of Delaware, USA and has its registered office at 2711 Centerville Road, Suite 400, City of Wilmington 19808, County of New Castle, Delaware, United States of America.

Rhinopharma Limited is incorporated under the laws of the Province of British Columbia, Canada and has its registered office at Suite 700, 625 Howe Street, Vancouver, British Columbia, Canada V6C 2T6. Rhinopharma Limited was a drug discovery and development company focused on developing proprietary drugs to treat allergic rhinitis and other respiratory diseases prior to its acquisition by the Company on 18 September 2006.

11. Taxation

Group	Year ended 31 December, 2015	Year ended 31 December, 2016
	£	£
Analysis of tax credit for the year		
Current tax:		
UK and US tax	(1,520,732)	(937,772)
Adjustment in respect of prior periods	11,284	(16,412)
Total tax credit	<u>(1,509,448)</u>	<u>(954,184)</u>
Factors affecting the tax charge for the year		
Loss on ordinary activities.....	<u>(9,002,291)</u>	<u>(5,972,577)</u>
Multiplied by standard rate of corporation tax of 20% (2015: 20.25%).....	(1,822,964)	(1,194,515)
Effects of:		
Non-deductible expenses.....	113,529	78,489
Research and development incentive.....	(599,368)	(427,304)
Timing differences not recognised	(1,880)	(4,131)
Difference in overseas tax rates	-	55,581
Tax losses carried forward not recognised	789,951	554,108
	<u>(1,520,732)</u>	<u>(937,772)</u>
Adjustment in respect of prior periods	11,284	(16,412)
Total tax credit	<u>(1,509,448)</u>	<u>(954,184)</u>

UK corporation tax is charged at 20% (2015: 20.25%) and US federal tax at 35% (2015: 35%).

VERONA PHARMA PLC
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEARS ENDED 31 DECEMBER, 2015 AND 2016

11. Taxation (continued)

Deferred tax

The following tables represent deferred tax balances recognised in the Consolidated Statement of Financial Position and the Company Statement of Financial Position, and the movements in both the deferred tax asset and the deferred tax liability.

	Year ended 31 December, 2015	Year ended 31 December, 2016
	£	£
Deferred tax assets.....	265,000	249,749
Deferred tax liabilities.....	(265,000)	(249,749)
Net balances.....	<u>-</u>	<u>-</u>
	£	£
Movements on the deferred tax asset		
1 January.....	294,000	265,000
Impact of rate changes.....	(29,000)	(15,251)
31 December.....	<u>265,000</u>	<u>249,749</u>
	£	£
Movements on the deferred tax liability		
1 January.....	(294,000)	(265,000)
Impact of rate changes.....	29,000	15,251
31 December.....	<u>(265,000)</u>	<u>(249,749)</u>

Factors that may affect future tax charges

The Group and Company have UK tax losses available for offset against future profits in the UK. However, an additional deferred tax asset has not been recognised in respect of such items due to uncertainty of future profit streams. As of 31 December, 2016, the unrecognised deferred tax asset at 17% is estimated to be £3,149 thousand (2015: £2,819 thousand at 18%).

VERONA PHARMA PLC
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEARS ENDED 31 DECEMBER, 2015 AND 2016

12. Prepayments and other receivables

Group	As of 31 December, 2015	As of 31 December, 2016
	£	£
Prepayments and accrued income	196,313	1,360,812
Deferred IPO costs.....	-	1,526,829
Other receivables	316,987	70,946
Total prepayments and other receivables	<u>513,300</u>	<u>2,958,587</u>

Deferred IPO costs relate to the Global Offering. These costs will be offset against share premium in the period in which the Global Offering is completed.

The prepayments balance includes prepayments for insurance and clinical activities.

Company	As of 31 December, 2015	As of 31 December, 2016
	£	£
Prepayments and accrued income	196,313	1,354,959
Deferred IPO costs.....	-	1,526,829
Other receivables	316,987	70,918
Amounts due from group undertakings	529	652
Total prepayments and other receivables	<u>513,829</u>	<u>2,953,358</u>

There are no impaired assets within prepayments and other receivables. Amounts due from group undertakings are unsecured, interest free and have no fixed date of repayment.

13. Cash and cash equivalents

Group	As of 31 December, 2015	As of 31 December, 2016
	£	£
Cash at bank and in hand.....	<u>3,524,387</u>	<u>39,785,098</u>

Company	As of 31 December, 2015	As of 31 December, 2016
	£	£
Cash at bank and in hand.....	<u>3,523,140</u>	<u>39,733,658</u>

The increase in cash during 2016 resulted from the July Placement.

VERONA PHARMA PLC
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEARS ENDED 31 DECEMBER, 2015 AND 2016

14. Trade and other payables

Group	As of 31 December, 2015	As of 31 December, 2016
	£	£
Trade payables	1,108,991	718,994
Trade payables due to related parties.....	172,955	-
Other payables	40,907	54,504
Accruals	475,829	2,049,991
Total trade and other payables	1,798,682	2,823,489

As of 31 December, 2016 accruals include £890 thousand related to expenses associated with the Global Offering.

Company	As of 31 December, 2015	As of 31 December, 2016
	£	£
Trade payables	1,108,991	718,994
Trade payables due to related parties.....	172,955	-
Other payables	32,328	53,718
Amounts due to group undertakings.....	135,900	462,131
Accruals	467,732	1,915,542
Total trade and other payables	1,917,906	3,150,385

Amounts due to Group undertakings are not interest bearing and have no fixed repayment date.

VERONA PHARMA PLC
 NOTES TO THE FINANCIAL STATEMENTS
 FOR THE YEARS ENDED 31 DECEMBER, 2015 AND 2016

15. Property, plant and equipment

Group and Company	Computer hardware	Office equipment	Total
	£	£	£
Cost			
At 1 January, 2015.....	41,302	36,461	77,763
Additions	1,193	—	1,193
At 31 December, 2015.....	<u>42,495</u>	<u>36,461</u>	<u>78,956</u>
Accumulated depreciation			
At 1 January, 2015.....	35,890	20,214	56,104
Charge for the year	2,664	7,025	9,689
At 31 December, 2015.....	<u>38,554</u>	<u>27,239</u>	<u>65,793</u>
Net book value			
At 31 December, 2015.....	<u>3,941</u>	<u>9,222</u>	<u>13,163</u>
	Computer hardware	Office equipment	Total
	£	£	£
Cost			
At 1 January, 2016.....	42,495	36,461	78,956
Additions	13,351	—	13,351
Disposals.....	(38,845)	(36,461)	(75,306)
At 31 December, 2016.....	<u>17,001</u>	<u>—</u>	<u>17,001</u>
Accumulated depreciation			
At 1 January, 2016.....	38,554	27,239	65,793
Charge for the year	3,027	7,024	10,051
Disposals.....	(38,418)	(34,263)	(72,681)
At 31 December, 2016.....	<u>3,163</u>	<u>—</u>	<u>3,163</u>
Net book value			
At 31 December, 2016.....	<u>13,838</u>	<u>—</u>	<u>13,838</u>

VERONA PHARMA PLC
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEARS ENDED 31 DECEMBER, 2015 AND 2016

16. Intangible assets

Group and Company	IP R&D	Computer software	Patents	Total
	£	£	£	£
Cost				
At 1 January, 2015.....	1,469,112	23,934	515,569	2,008,615
Additions	—	637	141,239	141,876
Disposal	—	—	(174,944)	(174,944)
At 31 December, 2015.....	<u>1,469,112</u>	<u>24,571</u>	<u>481,864</u>	<u>1,975,547</u>
Accumulated amortisation				
At 1 January, 2015.....	—	23,746	135,029	158,775
Charge for year	—	166	43,262	43,428
Disposal	—	—	(40,412)	(40,412)
At 31 December, 2015.....	<u>—</u>	<u>23,912</u>	<u>137,879</u>	<u>161,791</u>
Net book value				
At 31 December, 2015.....	<u>1,469,112</u>	<u>659</u>	<u>343,985</u>	<u>1,813,756</u>
	IP R&D	Computer software	Patents	Total
	£	£	£	£
Cost				
At 1 January, 2016.....	1,469,112	24,571	481,864	1,975,547
Additions	—	4,750	109,757	114,507
Disposal	—	(23,982)	—	(23,982)
At 31 December, 2016.....	<u>1,469,112</u>	<u>5,339</u>	<u>591,621</u>	<u>2,066,072</u>
Accumulated amortisation				
At 1 January, 2016.....	—	23,912	137,879	161,791
Charge for year	—	599	50,972	51,571
Disposal	—	(23,974)	—	(23,974)
At 31 December, 2016.....	<u>—</u>	<u>537</u>	<u>188,851</u>	<u>189,388</u>
Net book value				
At 31 December, 2016.....	<u>1,469,112</u>	<u>4,802</u>	<u>402,770</u>	<u>1,876,684</u>

Intangible assets comprise patents, computer software and an IP R&D asset that arose on the acquisition of Rhinopharma and investment in patents to protect RPL554.

IP R&D is currently not amortised and is reviewed for impairment on an annual basis or where there is an indication that the assets might be impaired until the asset is brought into use.

Patents are amortised over a period of ten years and are regularly reviewed for impairment to ensure the carrying amount exceeds the recoverable amount in accordance with note 2.9.

Recognising that the Group is still in pre-revenue phase and that the research projects are not yet ready for commercial use, the Group assesses the recoverable amount of the CGU containing the IP R&D with reference to the Group's market capitalisation as of 31 December, 2016, the date of testing of goodwill impairment. The market capitalisation of the Group was approximately £80 million as of 31 December, 2016, compared to the Group's net assets of £34.5 million. Therefore, no impairment was recognised.

VERONA PHARMA PLC
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEARS ENDED 31 DECEMBER, 2015 AND 2016

17. Goodwill

Group and Company	As of 31 December, 2015	As of 31 December, 2016
	£	£
Goodwill at 1 January and 31 December.....	<u>441,000</u>	<u>441,000</u>

Goodwill represents the excess of the purchase price over the book value of the net assets acquired in connection with the acquisition of Rhinopharma Limited in September 2006.

Recognising that the Group is still in pre-revenue phase and that the research projects are not yet ready for commercial use, management assesses the recoverable amount of such goodwill with reference to Verona's market capitalisation. As at 31 December 2016 this was several times the carrying value of goodwill. Accordingly, management believes it is appropriate to carry goodwill at full historical value.

Goodwill is not amortised, but is tested annually for impairment. Annual impairment testing is performed by comparing the expected recoverable amount of the CGU to the carrying amount of the CGU to which goodwill has been allocated to the carrying amount of the CGU. See notes 2.9, 4 and 16 to these financial statements.

18. Share Capital

The movements in the Company's share capital are summarised below:

<i>Date</i>	<i>Description</i>	<i>Number of shares</i>	<i>Share Capital amounts in £</i>
1 January, 2015	Brought forward	<u>1,009,923,481</u>	<u>1,009,923</u>
31 December, 2015.....		1,009,923,481	1,009,923
July 29, 2016	Issuance of shares	1,555,796,345	1,555,796
September 12, 2016.....	Exercise of options	166,667	167
October 24, 2016.....	Exercise of options	166,667	167
December 28, 2016.....	Exercise of options	<u>2,000,000</u>	<u>2,000</u>
31 December, 2016.....		<u>2,568,053,160</u>	<u>2,568,053</u>

The total number of authorised ordinary shares, with a nominal value of 0.1p each, is 10,000,000,000 (share capital of £10,000,000). All 2,568,053,160 ordinary shares at 31 December, 2016 are allotted, unrestricted, called up and fully paid.

On July 29, 2016, the Company issued 1,555,796,345 units to new and existing investors at the placing price of 2.8730p per unit. Each unit comprises one ordinary share and one warrant (with an entitlement to subscribe for 0.4 of an ordinary share at a per share exercise price of 120% of the placing price or 3.4476p). The warrants entitle the investors to subscribe for in aggregate a maximum of 622,318,538 shares. The gross proceeds received of £44.7 million were in exchange for both ordinary shares and the warrants. During 2016, the Company issued 2,333,334 ordinary shares (2015: nil) upon exercise of employee share options.

19. Related parties transactions

The Company entered into relationship agreements with Vivo Capital Fund VIII ("Vivo Capital"), Orbimed Private Investments VI L.P. ("Orbimed"), Abingworth Bioventures VI L.P. ("Abingworth") and Arix Bioscience plc ("Arix"), Arthurian Life Sciences SPV GP Limited, ("Arthurian"). As agreed in these relationship agreements, the above parties invested in the Company as part of the July Placement, and the Company agreed to appoint representatives designated by Vivo Capital, OrbiMed, Arix and Arthurian, and Abingworth to the board of directors, who are Dr. Mahendra Shah, Mr. Rishi Gupta, Dr. Ken Cunningham and Dr. Andrew Sinclair, respectively.

VERONA PHARMA PLC
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEARS ENDED 31 DECEMBER, 2015 AND 2016

19. Related parties transactions (continued)

These agreements will continue in effect after the Company's intended NASDAQ listing, except that the appointment rights within the relationship agreement with Arix and Arthurian will be terminated prior to the closing of that offering. The respective appointment rights under the remaining relationship agreements will automatically terminate upon (i) Vivo Capital, OrbiMed or Abingworth (or any of their associates), as applicable, ceasing to beneficially hold 6.5% of the issued ordinary shares, or (ii) the ordinary shares ceasing to be admitted to AIM.

The Company also has a management rights agreement with Novo A/S under which Novo A/S is entitled to appoint an observer to the Board until the earlier to occur of the Company's intended NASDAQ listing or a sale by Novo A/S of 50% of its shares in the Company.

The Company entered into a shareholder agreement with the Wales Life Sciences Investment Fund ("WLSIF") in connection with the March 2014 financing under which the Company has certain obligations to the WLSIF, including the obligation to maintain the registered office in Wales and to carry out certain other activities in Wales.

For the year ended 31 December, 2015, the Company and Group were charged £2,376 thousand by Simbec-Orion in respect of clinical and pre-clinical support and research services, a group of which Prof. Trevor Jones is a Director. As of 31 December, 2015, the Company owed £173 thousand to this related party. Prof. Trevor Jones was a Director of the Company until September 2015. During 2016, there were no transactions with Simbec-Orion or any other related parties. As of 31 December, 2016, there were no outstanding balances to related parties.

The Directors have authority and responsibility for planning, directing and controlling the activities of the Group and they therefore comprise key management personnel as defined by IAS 24, ("Related Party Disclosures"). Remuneration of Directors and senior management is disclosed in the Directors' emoluments report in note 8.

20. Share-based payments charge

Group and Company

In accordance with IFRS 2 "Share Based Payments," the cost of equity-settled transactions is measured by reference to their fair value at the date at which they are granted. Where equity-settled transactions were entered into with third party service providers, fair value is determined by reference to the value of the services provided. For other equity-settled transactions fair value is determined using the Black-Scholes model. The cost of equity-settled transactions is recognised over the period until the award vests. No expense is recognised for awards that do not ultimately vest. At each reporting date, the cumulative expense recognised for equity-based transactions reflects the extent to which the vesting period has expired and the number of awards that, in the opinion of the Directors at that date, will ultimately vest.

The costs of equity-settled share-based payments to employees are recognised in the Statement of Comprehensive Loss, together with a corresponding increase in equity during the vesting period. During the twelve months ended 31 December, 2016, the Group recognised a share-based payment expense of £576 thousand (2015: £399 thousand). The charge is included within both general and administrative costs as well as in research and development costs and represents the current year's allocation of the expense for relevant share options.

The Company grants share options under an Unapproved Share Option Scheme (the "Unapproved Scheme") and under its tax efficient EMI Option Scheme (the "EMI Scheme"). Under the Unapproved Scheme, options are granted to employees, directors and consultants to acquire shares at a price to be determined by the Directors which is typically set at a price that is above the share price at the date of the grant. In general, options are granted at a premium to the share price at the date of grant and vest over a period of three years from the date of the grant in two different methods. The first method is with one half vesting over 24 months and the other half vesting over 36 months. The second method is one third vesting over one year, the second third vesting over two years and the final third vesting over three years. The vesting period is defined as the period between the date of grant and the date when the options become exercisable. The options are exercisable during a period

VERONA PHARMA PLC
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEARS ENDED 31 DECEMBER, 2015 AND 2016

20. Share-based payments charge (continued)

ending ten years after the date of grant. Options also are issued to advisors under the Unapproved Scheme. Such options generally vest immediately and are exercisable between one and two years after grant. Under the EMI Scheme, options are granted to employees and directors who are contracted to work at least 25 hours a week for the Company or for at least 75% of their working time. The options granted under the EMI Scheme are exercisable at a price that is above the share price at the date of the grant and in accordance with a vesting schedule determined by the Directors at the time of grant and have an exercise period of ten years from the date of grant.

In the year ended 31 December, 2016, the Company granted 1,600,000 (2015: 5,100,000) share options under the EMI Scheme and 83,500,000 (2015: 27,500,000) share options under the Unapproved Scheme. The total fair values were estimated either by reference to the fair value of the services provided in respect of equity-settled transactions that were entered into with third-party service providers, or using the Black-Scholes option-pricing model for other equity-settled transactions and amounted to £1,927 thousand (2015: £371 thousand). The cost is amortised over the vesting period of the options on a straight-line basis. The expense for the Company during 2016 amounted to £413 thousand and the balance of £163 thousand is in relation to Verona Pharma Inc. and is held as an investment.

Prior to the July Placement, management determined to take an option's contractual maximum life as an input into the Black-Scholes option-pricing model. Starting from the July Placement and in line with the continued development of the Company's clinical trials, the Company determined the time to maturity to be used in the valuation model to be better represented by the weighted-average life of the options granted.

The following assumptions were used for the Black-Scholes valuation of share options granted in 2015 and 2016. For the options granted under the Unapproved Scheme the table indicates the ranges used in determining the fair-market values, aligning with the various dates of the underlying grants. The volatility is calculated using historic weekly averages of the Company's share price over a period that is in line with the expected life of the options.

	EMI Scheme Employees	Unapproved Scheme Employees
Issued in 2015		
Options granted.....	5,100,000	27,500,000
Risk-free interest rate.....	1.42%	1.42%
Expected life of options.....	10 years	10 years
Annualised volatility.....	76.5%	76.5%
Dividend rate	0.00%	0.00%
Issued in 2016		
Options granted.....	1,600,000	83,500,000
Risk-free interest rate.....	1.42%	0.23% - 1.42%
Expected life of options.....	10 years	5.5 - 10 years
Annualised volatility.....	88.0%	74.3% - 88.0%
Dividend rate	0.00%	0.00%

VERONA PHARMA PLC
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEARS ENDED 31 DECEMBER, 2015 AND 2016

20. Share-based payments charge (continued)

The Company had the following share options movements in the year ended 31 December, 2016:

Year of issue	Exercise price (p)	At 1 January, 2016	Options granted	Options exercised	Options forfeited	Options expired	At 31 December, 2016	Expiry date
2006	5	8,000,000	—	—	—	(8,000,000)	—	September 18, 2016*
2012	5 -15	5,000,000	—	—	—	—	5,000,000	June 1, 2022
2013	4.8	5,000,000	—	—	—	(5,000,000)	—	January 31, 2016**
2013	4	5,000,000	—	—	—	—	5,000,000	April 15, 2023
2013	4	1,000,000	—	—	—	—	1,000,000	June 1, 2023***
2013	4	8,000,000	—	—	—	—	8,000,000	July 29, 2023
2014	3.5	5,500,000	—	—	—	—	5,500,000	May 15, 2024
2014	3.5	3,500,000	—	—	(333,333)	—	3,166,667	May 15, 2024****
2014	2.2	6,000,000	—	(2,000,000)	(4,000,000)	—	—	September 26, 2024****
2014	2.2 – 3.5	10,000,000	—	—	—	—	10,000,000	August 6, 2018****
2015	2.5	5,100,000	—	(333,334)	(666,666)	—	4,100,000	January 29, 2025****
2015	2.5	27,500,000	—	—	(2,000,000)	—	25,500,000	January 29, 2025
2016	4	—	13,000,000	—	—	—	13,000,000	February 2, 2026
2016	4	—	1,600,000	—	(500,000)	—	1,100,000	February 2, 2026***
2016	3.6	—	40,500,000	—	—	—	40,500,000	August 3, 2026
2016	3.78	—	15,000,000	—	—	—	15,000,000	September 13, 2026
2016	4.08	—	15,000,000	—	—	—	15,000,000	September 16, 2026
Total		89,600,000	85,100,000	(2,333,334)	(7,4999,999)	(13,000,000)	151,866,667	

* 10,000,000 directors' options with an expiry date on September 18, 2011 were extended for five years to September 18, 2016 (2,000,000 of these options expired during 2015)

** Options granted to agents upon closing of a placing or financing facility.

*** Options granted under the EMI Scheme.

**** Valued based on fair value of services received.

The average fair value in p at grant date, by year of grant and plan, of the exercisable options as per 31 December, 2016 is presented in the below table.

Year of issue	EMI Scheme	Unapproved Scheme
2012	1.27 -2.40	-
2013	1.66	1.57 - 1.91
2014	1.53	0.47 – 1.53
2015	1.14	1.14
2016	2.70	1.86 – 2.70

Outstanding and exercisable share options by scheme as of 31 December, 2016:

Plan	Outstanding	Exercisable	Weighted average exercise price in p for Outstanding	Weighted average exercise price in p for Exercisable
Unapproved	139,500,000	30,833,335	3.55	3.29
EMI	12,366,667	9,033,336	5.80	6.74
Total	151,866,667	39,866,671	3.73	4.08

VERONA PHARMA PLC
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEARS ENDED 31 DECEMBER, 2015 AND 2016

20. Share-based payments charge (continued)

The options outstanding at 31 December, 2016 had a weighted average remaining contractual life of 8.2 years (2015: 6.6 years). For 2015 and 2016, the number of options granted and expired and the weighted average exercise price of options were as follows:

	Number of options	Weighted average exercise price (p)
At 1 January, 2015	<u>60,155,717</u>	4.2
Options granted in 2015:		
Employees	15,600,000	2.5
Directors	17,000,000	2.5
Options expired in the year	<u>(3,155,717)</u>	5.4
At 31 December, 2015	<u>89,600,000</u>	3.6
Exercisable at 31 December, 2015	<u>42,333,338</u>	4.5

	Number of options	Weighted average exercise price (p)
At 1 January, 2016	<u>89,600,000</u>	3.6
Options granted in 2016:		
Employees	50,100,000	3.8
Directors	35,000,000	4.1
Options exercised in the year	(2,333,334)	2.2
Options forfeited in the year	(7,499,999)	2.5
Options expired in the year	<u>(13,000,000)</u>	4.9
At 31 December, 2016	<u>151,866,667</u>	3.7
Exercisable at 31 December, 2016	<u>39,866,671</u>	4.1

21. Assumed contingent obligation related to the business combination

Group and Company

The value of the assumed contingent obligation as of 31 December, 2016 amounts to £802 thousand (2015: £594 thousand). The increase in value of the assumed contingent obligation during 2016 amounted to £208 thousand (2015: 72 thousand) and was recorded as finance expense. Periodic remeasurement is triggered by changes in updated timelines of achieving commercialisation and updated probabilities of success resulting from clinical programmes. In 2016 remeasurement was triggered by the success of the results of the Company's phase IIa trials which were presented in March 2016. The discount percentage applied is 12%.

	2015 £	2016 £
1 January, 2016.....	521,650	593,941
Re-measurement of assumed contingent obligation.....	9,239	123,554
Unwinding of discount factor.....	63,052	84,710
31 December, 2016.....	<u>593,941</u>	<u>802,205</u>

VERONA PHARMA PLC
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEARS ENDED 31 DECEMBER, 2015 AND 2016

21. Assumed contingent obligation related to the business combination (continued)

The table below describes the reported change to the value of the liability during 2016 of £208 thousand (2015: £72 thousand) compared to what this number would be following the presented variations to the underlying assumptions:

	2015	2016
Change in value of the assumed contingent obligation, in £ thousand	£72	£208
1% lower discount rate %	£73	£216
1% higher discount rate %	£71	£201
10% lower revenue assumption	£69	£202
10% higher revenue assumption	£75	£215
1% lower risk assumption	£70	£216
1% higher risk assumption	£75	£201

22. Warrants

Group and Company

Pursuant to the July Placement the Company has issued 1,555,796,345 units to new and existing investors at the placing price of 2.8730p per unit. Each unit comprises one ordinary share and one warrant.

The warrant holders can subscribe for 0.4 of an ordinary share at a per share exercise price of 120% of the placing price or 3.4476p. The warrant holders can opt for a cashless exercise of their warrants. The warrant holders can choose to exchange the warrants held for reduced number of warrants exercisable at nil consideration. The reduced number of warrants is calculated based on a formula considering the share price and the exercise price of the shares. The warrants were therefore classified as a derivative financial liability, since their exercise might result into a variable number of shares to be issued.

The warrants entitle the investors to subscribe for in aggregate a maximum of 622,318,538 shares. The warrants can be exercised on the earlier of the Company's planned Global Offering or the first anniversary of the grant, and the exercise period shall end on the fifth anniversary of such date.

The ordinary share and warrant were accounted for as a compound financial instrument. The warrants component of the instrument issued at the July Placement were classified as a derivative financial liability and were initially measured at fair value of £8,991 thousand. The residual amount of proceeds totalling £35,707,235 has been recognised within equity. Subsequently the financial liability was re-measured at the reporting date at fair value through profit or loss. A change in fair value of £1,068 thousand is recognised in the Consolidated Statement of Comprehensive Income within Finance income.

The residual value of the proceeds less the fair value of the financial instrument of £8,991 thousand was attributed to the equity component of the instrument.

The total of transaction costs the Company incurred for the above transactions amounted to £2,910 thousand of which £585 thousand was allocated to the warrants and the remaining £2,325 thousand has been presented as a reduction to share premium, by reference to the proceeds allocated to each component. The amount assigned to the financial liability of the warrants was subsequently presented as finance expense in the Consolidated Statement of Comprehensive Income.

VERONA PHARMA PLC
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEARS ENDED 31 DECEMBER, 2015 AND 2016

22. Warrants (continued)

The table below presents the assumptions in applying the Black-Scholes model to determine the fair value of the warrants at date of recognition and the reporting date of 31 December, 2016. For valuation purposes at recognition the Company used the closing share price on July 29, 2016.

Issued in 2016

	At recognition on July 29, 2016	At 31 December, 2016
Warrants.....	622,318,532	622,318,532
Exercise price	3.4476p	3.4476p
Risk-free interest rate.....	0.039 %	0.088 %
Expected life of options	2.86 years	2.43 years
Annualised volatility.....	82.61%	73.53%
Dividend rate	0.00%	0.00%

As per the reporting date the Company updated the underlying assumptions and calculated a fair value of these warrants amounting to £7,923 thousand. The variance of £1,068 thousand is recorded as finance income in the Consolidated Statement of Comprehensive Income.

	Derivative financial instrument	Total
	£	£
At 1 January, 2016		
Derivative Financial instrument issued following the July Placement	8,990,794	8,990,794
Fair value adjustments recognised in profit or loss.....	(1,068,191)	(1,068,191)
At 31 December, 2016	<u>7,922,603</u>	<u>7,922,603</u>

For the amount recognised at 31 December, 2016, the effect, when some of these underlying parameters would deviate up or down, is presented in the below table.

	Volatility (up / down 10 % pts)	Time to maturity (up / down 6 months)
	£ thousands	£ thousands
Variable up	8,972	8,687
Base case, reported fair value	7,923	7,923
Variable down.....	6,826	7,046

VERONA PHARMA PLC
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEARS ENDED 31 DECEMBER, 2015 AND 2016

23. Financial commitments

As of 31 December, 2016, the Group was committed to making the following payments under non-cancellable operating leases related to its facilities.

	<u>Land and Buildings</u> 2015	<u>Land and Buildings</u> 2016
	£	£
Operating leases which expire:		
Within one year.....	151,240	270,350
Beyond one year	—	—
Total.....	<u>151,240</u>	<u>270,350</u>

As of 31 December, 2016, the Company was committed to making the following payments under non-cancellable operating leases related to its facilities.

	<u>Land and Buildings</u> 2015	<u>Land and Buildings</u> 2016
	£	£
Operating leases which expire:		
Within one year.....	151,240	249,440
Beyond one year	—	—
Total.....	<u>151,240</u>	<u>249,440</u>

24. Loss of the parent company

The Parent has taken advantage of the exemption permitted by Section 408 of the Companies Act 2006 not to present an income statement for the year. The Parent Company's loss for the year was £4,964,487 (2015: loss of £7,514,076), which has been included in the Group's income statement.

25. Control

The Company is not under the control of any individual or group of connected parties.

26. Events after the reporting date

On 8 February, 2017 the board of the Company approved a share consolidation where every 50 existing ordinary shares of £0.001 each shall be consolidated into one ordinary share of £0.05. Prior to the consolidation the total number of issued shares as at 31 December, 2016 would read as a total of 2,568,053,160 shares and after the consolidation this number would read as a total of 51,361,063 shares. Earnings per share information has been retrospectively adjusted to reflect the consolidation as if it had occurred at the beginning of the earliest period presented.