Annual Report 2005

KARO BIO

CONTENT

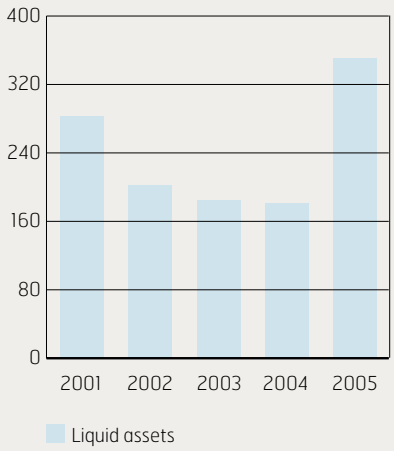
LEGAL DISCLAIMER

This Annual Report includes statements that are forward-looking, and actual results may differ materially from those stated. In addition to the factors discussed, among other factors that may affect results, are developments within research programs including development in preclinical and clinical trials, the impact of competing research programs, the effect of economic conditions, the effectiveness of the Company's intellectual property rights and preclusions of potential third party's intellectual property rights, technological development, exchange rate and interest rate fluctuations, and political risks.

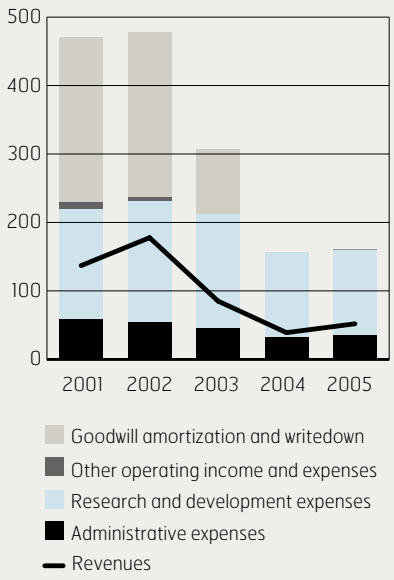
2005 In brief

- Per Olof Wallström was appointed President of Karo Bio in March.
- Karo Bio decided in September to modify its strategy. In addition to the current partnership based model, Karo Bio will bring selected compounds to late stage clinical development.
- Phase I clinical study with KB2115 successfully completed. The goal is to initiate phase II clinical studies in the second half of 2006.
- Clinical and preclinical development organization strengthened with specific competences to increase the chances of being successful in clinical development projects.
- The collaboration with Wyeth Pharmaceuticals was extended in August for an additional year until August 31, 2006.
- Significant milestone from Merck & Co. was triggered in January for initiation of phase I clinical trials. In April, the development was discontinued due to adverse findings in animals. Additional compounds continue to be evaluated in preclinical studies for their potential to advance to clinical study
- Successful new share issue completed in December, generating MSEK 263.4 after transaction costs.
- Net sales amounted to MSEK 51.9 (39.0).
- The loss for the year amounted to MSEK 111.0 (107.3).
- Cash flows from operating activities amounted to MSEK –90.0 (–111.7).
- Cash and bank balances and short-term investments amounted to MSEK 346.9 (181.0) at the end of the year.
- Loss per share amounted to SEK 2.37 (3.41).

LIQUID ASSETS, MSEK



REVENUES AND EXPENSES, MSEK



Introducing Karo Bio

Karo Bio is an innovative drug discovery and development company specializing in nuclear receptors for the development of novel pharmaceuticals. The company has a strong project portfolio primarily targeting metabolic diseases such as diabetes, obesity, atherosclerosis, and dyslipidemia. Karo Bio has expanded from being a drug discovery company by adding in-house preclinical development resources and expertise for drug development. The company also has two strategic collaborations with international pharmaceutical companies for developing innovative therapies for the treatment of common diseases. Karo Bio has been listed on the Stockholm stock exchange since 1998.

Karo Bio's Strategy and Business Model

Karo Bios strategy for developing the company and building shareholder value is to:

Generate new innovative projects through drug discovery on nuclear receptors

Projects

- Karo Bio has a strong project portfolio that includes projects developed in partnership with large international pharmaceutical companies.
- The portfolio also includes in-house projects with lead compounds such as KB2115, a project approaching phase II clinical trials.
- The project portfolio targets some of today's largest unmet clinical needs such as diabetes, obesity, atherosclerosis, and dyslipidemia.
- Karo Bio plans to start phase I and phase II clinical trials with two projects during 2006.

SEE PAGES 10-14

Reduce risk by maintaining a focused project portfolio and building a clinical pipeline

Bring selected projects in niche areas to the market or late stage out-licensing

License out compounds intended for treatment of broad patient populations

Organization

- In 2005 Karo Bio took important steps in its transformation into a pharmaceutical development company.
- The recruitment of Per Olof Wallström as President and recent hiring of vice president of preclinical and clinical development were cornerstones of the new strategy.
- Of the 73 employees, 32 hold doctorate degrees (Ph.D.) and 64 are engaged in research and development.

SEE PAGES 16-17

Dear fellow shareholder

As the president of the company, it is my privilege to address you and review Karo Bio's performance, strategy, and future direction as we sum up 2005. In many respects it was an active year, with some important changes in the strategic direction of the company.

I would like to divide this review as I originally did in early spring 2005 when I accepted the challenge of leading this exciting and promising biotech company:

- Analysis of performance, business model, competition, and strategy.
- Ensuring that the company is properly financed to be able to carry out its priorities.
- Implementation of the agreed strategy.

Karo Bio has a proud and, for a biotech company, reasonably long history. Four times in five years – between 1997 and 2001 – the company signed substantial agreements with four big pharma partners. Each of these commitments is founded on world-class, innovative science.

However, when you do early platform deals with the global pharmaceutical companies, all your intellectual know-how and your future results go into that collaboration, which is subsequently controlled by the pharma partner. With this strategy the challenge is therefore to reinvent the company, time and time agin with the purpose of producing new research deals based on new technology platforms. Karo Bio did this four times, a unique achievement, and-yet at the same time extremely difficult to keep up.

NEW BUSINESS MODEL AND CAPITAL INFUSION

This business model proved difficult to follow in the years to come, and subsequently the market lost faith in Karo Bio's ability to perform. Both the board and the management of the company were convinced that Karo Bio had to change its business model and seek to become more productive and perhaps more open, transparent, even courageous, as a company in order to continue its earlier successes.

In 2005, we outlined a new modified strategy and tested it for logic and potential flaws. In brief, the approach emphasizes holding on to projects longer in the development chain, preferably to proof-of-concept in clinical phase II, and then decide whether to outlicense the actual project, or continue the development to market by ourselves. In my view, all successful, cash flow-positive biotech companies have taken the chance to develop and market a product when the right opportunity appeared. Projects aimed at large target audiences will still be outlicensed. By keeping a project longer, a license deal, however, will be for a specific product, not an entire technology platform.

Hence, productivity in discovery will be aided by the platform and receptor knowledge accumulated as we develop multiple drug candidates for potentially different indications.

After outlining both the strategy and our roadmap for the future, the next phase was clearly to ensure that the owners shared this vision and were willing to finance the company through the next few crucial years. In the financing process that followed in the fall, Karo Bio received full support from all major shareholders. As a result, we raised MSEK 263, which, together with projected income from our existing or new agreements, will finance the development of four projects into clinical phase before the end of 2007. This constitutes a great opportunity for Karo Bio to prove itself in the years to come.

BUILDING AN ORGANIZATION FOR THE FUTURE

The third phase of the transition of Karo Bio from a discovery-oriented organization into an efficient discovery and development company, focusing on specific product opportunities, started immediately as the new strategy took form.

In this transition, both operational management and the ability to lead are crucial. Over the years, Karo Bio has built great expertise in the early phases of drug discovery, but lacked the experience to take projects through preclinical and clinical development, closer to the market.

In order to be efficient as a company, all these aspects of drug development require skilled management leading the way. During the year, we formed three units within R&D; Discovery Research led by Anders Berkenstam; Preclinical Development led by Anneli Hällgren, who joins Karo Bio in March 2006; and Clinical Development, led by Jens Kristensen, who joined us in 2005. I am confident that our new approach will create greater focus in all phases of research, particularly discovery creativeness, productivity, and development discipline, as well as adherence to timelines and budgets.

In the year to come, we will continue to assess our skills and competences, and we may selectively add a few people.

STRONG PROJECT PORTFOLIO AND NEW BUSINESS OPPORTUNITIES

The project portfolio continues to look good, and we are making progress on all fronts. Of course, like all other research and development organizations, we will most likely face snags and difficulties since we are working with innovative, first-in-class compounds in several of our projects. While this may cause us some delay, right now, we believe that the way forward for all on-going projects is manifest, and our drive to fulfill objectives and timelines is strong.

Traditionally Karo Bio has been very focused on making early deals with big pharma. In the new strategy, this is no longer a definite priority. As we develop our projects toward the later stages, closer to the actual market, we may be more flexible in our deal-making strategy. We will be open to risk-sharing agreements where we retain part ownership for projects up until phase II proof-of-concept. These types of deals mainly mitigate risk in the development phase, while the actual value of the project increases until a final outlicensing agreement may be signed.

For projects like KB2115, where we have the opportunity to develop a narrow indication or with a potential orphan drug status, another type of deal is possible. Here, subject to positive phase II proof-of-concept data, the objective would be to continue phase III development in a partnership with a pharma or biotech company based in the United States. In such a process, Karo Bio would plan to retain the European marketing rights and thus decide on the appropriate commercialization of KB2115. For this to be realistic the target audience has to be fairly small and the indication narrow, preferably an orphan.

The third deal option is a traditional big pharma agreement, where the target audience is large and global – requiring huge investments – and the competition is stiff. These sorts of deals may be made at any time in the research and development process.

> We have the skills to drive projects through all phases of development and we are committed to show the results that the market expects from us.

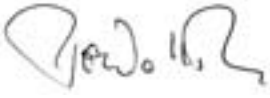
The later-stage focus on product development also gives us a different perspective on actual patients, competition and market potential. All these aspects are important in the development of the drug, as well as in potential deal making. It is my firm belief that Karo Bio's projects have great opportunities from a commercial point of view. With the intended profile, they will be very competitive and have the potential to become major drugs. Our present projects aim at disease areas such as diabetes, depression, and dyslipidemia, which are all large and fast-growing. As the risk /benefit profile is clearly defined, the commercial potential is better understood.

In summary, Karo Bio is in good shape. We have a number of highly promising projects in preclinical and clinical development, all emanating from Karo Bio world-class research. We have the skills to drive projects through all phases of development and we are committed to show the results that the market expects from us.

As importantly, we now have the financial means to develop these projects and ensure that Karo Bio will continue to be an innovative and exciting player in the pharmaceutical arena.

We look forward to an exciting and eventful year.

HUDDINGE FEBRUARY 2006



Per Olof Wallström

Market

Competitors

COMPANY	RECEPTORS
Eli Lilly & Co.	MR, PPAR, ER
F Hoffmann-La Roche Ltd	VDR, Unspecified
Amgen	LXR, PPAR
GlaxoSmithKline Inc.	ER, PPAR, LXR, GR, FXR
Johnson & Johnson	PR, RXR
Merck & Co Inc.	AR, PPAR, GR, ER
Pfizer Inc.	GR
Takeda Pharmaceutical	PPAR
Wyeth Research	ER, PPAR, LXR
AstraZeneca	AR, PPAR, GR
Sanofi-Aventis	ER, GR, PPAR
Astellas	RXR, AR

Source: IDDB June 2005

NUCLEAR RECEPTORS: PROMISING TARGETS IN AN EXPANDING MARKET

Karo Bio is primarily focusing its efforts on development of drugs targeting the metabolic disease area. The metabolic syndrome pharmaceutical market exceeds USD 60 billion (source: Decision Resources International Inc., 2005) and thus constitutes a significant portion of the total pharmaceutical market of USD 400 billion. The metabolic syndrome market, which includes type 2 diabetes, obesity, dyslipidemia, and hypertension, is expected to expand significantly with the growing need for new and improved treatments. Since nuclear receptors are key regulators of metabolism, glucose control, and lipid regulation, Karo Bio expects that the market for drugs acting on these receptors will grow significantly in the future.

MULTIPLE MARKET OPPORTUNITIES

Through its research platform in the field of nuclear receptors, Karo Bio has discovered candidate drugs that target large patient groups in the pharmaceutical market for the treatment of metabolic diseases. In developing the products in the portfolio, which are aimed at a large market, Karo Bio collaborates with pharmaceutical companies that have the capacity and the expertise to develop and launch major pharmaceuticals in a global market. Besides these market segments in the field of metabolic diseases, there are market segments with restricted patient populations that have great medical needs that cannot be treated effectively today. The global pharmaceutical companies primarily target large markets and invest only marginally in development of pharmaceuticals for treatment of more rare diseases. Karo Bio's goal is to independently develop KB2115, a compound in clinical development stage, for a market segment with great medical needs. Karo Bio is considering segments such as small patient groups with genetic dyslipidemia that currently do not effectively respond to existing treatment alternatives.

COMPETITORS

Most of the major pharmaceutical companies have drug discovery projects in the field of nuclear receptors. The table below lists the most important companies and the receptors they target in drug discovery.

In addition to the discovery projects there are numerous compounds in development, mainly targeting PPAR and diabetes. PPAR, a receptor with several sub types, is a target for a number of new type 2 diabetes drugs.

With respect to the targets that Karo Bio has chosen to focus on, the company is in a unique position with development of TR agonists for obesity/dyslipidemia and GR antagonists for type 2 diabetes. Karo Bio believes it has the most advanced projects in the TR field and it is the only company that has succeeded in developing liver selective GR antagonists. It is also evident that many companies in the pharmaceutical sector are focusing on PPAR for treatment of type 2 diabetes. Karo Bio has chosen to stay out of that field for two reasons. Firstly, the field is crowded, and secondly, many PPAR agonists are associated with adverse events that limit their use. In addition to the big pharmaceutical companies, a number of biotech companies are active in the nuclear receptor field.

Business Strategy

NEW BUSINESS MODEL

Karo Bio's business is based on a model in which projects targeting major patient populations in competitive market segments are outlicensed to partners in preclinical or early clinical stages of development. In addition to the partnership-based model, Karo Bio will bring selected compounds aimed at targeted patient populations to late stage clinical development. The company will potentially launch such compounds in selected markets, which represents a change in strategy for Karo Bio.

In addition to early stage partnerships for major clinical indications, Karo Bio is aiming for late-stage deals at better terms or an introduction into selected markets. The modified strategy will create opportunities for flexibility in dealmaking, while providing better control of the business and improved prospects for revenue and earnings-generation over time. Thus, the risks in this strategy are better balanced.

EARLY PARTNERING FOR TREATMENT OF BROAD PATIENT POPULATIONS

Karo Bio's collaborative agreements with major pharmaceutical companies such as Merck & Co. and Wyeth Pharmaceuticals, as well as interest from the pharmaceutical industry in the area of drugs targeting nuclear receptors, illustrate the company's potential. These partnerships target major clinical indications and global markets. Karo Bio does not carry any costs for these projects as these are borne by the partner. Instead, Karo Bio will receive milestone payments triggered by progress in relation to goals in these partnerships, as well as royalty payments on sales of future potential drugs emanating from the collaborations, provided such goals are met and drugs are launched in the market.

BALANCED RISK

Karo Bio has promising clinical candidates in KB2115 for severe dyslipidemia (in clinical phase I) and KB3305 for type 2 diabetes (currently in late preclinical development). Karo Bio plans to take KB3305 to the proof of concept stage in clinical phase II and then find a partner for further development and commercialization. The company believes there is a significant opportunity for bringing KB2115 through clinical trials all the way to the market in selected areas.

Based on its research organization, Karo Bio also develops new compounds and compound classes such as TR STAD for dyslipidemia, where the company has discovered promising clinical candidates. In 2006 Karo Bio will seek a global partner for the STAD project.

Karo Bio intends to be the leading partner in its future late-stage alliances. Cost and risk sharing in phase III will be sought, as well as the possibility for retention of regional marketing rights.

Karo Bio firmly believe that this newly modified business model, aimed at taking selected drugs further downstream in the development process in selected areas, best combines balanced risk with the potential for large returns for investors.

"In addition to the partnership-based model, Karo Bio will bring selected compounds aimed at targeted patient populations to late stage clincal development."

The Drug Development Process

The development of a new drug to the market is a costly process that takes five to 15 years, with no guarantee for success. In fact, only one of ten compounds that enter clinical trials successfully reaches the market. Considering the sales of pharmaceuticals on a global market, it can also be extremely rewarding for successful companies. The company's risk can be managed by focusing on validated targets and maintaining a broad product portfolio. The main steps and processes in pharmaceutical development are described in this section.

DRUG DISCOVERY AND PRECLINICAL DEVELOPMENT

The initial steps in drug discovery involve linking a certain disease to a specific protein, followed by a search for molecules that have the ability to bind to and affect the target protein in a direction that prevents disease progression. Test methods, or assays, are developed to characterize and select the compounds of greatest interest. This screening process of compound libraries, or high throughput screening (HTS) on a larger scale, is carried out in the laboratory (in vitro) and is followed by optimization of lead compounds, testing in animal models and finally, selection of a compound called the candidate drug (CD).

The CD is subject to additional preclinical testing that involves toxicity studies in animal models as well as studies of uptake, distribution, metabolism, and secretion (ADMET). If a compound shows promising results in all these tests, it will be selected for clinical development. An investigational new drug application (IND) is sent to the regulatory authorities and, after approval, clinical studies can begin.

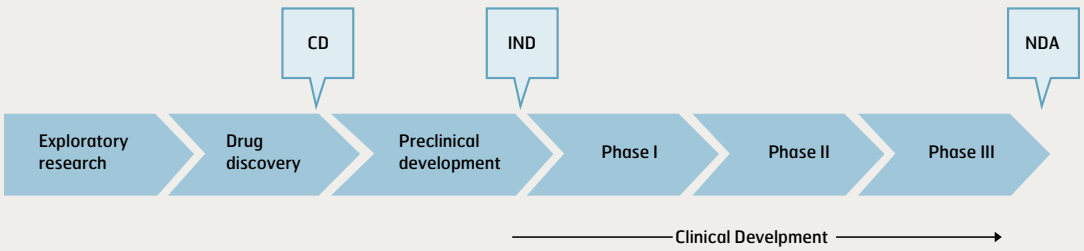
CLINICAL DEVELOPMENT

The starting point for clinical studies is a decision, based on documentation from preclinical work on animal pharmacology and toxicology, that it is safe to proceed to human trials. Karo Bio makes this decision, but the regulatory authorities must approve it. Clinical trials represent the ultimate pre-market testing ground for unapproved drugs. During these trials the compound is evaluated for its safety and efficacy in treating or preventing a specific disease or condition. The result of these studies will comprise the most important factors in the approval process.

Phase I

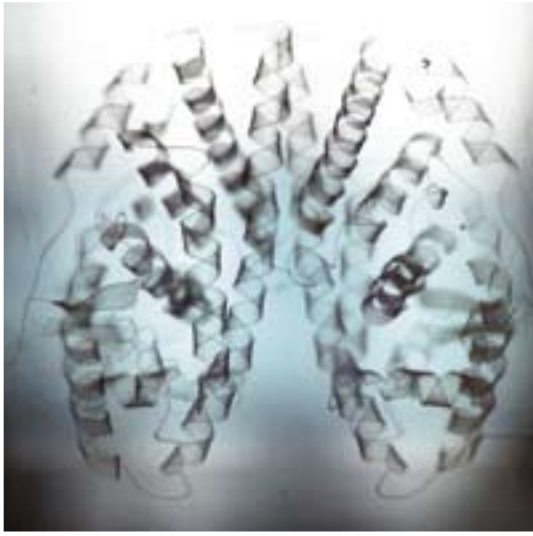
In phase I the compound is administered to humans for the first time. The focus is initial safety and tolerability, as well as uptake, elimination and effects of the drug (PK/PD data) to define a dose range and dose regimen for the following phase II studies and to

Major Steps in Drug Development



CD: Candidate Drug
IND: Investigational New Drug Application
NDA: New Drug Application

determine the nature of adverse reactions that can be expected. Specific biomarkers for pharmacological effects at the pursued target are included in phase I studies, to add information for dosing. Normally healthy volunteers are used in phase I, although in some instances patients can also be included; for example, if the disease has low impact on the subject's general health (mild hypertension, overweight, dermatitis), or if the compound is toxic (cancer treatment).



Phase II

Phase II is normally the first time patients are exposed to the compound. Phase II is a therapeutic exploratory phase, often divided into phase IIa, which is aimed at proof of concept showing that the compound has beneficial effects by proving efficacy compared to placebo in a small group of homogeneous patients with a well defined diagnosis). In phase IIb is the scope is to prepare for the pivotal phase III studies by confirming the dose selection, administration regimen, endpoints, and other information in a wider patient population and for longer duration. The study duration can be extended to several months to look at possible tolerance or rebound effects.

Phase III

In phase III pivotal studies a large number of patients are studied to confirm therapeutic benefit and to provide documentation needed for approval of the targeted claims and for regulatory purpose. To a large extent, study designs are determined by the level of efficacy seen in phase II studies. Indication- or compound-specific issues may need to be addressed, such as head-to-head comparison, combined treatment and efficacy in different disease states. For safety and tolerability, general regulatory demands define the number of patients and the exposure time needed for approval.

Once all clinical documentation has been compiled and evaluated, a new drug application (NDA) is submitted to the regulatory authorities.

Karo Bio conducts its drug discovery and preclinical development in-house but uses contract research organizations to carry through its clinical trials. At these sites the subjects that volunteer in the trials are carefully monitored and taken care of according to international guidelines for pharmaceutical development. The studies are generally double blinded which means that neither test subject nor personnel knows which individuals receive placebo and which receive active compound.

Karo Bio Projects

Karo Bio has experience, knowledge and drug discovery technologies that are applicable across the entire nuclear receptor family, consisting of some 40 proteins. Currently there is a focus on TR, GR and ER as drug discovery targets for the internal projects. There are many good reasons for this prioritization. First of all, there is a potential for treatment of many important diseases by targeting these receptors. With reference to TR, it is well known that TR is involved in lipid metabolism and energy expenditure which opens possibilities to treat dyslipidemia and obesity. Metabolic diseases are also targets regarding GR which is a key regulator of glucose metabolism. In this area, Karo Bio runs a project for treatment of type 2 diabetes. In the ER area Karo Bio is focusing and ER beta and depression since this receptor appear to play an important role for mood and cognitive function.

Apart from internal projects Karo Bio collaborates with international pharmaceutical companies. The collaboration with Wyeth Pharmaceuticals targets the LXR receptor for treatment of atherosclerosis whereas the indication in the Merck collaboration is undisclosed.

The receptor targets, with respective clinical indications and the Karo Bio compounds and projects, are described on the next pages with the following structure.

- **THYROID HORMONE RECEPTOR**
- **GLUCOCORTICOID RECEPTOR**
- **ESTROGEN RECEPTOR**
- **EXPLORATIVE RESEARCH**
- **PARTNER PROJECTS**

Project portfolio outlook

The project portfolio describes the development status of the projects by the end of 2005 and an estimation of the projects development during the next two years. This estimation of future development is based on the assumption that the projects develop according to plan.

PROGRAM	2005				2006				2007			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
KB2115 Dyslipidemia, obesity	Preclinical Develepment		Phase I						Phase II			
KB3305 Diabetes	Preclinical Develepment								Phase I		Phase II	
STAD Dyslipidemia	Lead Optimization						Preclinical Develepment			Phase I		Phase II
ER beta Depression	Lead Optimization								Preclinical Develepment			Phase I
Wyeth (LXR) Atherosclerosis	Preclinical /early clinical development led by Wyeth											
Merck (ER) Undisclosed	Preclinical /early clinical development led by Merck											

THYROID HORMONE RECEPTOR – TR

A key project within Karo Bio is targeting the thyroid hormone receptor (TR) for treatment of obesity and dyslipidemia. Thyroid hormone has the capacity to lower body weight by increasing energy expenditure and also to lower blood lipids. Natural thyroid hormone cannot be therapeutically used to obtain these effects due to the risk of adverse effects on the heart. The most advanced compound, KB2115, lowers body weight and blood lipids as well as blood glucose. KB2115 shows selectivity for the TR beta subtype and in animal studies as well as initial phase I studies in humans, the compound has shown a broad therapeutic dose range of efficacy.

Karo Bio has also been able to design selective thyroid hormone receptor agonists for dyslipidemia (STAD). From its library of several thousand proprietary thyroid hormone analogs, Karo Bio will next select a candidate drug for development and potentially enter into a new partnership.

The situation in the dyslipidemia market is different; there are numerous marketed statins that effectively lower LDL cholesterol ('bad' cholesterol that increases the risk of heart disease). Some of these drugs also have beneficial effects on triglycerides, a risk factor for development of cardiovascular disease. Nevertheless, new drugs are needed in this field since a significant percentage of cardiovascular deaths are related to dyslipidemia. In the United States, 40 million people need treatment for elevated cholesterol levels using therapies such as statins.

However, certain patient populations do not benefit from statin treatment. Of the 20 million people in the United States undergoing statin treatment, an estimated 11 percent do not respond effectively despite high doses. Furthermore, some patient groups suffer from drug refractory hypercholesterolemia and do not respond to treatment.

Through its research platform in the field of nuclear receptors, Karo Bio has discovered candidate drugs that target large patient groups within the pharmaceutical market for metabolic diseases. In its development of products in the portfolio aimed at a large market, Karo Bio collaborates with pharmaceutical companies that have the capacity and the expertise to develop and launch large volumes of pharmaceuticals in a global market.

Besides these market segments in the field of metabolic diseases, there are market segments in which restricted patient populations with great medical needs cannot be treated effectively today. The large pharmaceutical companies are primarily targeting large markets and invest only marginally in development of pharmaceuticals for treatment of more rare diseases in niche markets. Therefore the medical needs in these markets are huge.

KB2115

Through a number of animal studies Karo Bio has shown that KB2115 increases the body's energy consumption, reduces body weight, and markedly reduces blood lipids and blood glucose. Karo Bio's extensive preclinical safety documentation shows that KB2115 does not generate cardiac adverse effects.

In a previous phase Ia study, conducted by Bristol-Myers Squibb in healthy individuals, KB2115 appeared to be safe.

"Through its research platform in the field of nuclear receptors, Karo Bio has discovered candidate drugs that target large patient groups in the pharmaceutical market for metabolic diseases."

Promising Phase I data

During the fall of 2005 Karo Bio successfully completed a phase I study with KB2115 in healthy but overweight individuals with dyslipidemia. The primary objective of the phase I study was to determine the short-term safety and tolerability of single (phase Ia) and multiple oral doses of KB2115 administered daily over a 14-day period (phase Ib). No significant adverse events were recorded, and KB2115 was well tolerated. Also, excellent bioavailability and pharmacokinetic properties were documented. No negative effects on the heart were reported. The compound also showed excellent pharmacokinetic and bioavailability properties. In addition to the clean safety profile of KB2115, a significant lowering of total and LDL cholesterol has been documented. Thus, the compound has the potential to become an important agent for the treatment of severe dyslipidemia. The plan is to initiate phase II clinical development in the second half of 2006.

In the phase I clinical study Karo Bio carefully examined possible formation of a reaction product of KB2115 that can be formed under acidic conditions, such as in the stomach. This "nitrated" form of KB2115 is potentially toxic, but in the previous collaboration with Bristol Myers-Squibb it has only been detected in low doses that do not prevent clinical development in early phases. The data from Karo Bio's phase I study confirms that the levels of the reaction product are below levels of toxicological concern. Karo Bio is also developing an acid-resistant tablet and believes that this formulation will eliminate nitration of KB2115.

> In addition to the clean safety profile of KB2115, a significant lowering of total and LDL cholesterol has been documented.

Opportunities for treatment of dyslipidemia

Karo Bio has identified different options for the further development of KB2115. The profile of the compound regarding efficacy and safety provide opportunities for several medical applications. However, it is Karo Bio's goal to take the substance through clinical development with the purpose of creating value and business opportunities at later stages of development, and therefore the clinical opportunities will be carefully evaluated with respect to patient need, development costs and time perspectives, as well as regulatory issues. There appear to be several well defined patient groups with a high medical need for treatment of dyslipidemia that may benefit from treatment with KB2115. However, the safety profile of the compound so far does not preclude a later positioning of KB2115 for treatment of broader patient populations.

TR STAD

Karo Bio has developed a new series of compounds intended for treatment of various forms of dyslipidemia. Significant progress has been made during the past year. Potent compounds that lower LDL cholesterol and triglycerides with no effect on the heart have been discovered. These compounds can also lower independent risk factors for development of cardiovascular disease such as lipoprotein(a). In addition, the compounds act synergistically with statins in animal models. There is still significant medical need for treatment that can significantly lower blood lipids, either as single therapy or in combination with other drugs. STADs are therefore promising

for treatment of broad patient populations with dyslipidemia. A promising feature of these compounds is also their capacity to lower blood glucose levels, which may make them useful for treatment of many aspects of the metabolic syndrome including type 2 diabetes.

Karo Bio plans to select a candidate drug and perform preclinical preclinical development.

GLUCOCORTICOID RECEPTOR – GR

TYPE 2 DIABETES

The spread of diabetes has reached epidemic proportions. According to the World Health Organization (WHO), 150 to 200 million people have diabetes. More than 90 percent of diabetics have type 2 diabetes, also known as non-insulin-dependent diabetes, which is characterized by the body's inability to respond adequately to insulin. The increasing incidence of the disease has been linked to lifestyle, diet, and an aging population, but obesity is probably the most important cause.

Therapy for type 2 diabetes remains inadequate in spite of a number of available treatments. None of the existing treatments directly targets the increased glucose production in the liver that occurs in type 2 diabetics and that is driven by glucocorticoid hormones. However, Karo Bio has targeted the increased glucose production in the liver. The drug discovery efforts have led to the development of KB3305, a liver selective glucocorticoid antagonist.

KB3305

Unique profile for treatment of type 2 diabetes

KB3305 has a favorable pharmacological profile in animal diabetes models and acts by antagonizing the action of specific hormones called glucocorticoids, so named because of their key role in glucose metabolism. By developing compounds that are liver selective the pharmacological effects in other organs can be minimized. The compound KB3305 is the first known example of such a liver selective GR antagonist. It demonstrates significant anti-diabetic effects in three separate animal disease models. In addition to this beneficial effect of KB3305 and its potential use as an anti-diabetic agent, KB3305 significantly improves several measures of blood lipid levels in these animals. This is important since elevated triglycerides in patients with type 2 diabetes severely increase the risk for serious cardiovascular events such as myocardial infarction and stroke.

Preparing for clinical development

Preclinical safety and toxicity studies suggest that KB3305 is a safe and well-tolerated drug with a 100-fold safety margin over the expected clinical dose.

The preclinical development of KB3305 progressed well in 2005 and was primarily directed toward improving bioavailability and thus the manufacturing cost for the final product. Several different formulations were examined and Karo Bio expects that a formulation for clinical study will be selected during spring 2006 and thereafter initiate phase I studies.

ESTROGEN RECEPTORS – ER

DEPRESSION

Depression is a major and disabling disorder that causes suffering in patients and burdens society with enormous costs. Although new treatments have been developed, these are associated with side effects that create a need for new medicines. It is well known that estrogens have beneficial effects on mood, but the side effects of estrogens limit their use in a broader context. The discovery of the new estrogen

> Karo Bio obtained proof of concept in animal models for the use of ER beta selective agonists in depression during the year.

receptor beta has opened possibilities for development of new selective compounds with fewer side effects. Depression is an area where ER beta selective agonists may be useful since the ER beta receptor colocalizes in areas in the brain that control mood and feelings of anxiety.

ER BETA PROJECT

Karo Bio obtained proof of concept in animal models for the use of ER beta selective agonists in depression during the year. Three different series of compounds are currently being optimized to select a candidate drug. Karo Bio's unique knowledge of receptor structures and the mode of compound binding to the receptor have guided the design of our molecules and new crystal structures are repeatedly solved in the optimization process.

EXPLORATIVE RESEARCH

In addition to the projects described above Karo Bio runs several innovative and explorative activities and the company aims to maintain a rich pipeline of projects. The vast compound libraries and the unique knowledge about receptor structure and function, coupled with deep insights in biology, create new opportunities for the future. As these projects mature, Karo Bio will bring them to the attention of the market.

KARO BIO PARTNER PROJECTS

ESTROGEN RECEPTORS – MERCK & CO., INC.

In the beginning of the year, Karo Bio received a significant milestone from Merck for the initiation of phase I clinical trials. In April clinical development was discontinued due to adverse findings in an animal study. Merck continues with evaluation of additional compounds in preclinical studies to assess suitability to progress to clinical study.

Merck covers all costs in this project and Karo Bio has rights to milestone payments when development milestones are met and to royalties on future sales of product in the market.

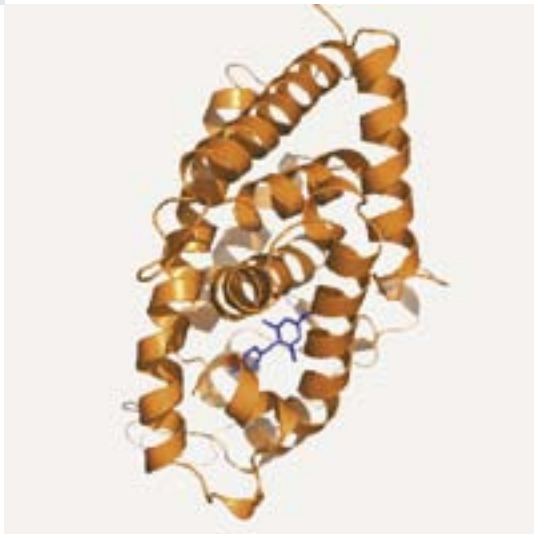
ATHEROSCLEROSIS – WYETH PHARMACEUTICALS

The collaboration targets the liver X receptor (LXR) with the aim to develop new treatments for atherosclerosis. LXR is a regulator of cholesterol metabolism. It has been demonstrated that compounds that modulate the activity of LXR promote net cholesterol efflux from atherosclerotic blood vessels resulting in the regression of vascular plaque formation. In August 2005 the research term of the collaboration was extended for an additional year until August 31, 2006 with the intention of selecting additional drug candidates for development.

Wyeth covers all costs in this project and Karo Bio has rights to milestone payments when development milestones are met and to royalties on future sales of product in the market.

Technology and Development Capabilities

Karo Bio maintains a leading position in nuclear receptor structural biology. The structural information is used to design new compounds and is regularly used in the optimization of lead compounds. The figure illustrates the structure of the thyroid hormone receptor (yellow ribbons) in complex with a compound (blue structure) that binds to the receptor. Using computational techniques it is possible to study the interaction with a resolution at the atomic level.



DRUG DISCOVERY PLATFORM

Karo Bio has an integrated drug discovery technology with resources for compound screening and characterization using numerous assays. The company has also established a medicinal chemistry department and a structural biology department.

Karo Bio's structural biology department focuses on determination of three-dimensional structures of nuclear receptors in complexes with the different candidate drugs. In this field Karo Bio has established an internationally leading position and it has significantly contributed to the design of unique compound libraries.

In recent years Karo Bio has built up resources for preclinical development to support selection of drug candidates. In-house capabilities include ADMET (absorption, distribution, metabolism, excretion and toxicity), pharmacokinetics, bioanalysis, and in vivo pharmacology. The ADMET characterization addresses compound absorption and distribution in the body, as well as metabolism and toxicity. Certain resources for safety pharmacology and safety toxicology are also available and when necessary, are complemented with external resources. Karo Bio has also built up expertise and resources for scale up synthesis of chemical compounds required for preclinical development.

BUILDING CLINICAL DEVELOPMENT CAPABILITIES

To support clinical development Karo Bio has previously mainly relied on contract research organizations. In the fall of 2005 Karo Bio recruited new Vice Presidents for preclinical and clinical development respectively to support the evolution of Karo Bio into a clinical development company.

In addition to in-house resources, Karo Bio works with leading scientists in the field. Scientific advisory boards have been established with leading clinicians who take an active part in the evaluation of preclinical and clinical data and support Karo Bio in positioning its compounds. Through this interaction new possible indications for the compounds are continuously evaluated.

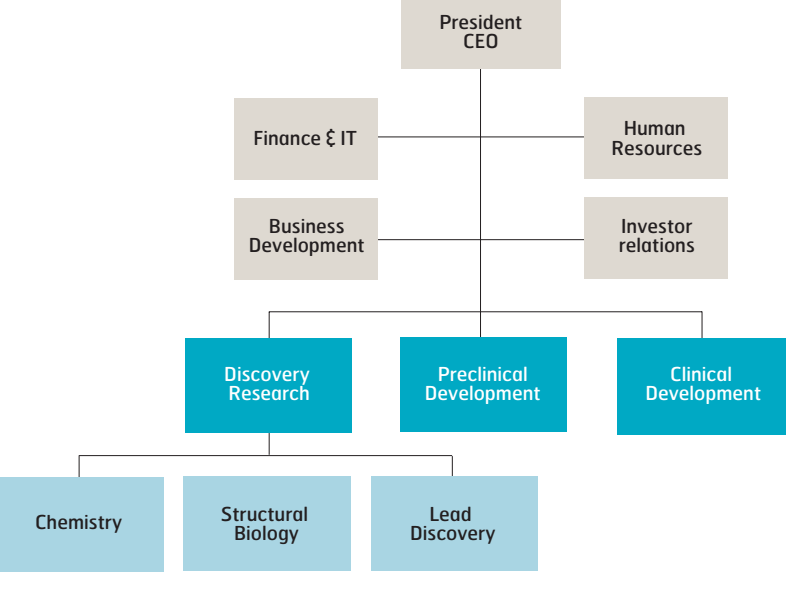
Human Resources and Organization

Karo Bio has modified its strategy over the past few years. We have cut back on early exploratory research and focused on building up an organization that can effectively run preclinical and clinical development projects.

At the same time that we were putting the finishing touches on our new, modified strategy in autumn 2005, we recruited a few key employees to strengthen the organization and be able to run clinical projects in-house without being as dependent on external consultants as previously. With Jens Kristensen and Anneli Hällgren on board in charge of clinical development and preclinical development, respectively, we have an effective organization ready to bring multiple projects to clinical trials. The company's management was also reinforced with a new President in March 2005.

ORGANIZATION

Karo Bio's business consists of a research organization, divided into departments for discovery research, preclinical development, and clinical development, as well as functions for business development, finance, human resources, and investor relations.



Karo Bio has a total of 73 employees with 64 active in research and development. Almost half of our employees have a PhD. The average age is 43 years. Karo Bio's staff has always consisted of employees from all over the world. Our current employees come from 16 countries covering Europe, Asia and South America. Our employees also include second generation Swedes.

The company is guided by its vision, goals, and values. The line organization supplies the projects with the right expertise at the right time.

The company has a program for skills development and individual development. At the individual goals and development discussions, goals are defined and plans are made for skills replenishment. Based on these goals, skills development needs are identified that are then met during the year. Evaluation of goal attainment forms the basis of salary structuring and allocation of options.

WORK ENVIRONMENT AND HEALTH

The well-being and health of the individual and the group are important competitive factors. We now offer our staff the opportunity to have a wellness profile that sheds light on each employee's lifestyle. The profile provides each employee with the knowledge and incentive to make changes that can lead to a better life.

To ensure a stimulating workplace and to prevent long-term illness, we work proactively with rehabilitation at an early phase of the illness. The constant evolution of the organization is also part of this initiative. The organization must adapt to fit in with the world around us and the goals we strive to achieve. This is particularly important in the biotech industry, in which developments occur rapidly. It requires much adaptation and an innovative approach from the staff. We work together to smoothly implement changes.

Because equality creates a better workplace, Karo Bio's equal opportunities plan has goals that must be achieved and requirements that must be met within a specific period in accordance with the Swedish Equal Opportunities Act. Men and women must have the same opportunities for employment, training, promotion, and development in the workplace. In addition, no employee shall be discriminated against on the basis of nationality, religion, or sexual orientation.

COMMUNITY RESPONSIBILITY

As is the case with all industrial operations, Karo Bio affects the environment. As a research company without its own production facilities, Karo Bio's consumption of energy and other natural resources and its discharges of substances into the air and water are relatively limited.

Karo Bio routinely works with chemical substances as well as genetically modified cells and microorganisms, which places stringent demands for comprehensive environmental and safety efforts to minimize adverse effects on the environment and human health.

Our environmental program is conducted as an integrated part of our operation and is oriented to preventive measures for constant improvement with the goal of meeting with or exceeding applicable legal requirements, directives, and international agreements.

Constant efforts in attaining optimal environmentally friendly waste handling are conducted in collaboration with accredited contractors. Karo Bio currently practices extensive source separation of waste, with the focus on environmentally impacting waste classified as hazardous.

Karo Bio is constantly striving to improve tools and methods for risk analysis, assessment, and audits in the fields of the environment and safety.

> Karo Bio has an effective organization ready to bring multiple projects to clinical trial.

Board of Directors









PER-OLOF MÅRTENSSON (1937), Höganäs, Sweden
Chairman since 2000. Elected 1994.
M.Sc. Pharm
President Karo Bio AB 1991–2000
Board memberships: BioInvent International AB (chairman), Photocure a/s (vice chairman), Alligator Bioscience AB (chairman) and others.
Shares in Karo Bio: 297,905

DANA FOWLKES (1950), Chapel Hill, North Carolina, USA
Elected 2000. M.D., Ph.D.
General Partner, Hatteras BioCapital LLC
Board Memberships: Integrion Therapeutics Inc. (chairman)
Shares in Karo Bio: 735,847

LARS INGELMARK (1949), Halmstad, Sweden
Elected 1999.
Senior Vice President, Head of Life Science Ventures, Sixth Swedish National Pension Fund
Board memberships: Scandinavian Life Science Venture (chairman), Cefar AB (chairman), Svensk Våtmarksfond (chairman), A Carlsson Research AB, Innoventus AB and others
Shares in Karo Bio: 7,000

ULLA LITZÉN (1956), Stockholm, Sweden
Elected 2003.
Board memberships: AB SKF, Atlas Copco AB, Boliden AB, Posten AB
Shares in Karo Bio: 16,500

LEON E. ROSENBERG (1933), Princeton, New Jersey, USA
Elected 2000. M.D.
Professor, Princeton University
Board memberships: Hana Biosciences Company, Lovelace Respiratory Research Institute, Robert Wood Johnson Medical School, Medicines for Malaria Venture
Shares in Karo Bio: 1,754

PER OLOF WALLSTRÖM (1949), Stockholm, Sweden
Elected 2005.
M.Sc. Pharm
President & Chief Executive Officer Karo Bio AB
Board memberships: Envirotainer Holding AB, Swedish Orphan Holding AB, ArosGruppen Holding AB (chairman) and SwedenBio
Shares in Karo Bio: 125,000
Options in Karo Bio: -

BO CARLSSON (1958), Stockholm, Sweden
Appointed 1997.
Project Manager.
Employee representative
Shares in Karo Bio: 6,361
Options in Karo Bio: 5,003

DEPUTY DIRECTORS

JAN-ÅKE GUSTAFSSON (1943), Stockholm, Sweden
Elected 1987. M.D., Ph.D.
Consultant & Co-Founder of Karo Bio AB
Head of the Department of Medical Nutrition and Biosciences at Karolinska Institutet
Shares in Karo Bio: 101,830

HENRIK JERNSTEDT (1974), Uppsala, Sweden
Appointed 2005. Senior Research Investigator.
Employee representative
Shares in Karo Bio: -
Options in Karo Bio: 1,102

Executive Management and Auditors








PER OLOF WALLSTRÖM (1949)
M.Sc. Pharm
President & Chief Executive Officer
Employed by Karo Bio since 2005
Shares in Karo Bio: 125,000
Options in Karo Bio: -

ANDERS BERKENSTAM (1959)
Ph.D., Associate Professor
Vice president Discovery Research
Employed by Karo Bio since 2001
Shares in Karo Bio: 200
Options in Karo Bio: 11,714

BERIT EDLUND (1948)
Director, Human Resources
Employed by Karo Bio since 2001
Shares in Karo Bio: 2,315
Options in Karo Bio: 12,966

ANNELI HÄLLGREN (1965)
Ph.D.
Vice president Preclinical Development
Employed by Karo Bio since March 2006
Shares in Karo Bio: -
Options in Karo Bio: -

BERTIL JUNGMAR (1961)
Vice president, Chief Financial Officer
Employed by Karo Bio since 2001
Shares in Karo Bio: 12,165
Options in Karo Bio: 14,349

JENS KRISTENSEN (1958)
Ph.D., Associate Professor, M.D.
Vice president Clinical Development
Employed by Karo Bio since 2005
Shares in Karo Bio: -
Options in Karo Bio: -

PER OTTESKOG (1947)
Ph.D.
Senior vice president Investor Relations
Employed by Karo Bio since 1987
Shares in Karo Bio: 187,187
Options in Karo Bio: 12,549

LARS ÖHMAN (1957)
Vice president Business Development
Employed by Karo Bio since 1989
Shares in Karo Bio: 6,632
Options in Karo Bio: 6,098

AUDITORS

PricewaterhouseCoopers AB
Auditor in charge: Claes Dahlén (1950),
Sollentuna, Sweden
Authorized public accountant
Auditor for Karo Bio since 2001

Shareholdings are as of December 31, 2005, and include family members and shares held through companies.
Information regarding options refers to the number of shares options held represents.

Administration Report

OPERATIONS

Karo Bio is an innovative drug discovery and development company specializing in the development of novel pharmaceuticals with focus on metabolic diseases.

The Company has expanded from being a drug discovery company by adding in-house preclinical and clinical development resources and competence for development of drugs to treat metabolic diseases. With its new strategy Karo Bio has the intention of bringing selected compounds in niche areas into the market or late stage clinical trials. For compounds aimed at treatment of broad patient populations, Karo Bio intends to develop these to clinical proof of concept before outlicensing.

RESEARCH AND DEVELOPMENT

Karo Bio has a portfolio of four prioritized internal projects and two ongoing partnerships with major pharmaceutical companies.

Thyroid Hormone Receptor – TR

KB2115

Through a number of animal studies Karo Bio has previously shown that KB2115 increases the body's energy consumption and reduces body weight and markedly reduces blood lipids and blood glucose. Karo Bio's extensive preclinical safety documentation shows that KB2115 has efficacy over a broad dose range with excellent tolerability.

During the fall of 2005 Karo Bio successfully completed a phase I study with KB2115 in healthy but overweight individuals with dyslipidemia. The primary objective of the phase I study was to determine the short-term safety and tolerability of single (phase Ia) and multiple oral doses of KB2115 administered daily over a 14-day period (phase Ib). No significant adverse events were recorded, and KB2115 was well tolerated. Also, excellent bioavailability and pharmacokinetic properties were documented. No negative effects on the heart were reported. In addition to the clean safety profile of KB2115, significant lowering of total and LDL cholesterol has been documented. Thus, the compound has the potential to become an important agent for the treatment of severe dyslipidemia. A bioavailability study of an improved formulation will be performed in the first half of 2006. The goal is to initiate phase II clinical trials in the second half of 2006, which means that the compound will be evaluated in patients.

TR STAD (Selective Thyroid Hormone Agonists for Dyslipidemia)

Karo Bio has developed a new series of compounds intended for treatment of different forms of dyslipidemia. Significant progress has been made during the past year. Potent compounds which lower LDL cholesterol and triglycerides with no effect on the heart have been discovered. Regarding LDL lowering, these compounds act synergistically with statins in an animal model. The compounds also have the ability to lower independent risk factors for development of cardiovascular disease such as lipoprotein(a). There is still significant medical need for treatments that can significantly lower blood lipids, either as single therapy or in combinations with other drugs. STADs are therefore promising for treatment of broad patient populations with dyslipidemia.

Glucocorticoid Receptor – GR

KB3305

KB3305, intended for treatment of type 2 diabetes, has a favorable pharmacological profile in animal diabetes models and acts by selectively antagonizing the action of glucocorticoid hormone. By developing compounds that are liver selective the pharmacological effects in other organs can be minimized. KB3305 demonstrates significant anti-diabetic effects in three separate animal disease models. As a consequence, KB3305 normalizes the hyperglycemia associated with type 2 diabetes. Preclinical safety and toxicity studies suggest that KB3305 is a safe and well-tolerated drug with a 100-fold safety margin over the expected clinical dose.

The preclinical development of KB3305 is progressing and during 2005 improvements have been made regarding the pharmaceutical formulation. The objective is to finalize the pharmaceutical formulation for clinical trials during spring 2006 and thereafter initiate phase I studies.

Estrogen Receptors – ER

ER BETA – Depression

Karo Bio is concentrating its efforts on the ER beta receptor. ER beta selective compounds have potential for a number of important diseases such as depression. Proof of principle in animal models, for the use of ER beta selective agonists in depression, has been obtained during the year. Currently three different series of compounds are being optimized for selection of candidate drug.

Karo Bio partner projects

Estrogen Receptors – Merck & Co., Inc.

In the beginning of the year Karo Bio received a significant milestone from Merck for the initiation of phase I clinical trials. In April the clinical development was discontinued due to adverse findings in an animal study. Merck continues with evaluation of additional compounds in preclinical studies to assess suitability to progress to clinical study.

Atherosclerosis – Wyeth Pharmaceuticals

The collaboration targets the liver X receptor (LXR) with the aim to develop

new treatments for atherosclerosis. LXR is a regulator of cholesterol metabolism. It has been demonstrated that compounds that modulate the activity of LXR promote net cholesterol efflux from atherosclerotic blood vessels resulting in the regression of vascular plaque formation. In August 2005 the research term of the collaboration was extended for an additional year until August 31, 2006 with the intention of selecting additional drug candidates for development.

ORGANIZATION

Per Olof Wallström was appointed President of Karo Bio in March, replacing Björn Nilsson who then left the Company.

Karo Bio is strengthening its clinical and preclinical development organization with specific competences to increase the chances of being successful in bringing the prioritized projects into clinical trials. Consequently, Dr Jens Kristensen was recruited to be responsible for Karo Bio's clinical development activities. He joined Karo Bio as Chief Medical Officer and Vice President Clinical Development in November 2005. Dr. Anneli Hällgren was recruited in January 2006 to be responsible for preclinical development as Vice President of Preclinical Development from March 2006. Dr. Anders Berkenstam remains as Vice President of Discovery Research.

By the end of the year, Karo Bio had 73 (77) employed, of which 64 (67) are engaged in research and development.

NEW SHARE ISSUE

Karo Bio's new share issue was completed in December. The rights issue of 46,447,677 shares generated MSEK 263.4 after transaction costs amounting to MSEK 15.3.

RESULT AND FINANCIAL POSITION

Result

Net sales increased to MSEK 51.9 as compared to MSEK 39.0 for the same period last year. Revenues during 2005 consist of the milestone payment triggered in January under the collaboration with Merck & Co in relation to initiation of phase I clinical trials and research funding from the research collaboration with Wyeth Pharmaceuticals. Revenues in 2005 from the research collaboration with Wyeth Pharmaceuticals decreased compared to 2004 as 2004 included the period's share of an upfront payment received at the initiation of the collaboration in September 2001, which was fully taken as income as of August 31, 2004. Revenues also decreased due to fewer Karo Bio scientists engaged and paid for in the collaboration.

Expenses increased by MSEK 7.3 to MSEK 160.6 (153.3). The cost increase is attributable to costs for performing clinical trials as well as severance costs in relation to the change of presidents.

Operating loss amounted to MSEK 108.7 (114.3). Financial net amounted to MSEK –2.3 (7.0), including a currency effect of MSEK –5.2 (2.4) related to financial items. The reported loss amounted to MSEK 111.0 (107.3).

Cash Flow

Cash flows from operating activities amounted to MSEK –90.0 (–111.7).

Cash and bank balances and short-term investments with duration less than 90 days, amounted to MSEK 307.3 (65.6) at the end of the year. If including short-term investments with duration exceeding 90 days, the assets amounted to MSEK 346.9 (181.0).

Capital Investments

Capital investments in equipment amounted to MSEK 1.8 (4.1) including equipment financed with capital leases.

Shareholders' Equity and Per Share Data

At year-end, warrants representing 1,014,470 shares were outstanding. The warrants were issued in conjunction with the implementation of the 2001 and 2003 stock option programs (warrants representing 612,000 and 402,470 shares, respectively, after adjustment for the effect of rights issues in accordance with the terms of the programs). The remaining warrants issued in conjunction the acquisition of Karo Bio USA, Inc. in year 2000 (warrants representing 3,219 shares) were cancelled in May 2005. No warrants were exercised during 2005.

The share capital at the end of the year amounted to MSEK 154.8. The total number of shares amounted to 77,412,795 shares at a par value of SEK 2. The number of shares increased by 46,447,677 from the rights issue. The par value of the shares was reduced from SEK 5 to 2 through a resolution by the general meeting in April 2005 which was subsequently approved and registered by the Swedish Companies Registration Office in May 2005. Total consolidated shareholders' equity amounted to MSEK 336.5 after taking into account the loss for the year.

Loss per share, based on the weighted average number of shares outstanding, amounted to SEK 2.37 (3.41). The Group's equity ratio at the end of the year was 89.8 percent (83.6) and equity per share was SEK 4.35 (4.07).

Parent Company

The Parent Company recorded revenues amounting to MSEK 51.9 (39.0) and is reporting a loss after financial items of MSEK 112.3 (116.0).

Capital investments in equipment amounted to MSEK 1.8 (1.6), excluding capital investments financed with capital leases.

Cash and bank balances and short-term investments amounted to MSEK 346.9 (181.0) at the end of the year.

FUTURE DEVELOPMENT

Karo Bio has recently taken important steps in its development towards a pharmaceutical development company. The phase I clinical study with KB2115 has been successfully concluded and Karo Bio intends to bring KB2115 forward into phase II during 2006. So far, the data is promising and shows that there are great opportunities to position KB2115 for treatment of severe dyslipidemia which is an expanding market with great medical needs. The phase II data will guide future development of the drug.

It is planned for KB3305 to enter clinical phase I studies in 2006 and select a candidate drug in the STAD project during spring 2006.

Since the TR STAD and ER beta depression projects are targeting major clinical indications, it is Karo Bio's goal to seek partners for these projects after selection of candidate drugs. For the STAD project the goal is to find a partner in 2006.

PROPOSED TREATMENT OF LOSS

The Group's and the Parent Company's aggregate deficit as per the balance sheet total as follows.

	Group kSEK	Parent Company SEK
Loss carried forward from prior year	14,403	23,096,906
Current years loss	111,007	112,282,338
Aggregate deficit	125,410	135,379,244

The Board of Directors recommend that the Parent Company's aggregate deficit of SEK 135,379,244 be carried forward.

The Company's net result for the financial year and financial position as of December 31, 2005 are shown on the appended income statement, balance sheet, cash flow statement and statement of changes in shareholders' equity and notes to the accounts, which are an integral part of the financial statements.

Income Statements

kSEK	Note	GROUP 2005	GROUP 2004	PARENT COMPANY 2005	PARENT COMPANY 2004
Net sales	1	51,913	38,953	51,913	38,953
Operating expenses	2–5				
Administrative expenses		–34,572	–31,980	–34,550	–31,796
Research and development expenses		–125,226	–123,456	–125,227	–131,952
Other operating income and expenses	6	–804	2,140	–804	2,140
		–160,602	**–153,296**	**–160,581**	**–161,608**
Operating loss		**–108,689**	**–114,343**	**–108,668**	**–122,655**
Income from financial investments					
Interest income and other similar income	7	–2,061	7,507	–2,061	7,505
Interest expenses and other similar expenses	8	–257	–462	–1,553	–842
		–2,318	**7,045**	**–3,614**	**6,663**
Loss after financial items		**–111,007**	**–107,298**	**–112,282**	**–115,992**
Tax	9	–	–	–	–
LOSS FOR THE YEAR	10	**–111,007**	**–107,298**	**–112,282**	**–115,992**
Loss per share based on weighted-average number of shares outstanding	11	–2.37	–3.41		

Balance Sheets

ASSETS (kSEK)		GROUP		PARENT COMPANY	
At December 31	Note	2005	2004	2005	2004
NON-CURRENT ASSETS					
Intangible assets					
Licenses and similar rights	12	–	78	–	78
Tangible assets					
Equipment	13, 20	13,124	18,531	10,937	15,287
Financial assets					
Shares in group companies	14	–	–	23,100	23,100
Total non-current assets		**13,124**	**18,609**	**34,037**	**38,465**
CURRENT ASSETS					
Current receivables					
Accounts receivable – trade		388	2,888	388	2,888
Other receivables		8,492	4,254	8,492	4,253
Prepaid expenses and accrued income	15	5,931	7,391	5,931	7,391
		14,811	**14,533**	**14,811**	**14,532**
Other short-term investments	16	39,610	115,399	39,610	115,399
Liquid assets	17	307,270	65,590	307,260	65,578
Total current assets		**361,691**	**195,522**	**361,681**	**195,509**
TOTAL ASSETS		**374,815**	**214,131**	**395,718**	**233,974**

SHAREHOLDERS' EQUITY AND LIABILITIES (kSEK)		GROUP		PARENT COMPANY	
At December 31	Note	2005	2004	2005	2004
SHAREHOLDERS' EQUITY	18				
Share capital		154,826	154,825	154,826	154,825
Reserves		307,132	131,425	311,076	140,184
Accumulated loss		–14,403	–	–23,097	–
Loss for the year		–111,007	–107,298	–112,282	–115,992
Total shareholders' equity		**336,548**	**178,952**	**330,523**	**179,017**
Non-current liabilities	19				
Other non-current liabilities	20	1,644	2,573	–	–
Total non-current liabilities		**1,644**	**2,573**	**–**	**–**
Current liabilities					
Accounts payable – trade		18,041	7,359	18,041	7,359
Payables to group companies		–	–	29,625	23,402
Other current liabilities	20	2,956	5,946	1,904	4,895
Accrued expenses	21	14,299	16,620	14,299	16,620
Deferred revenues		1,327	2,681	1,327	2,681
Total current liabilities		**36,623**	**32,606**	**65,196**	**54,957**
TOTAL SHAREHOLDERS' EQUITY AND LIABILITIES		**374,815**	**214,131**	**395,718**	**233,974**
Pledged assets		–	–	–	–
Contingent liabilities	*22*	*43,226*	*40,118*	*43,226*	*40,118*

Cash Flow Statements

kSEK	Note	GROUP 2005	GROUP 2004	PARENT COMPANY 2005	PARENT COMPANY 2004
Operating activities					
Operating loss before financial items		–108,689	–114,343	–108,668	–122,655
Items not affecting cash flows					
Depreciation and amortization	5	7,233	12,369	6,175	19,496
Other		407	–76	189	22
		–101,049	**–102,050**	**–102,304**	**–103,137**
Financial income received	23	5,670	4,001	5,670	4,000
Financial items paid	23	–257	–470	–1,553	–851
Cash flow from operating activities before changes in working capital		**–95,636**	**–98,519**	**–98,187**	**–99,988**
Changes in working capital					
Changes in current operating receivables		–1,638	3,576	–1,419	3,426
Changes in accounts payable		10,682	358	10,682	878
Changes in other current operating liabilities		–3,358	–17,105	–1,952	–9,218
Cash flow from operating activities		**–89,950**	**–111,690**	**–90,876**	**–104,902**
Investing activities					
Investment in licenses and similar rights		–3,700	–3,775	–3,700	–7,550
Investment in equipment		–2,704	–2,437	–1,775	–1,642
Sale of equipment		5	1,362	5	106
Investments in other short-term investments		–63,984	–70,292	–63,984	–70,292
Sale and redemption of other short-term investments		138,600	13,000	138,600	13,000
Cash flow from investing activities		**68,217**	**–62,142**	**69,146**	**–66,378**
Financing activities					
Proceeds from new share issues		263,413	113,482	263,413	113,482
Cash flow from financing activities		**263,413**	**113,482**	**263,413**	**113,482**
CASH FLOW FOR THE YEAR		**241,680**	**–60,350**	**241,683**	**–57,798**
Liquid assets at the beginning of the year		**65,590**	**125,940**	**65,578**	**123,276**
Liquid assets at the end of the year		**307,270**	**65,590**	**307,261**	**65,578**

Statements of Changes in Shareholders' Equity

Group (kSEK)	Note	Share capital	Reserves	Accumulated losses	Loss for the year	Total
Amount at January 1, 2004		**84,390**	**299,201**	**0**	**–208,741**	**174,850**
Currency translation differences			–2,200			–2,200
Loss for the year					–107,298	–107,298
			–2,200		–107,298	–109,498
Employee stock option program						
– value of employee services			118			118
New issues of shares						
– rights issue	18	56,300	34,438			90,738
– directed issue	18	14,075	8,609			22,684
– warrants exercise		60				60
		70,435	43,165			113,600
Treatment of loss			–208,741		208,741	0
Amount at December 31, 2004		**154,825**	**131,425**	**0**	**–107,298**	**178,952**
Effect from changes in accounting principles	18		249			249
		154,825	**131,674**	**0**	**–107,298**	**179,201**
Currency translation differences			4,815			4,815
Loss for the year					–111,007	–111,007
			4,815		–111,007	–106,192
Employee stock option program						
– value of employee services			126			126
Rights issue of new shares	18	92,896	170,517			263,413
		92,896	170,643			263,539
Treatment of loss				–107,298	107,298	0
Reduction of share capital	18	–92,895		92,895		0
AMOUNT AT DECEMBER 31, 2005		**154,826**	**307,132**	**–14,403**	**–111,007**	**336,548**

Also see note 18 for further information.

Parent Company (kSEK)	Note	Share capital	Share premium reserve	Statutory reserve	Accu-mulated losses	Loss for the year	Total
Amount at January 1, 2004		**84,390**	**231,442**	**0**	**0**	**–134,423**	**181,409**
Loss for the year						–115,992	–115,992
Employee stock option program							
– value of employee services			118				118
New issues of shares							
– rights issue	18	56,300	34,438				90,738
– directed issue	18	14,075	8,609				22,684
– warrants exercise		60					60
		70,435	43,165				113,600
Treatment of loss			–134,423			134,423	0
Amount at December 31, 2004		**154,825**	**140,184**	**0**	**0**	**–115,992**	**179,017**
Effect from changes in accounting principles	18		249				249
		154,825	**140,433**	**0**	**0**	**–115,992**	**179,266**
Loss for the year						–112,282	–112,282
Employee stock option program							
- value of employee services			126				126
Rights issue of new shares	18	92,896	170,517				263,413
		92,896	170,643				263,539
Treatment of loss					–115,992	115,992	0
Reduction of share capital	18	–92,895			92,895		0
Transfer of share premium reserve to statutory reserve			–311,076	311,076			0
AMOUNT AT DECEMBER 31, 2005		**154,826**	**0**	**311,076**	**–23,097**	**–112,282**	**330,523**

Also see note 18 for further information.

Accounting and Valuation Principles

THE GROUP

Effective January 1, 2005, companies listed on a stock exchange within the European Union are required to present consolidated financial statements in accordance with international financial reporting standards IFRS issued by the International Accounting Standards Board. The consolidated financial statements have been prepared in accordance with international financial reporting standards IFRS as adopted by the EU and the Annual Accounts Act. The annuel report is prepared in accordance with the Swedish Annuel Accounts Act.

Amounts are expressed in kSEK (thousands of Swedish kronor) unless otherwise indicated. MSEK is an abbreviation for millions of SEK. Amounts or figures in parentheses indicate comparative figures for 2004.

Changes in accounting principles

As indicated above, Karo Bio has transitioned to IFRS. Other than presentational changes and increased disclosure requirements in the annual report, the transition to IFRS leads to changes in the following areas for the Company:

- IFRS 2 Share-based Payments – accounting for stock option programs
- IAS 39 Financial Instruments: Recognition and Measurement
- Accounting for currency forward contract intended for hedging exposure to currency fluctuations
- Valuation of short-term investments
- IAS 7 Cash Flow Statements – definition of cash and cash equivalents in the cash flow statement

IAS 39 became effective January 1, 2005. In accordance with the provisions of IFRS 1, Karo Bio has elected not to restate the periods prior to 2005 with regard to financial instruments in accordance with IAS 39. Financial instruments are, consequently, accounted for in accordance with previously adopted principles in restated financial statements for 2004.

Karo Bio has, based on IRFS 1, elected to not adjust business acquisitions made before 2004. Further, Karo Bio elected not to reset currency translation differences in equity as of January 1, 2004.

Additional description of the changes in accounting principles is provided below under each respective heading.

A review of all other IFRS standards not described in the previous sections was performed. The adoption of those standards did not have a material effect on Karo Bio's financial position or result.

Comparative figures for 2004 have been adjusted for changes in accounting principles except for changes from IAS 39 as described above.

New accounting standards

The new or amended accounting standards issued and effective January 1, 2006 or later are deemed not to have a significant impact on Karo Bio's result and financial position. The relevant accounting standards are deemed only to affect disclosures and have presentational effects on Karo Bio's annual report.

Reconciliation of reported loss and shareholders equity for comparative periods according to IFRS

The Company's financial statements have been affected by the transition to IFRS in the following way:

Equity as at January 1 and December 31, 2004, was not affected.

The reported loss for 2004 increased by kSEK 118 related to the costs of share-based payments for the 2003 stock option program. The value of the options was credited to equity, leading to a neutral net effect in equity.

Critical accounting estimates and judgments

The preparation of financial statements requires the use of certain critical accounting estimates. It also requires management to exercise its judgment in the process of applying the Company's accounting principles. Estimates and judgments are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

The areas involving a higher degree of judgment or complexity, or areas where assumptions and estimates are significant to the financial statements, relate to the valuation of tax losses carried forward and the valuation of stock options issued to employees. For further information, see below regarding respective accounting and valuation principles and notes 9 and 27.

Consolidated financial statements

The consolidated financial statements have been prepared in accordance with the purchase accounting method. Thus, in addition to the Parent Company's equity, only the result from the subsidiaries' operations after the date of acquisition is included in the Group's equity. The difference between the Group's cost for the shares in the subsidiaries and the fair value of identifiable assets and liabilities at the time of acquisition is reported as surplus values and is amortized over its estimated useful life. Inter-company receivables and payables as well as intercompany transactions have been eliminated.

The consolidated financial statements include all subsidiaries. A subsidiary is a company in which the Parent Company directly or indirectly has a controlling influence.

When translating financial statements of foreign subsidiaries, assets and liabilities of the subsidiary are translated at the closing day rate and income statement items are translated at the average rate. Currency translation differences are charged directly to equity.

Assets, liabilities and provisons
The financial statements have been prepared under the historical cost convention, except for financial assets and liabilities (including derivative intruments) at fair value through the income statement.

Assets and liabilities are stated at cost and nominal value respectively, unless otherwise indicated. Receivables are stated at the amounts expected to be received based on individual assessment.

Provisions are recorded when Karo Bio has a legal or informal commitment as a result of an event that has occurred, it is likely that a disbursement of resources will be required to settle the commitment and the amount can be reliably estimated.

Revenues
Karo Bio may receive four types of revenues from its strategic collaborative research projects: upfront payments, research funding milestone payments and royalties. Upfront payments are received at the initiation of collaborations and are non-refundable. Research funding is received periodically as a fixed amount for a defined number of Karo Bio scientists working in the project. Milestone payments are triggered when compounds enter or pass a major step in the development process, as defined in the research collaboration agreement. These steps are usually linked to significant decision points in the partner's drug development process. Royalties are based on the sale of finished pharmaceutical products in the market.

Research funding is reported as revenue in the period during which Karo Bio scientists are engaged in a collaboration in accordance with the research agreement. Upfront payments are reported as revenue over the collaborative research period for which Karo Bio is receiving research funding as specified in the research collaboration agreement, which usually is three years. Milestone payments are reported as revenue when all requirements specified in the research collaboration agreement for earning the milestone are met.

Other types of revenue are recorded when earned and possible to reliably estimate.

Income taxes
As required by IAS 12 Income Taxes, deferred income taxes on temporary differences between the tax basis of assets and liabilities and their carrying amounts in the financial statements are provided for in full, using the liability method. Deferred income tax is determined using tax laws and rates that have been enacted at the balance sheet date.

Financial instruments
Currency forward contracts
Karo Bio's policy is to hedge forecasted cash flows in foreign currencies from large currency rate fluctuations as provided in the Company's financial policy. In this respect, a certain level of assurance must exist in order to consider possible transactions and related cash flows. Currency hedging is accomplished through currency forward contracts. In accordance with IAS 39, all derivatives are to be measured at fair value defined as market value by Karo Bio. The derivatives currently used by the Company do not qualify for hedge accounting in accordance with IAS 39. The classification of these instruments provides for them to be reported in the balance sheet at fair value with changes in fair value included in other operating income and expenses in the income statement.

The previous accounting principle for forward currency contracts entered into for hedging purposes was to apply hedge accounting as per the old accounting pratctice, which meant that unrealized gains and losses on forward currency contracts were deferred and reported when realized.

Short-term investments
Short-term investments consist of investments in money market instruments, highly liquid bonds with maturities of less than five years and investments in highly liquid fixed income mutual funds. Short-term investments are classified as financial assets held for trading purposes. This entails that the assets are stated at fair value in the balance sheet, defined as market value. Changes in fair value are included in financial items in the income statement.

Acquisitions and dispositions of short-term investments are reported as of the transaction day, the day when Karo Bio is committed to buy or sell the asset.

Previously, short-term investments in debt instruments were stated at the lower of cost or market value. Any premium or discount on investments intended to be held to maturity was amortized over the life of the instrument.

Transactions in foreign currencies
Karo Bio's functional and reporting currency is Swedish kronor.

Receivables and payables in foreign currencies are translated at the exchange rate at the closing day. Revenues and expenses are translated at the exchange rate for the month in which the transaction occurred.

The majority of the Group's revenues are received in US dollars while most expenses are incurred in Swedish kronor. To reduce the Group's exposure to fluctuations in currency exchange rates, forecasted net cash flows in foreign currencies are hedged through forward currency agreements.

Non-current assets
Tangible and intangible non-current assets are depreciated and amortized, using a straight-line depreciation and amortization method, over their estimated useful life based on the assets cost as per the following schedule.

	Years
Licenses	3–10
Laboratory equipment	4–7
Leasehold improvements, IT equipment and other equipment	4

Depreciation of the exclusive rights to technology licensed from Duke University (see Note 12) is being taken over a three-year period, beginning in May 2001. Due to rapid development in the biotech area, a longer depreciation period is not considered appropriate. The milestone payments under this agreement will be expensed as incurred in order to match expected milestone payments received from partners.

Non-current assets are regularly assessed for impairment in accordance with the accounting standard IAS 36 Impairment of assets, if there are indications that an asset may have decreased in value. If the record-

ed amount is higher than the recoverable amount, the asset will be written down to this amount.

Research and development
Costs regarding development activities shall, as stipulated by IAS 38 Intangible Assets, be capitalized and reported in the balance sheet if certain criteria are met, while costs for research activities are expensed. One important criterion for capitalization of development costs relate to the future economic benefit from the result of such activities. The development activities that Karo Bio is engaged in are exposed to such a high level of uncertainty regarding future economic benefit as per IAS 38 that the criteria are not met. Consequently, all costs for research and development are expensed as incurred.

Pension costs
Employees in Sweden are entitled to retirement and family pension benefits in accordance with the nationwide ITP Plan. Commitments for theses pensions are secured through an insurance arrangement with Alecta Pension Insurance (Alecta). In accordance with an announcement from the Swedish Financial Accounting Standards Council's emerging issues group (URA 42), this arrangement is considered a defined benefit multi-employer plan. Karo Bio has not had access to such information to facilitate reporting of the plan as a defined benefit plan. Consequently, the ITP plan that is secured through an insurance arrangement with Alecta is reported, in accordance with IAS 19 Employee benefits, as a defined contribution plan. Premiums for pension insurance written with Alecta are expensed in the year they relate to. It is possible for participants in the ITP plan with a salary over a certain amount to make certain individualized choices as to how the premiums should be invested. In such situations premiums may be invested with other pension institutions than Alecta.

Leasing
Karo Bio has entered into leasing contracts with third parties in the ordinary course of business. These contracts are for office and laboratory space, laboratory equipment, automobiles and other equipment. Leasing contracts are classified as either financial or operating depending on the terms of the lease. A capital lease is a contract where the economic risks and rewards related to ownership of an asset in all material respects belong to Karo Bio. All other contracts are considered operational leases.

Capital leases are in essence reported as installment purchase contracts, where the equipment under lease is recorded as an asset and the net present value of future minimum lease payments are recorded as a liability. Equipment is depreciated as described under the heading Non-current assets.

Lease payments regarding operating leases are expensed in the period they relate to.

Stock option programs
Karo Bio has issued stock options to employees under two stock option programs, Program 2001 and Program 2003. Accounting for such stock options is regulated by IFRS 2 Share-based Payments. IFRS 2 applies to Program 2003, while Program 2001 under the transition rules is not covered by IFRS 2 except for the disclosure requirements since the options under this program were issued before November 7, 2002. Program 2003 is considered an equity-settled payment transaction under IFRS 2, where the fair value of the options granted is recognized in the income statement as a payroll expense over the vesting period. The fair value of the options granted under Program 2003, determined as of the grant date, amounted to MSEK 0.4 based on a valuation performed by Ernst & Young. The Black-Scholes model for option pricing was used for the valuation. The expected life used in the model has been adjusted, based on management's best estimate, for the effects of non-transferability, exercise restrictions, and behavioral considerations. Vesting conditions are included in assumptions about the number of options that are expected to become exercisable. These estimates are revised regularly. Karo Bio recognizes the impact of the revision of original estimate, if any, in the income statement, and a corresponding entry to equity over the remaining vesting period. The proceeds received net of any directly attributable transaction costs are credited to equity when options are exercised.

The previously used accounting principle for stock-based compensation was, upon exercise of the stock option, to credit the exercise price to equity. No charge was taken to the income statement for stock options granted as compensation for employees. This principle will continue to apply for Program 2001.

Cash flow statements
Karo Bio has used the term liquid assets, defined as bank holdings and short-term investments, as the ending component of the cash flow statement. In accordance with IAS 7 Cash Flow Statements, only investments with maturities of less than 90 days at the time of acquisition are to be included in the term cash and cash equivalents used by IAS 7. As a consequence, changes such as investments in and redemptions or sales of short-term investments with maturities exceeding 90 days are reported as cash flows from investing activities. Hence, cash and cash equivalents as of January 1 and December 31, 2004 are lower than liquid assets previously reported in the cash flow statement.

Segment reporting
Karo Bio's operations entail only one segment, discovery and development of drugs, and the consolidated income statement and balance sheet is therefore the primary segment. Geographical areas are secondary segments and involve Europe, NAFTA and the rest of the world.

THE PARENT COMPANY
Beginning January 1, 2005 the Parent Company implemented RR 32 Reporting for legal entities, which has lead to the same effects in the financial statements as for the Group from IAS 39 and IFRS 2.

The Parent Company's accounting and valuation principles are the same as the Group's with the exception for leasing. All leasing contracts are reported as operating leases in the Parent Company.

Notes to the Financial Statements

NOTE 1 NET SALES

Net sales consist of research funding and milestone payment. Net sales in 2004 also included the year's share of upfront payment from a collaboration partner.

NOTE 2 PERSONNEL AND REMUNERATION TO MEMBERS OF THE BOARD AND EXECUTIVE MANAGEMENT

AVERAGE NUMBER OF EMPLOYEES

	2005		2004	
	Number of employees	Men	Number of employees	Men
Parent Company				
Huddinge, Sweden	76	43	85	47
Subsidiaries				
USA	–	–	0	0
Group	**76**	**43**	**85**	**47**

WAGES, SALARIES, OTHER REMUNERATION AND SOCIAL SECURITY EXPENSES

	2005		2004	
	Wages, salaries and other remuneration	Social security expenses (of which pension costs)	Wages, salaries and other remuneration	Social security expenses (of which pension costs)
Parent Company				
Board and Presidents	7,886	3,036	3,315	1,471
		(383)		(340)
Other employees	37,369	20,516	43,652	23,623
		(6,730)		(7,694)
Subsidiaries				
USA	–	–	518	39
Group	**45,255**	**23,552**	**47,485**	**25,133**
		(7,113)		**(8,034)**

Of wages, salaries and other remuneration for the Group and the Parent Company, kSEK 6,572 (2,275) refers to the Presidents, of which 4,296 is severance payment.

LEAVE OF ABSENCE DUE TO SICKNESS

January 1–December 31	2005	2004
Parent Company		
Leave of absence due to sickness, total	2.3 %	4.3 %
whereof long-term sickness	1.2 %	3.3 %
Leave of absence due to sickness,		
men	0.9 %	2.4 %
women	4.0 %	6.5 %
Leave of absence due to sickness, employees		
under 30 years of age	–	–
30 - 50 years of age	1.7 %	3.1 %
over 50 years of age	4.5 %	10.1 %

The information provided applies, in accordance with the Swedish Annual Accounts Act, to Swedish employees only.
Information has been intentionally omitted where a group of employees is too small for disclosure.

NOTE 2 Continued

REMUNERATION TO BOARD MEMBERS

The Board elected by the shareholders' meeting consists of six Directors, including one woman, with one deputy Director and one Director with deputy appointed by an employee organization.

The Chairman of the Board receives annual remuneration of kSEK 390 and each Board member, who is not paid as an employee or consultant by the Company, receives kSEK 130 based on the decision at the April 13, 2005 shareholders' meeting. A total of kSEK 910 (1,040) in remuneration was paid as Directors' fee to Board members during 2005. Members of the Board are also reimbursed for direct expenses, such as travel costs. kSEK 110 was paid for committee engagements for 2005.

Two deputy Board members, Dr. John D. Baxter, professor at University of California, San Francisco and Dr. Jan-Åke Gustafsson, professor at Karolinska Institutet, Stockholm, provide scientific consulting services to the Company and are therefore paid no remuneration for their service as Directors. Fees for scientific services provided, amounting to kSEK 180 (567) and 960 (960) respectively, was paid to these deputy Board members. The amount regarding Dr. Baxter relates to the period until April 2005, when his Board engagement ended. No other remuneration was paid to members of the Board in 2005.

Karo Bio has an extensive academic network that is of utmost importance for the Company's success. Karo Bio has different types of collaborations with the institutions in the network. The network also includes an academic institution where a member of the Karo Bio Board, Jan-Åke Gustafsson, holds a professorship. Professor Gustafsson does not participate in Karo Bio's preparation of or decisions regarding financial terms in such collaborations.

REMUNERATION TO EXECUTIVE MANAGEMENT

A Compensation Committee, consisting of three Board members including the Chairman of the Board, is handling questions regarding executive management's compensation and benefits, including that of the President. Per-Olof Mårtensson, Chairman, Lars Ingelmark and Dr Leon E. Rosenberg served on the Committee during 2005. The Committee prepares remuneration matters for Board consideration and makes decisions in compensation matters of lesser significance. The Board makes all policy decisions regarding remuneration of executive management and the salary of the President.

Members of executive management are paid a fixed monthly salary and participate in an incentive bonus program. The program is based on achievement of goals set by the Compensation Committee. Maximum bonus for individuals covered by the program is equal to 20 percent of their annual base salary. The monetary information below regarding bonus represents the bonus for 2005, which is paid in 2006. Other benefits provided to executive management are company cars and health care insurance. Executive management is entitled to pension benefits in accordance with the nationwide ITP Plan as are all other Swedish employees, unless stated otherwise below. Pension benefits are based on a retirement age of 65 and paid as long as the retiree lives. Paid salary including bonus qualifies for pension benefits. The ITP Plan provides for no pension benefits for annual salaries currently exceeding kSEK 1,299.

Executive management is eligible to participate in company-wide stock-based incentive programs. See Note 27 Stock Option Programs for further information.

During 2005 executive management consisted of six (four) persons in addition to the President, one of whom is a woman. These people are: Anders Berkenstam, Vice President Discovery Research; Berit Edlund, Director of Human Resources; Bertil Jungmar, Chief Financial Officer; Jens Kristensen, Chief Medical Officer; Per Otteskog, Senior Vice President Investor Relations and Lars Öhman, Vice President Business Development. Jens Kristensen was hired as of November 1, 2005 and is included in the amounts below from this date.

Per Olof Wallström was appointed President in March 2005, replacing Björn Nilsson, who then left the Company. Per Olof Wallström received a total fixed salary of kSEK 1,807 (-) during his employment in 2005 and a bonus for 2005 amounting to kSEK 293 (0). Wallström earns pension benefits in the form of a defined contribution of 18.5 percent of the annual salary. Pension costs totaled kSEK 345 (-) and other benefits amounted to kSEK 85 (-).Wallström held no stock options at year-end.

Björn Nilsson received a total fixed salary, including earned vacation pay, of kSEK 642 (2,175) in 2005 and no bonus for 2005 (0). Pension costs amounted to kSEK 38 (340) and other benefits amounted to kSEK 61 (100). Nilsson received two years salary, amounting to kSEK 4,296, in severance in conjunction with the termination of his employment. In addition to the benefits in accordance with the ITP Plan as per above, Nilsson is entitled to an annual pension of approximately kSEK 21 (128). The pension benefit is secured through an agreement with a life insurance company and premiums are paid annually. Nilsson's stock options forfeited in 2005.

Other members of executive management received a total fixed salary of kSEK 5,030 (3,782) in 2005 and bonus for 2005 amounting to kSEK 697 (0). Pension costs amounted to kSEK 1,748 (1,657) and other benefits amounted to kSEK 171 (196). Severance payment amounted to kSEK 0 (2,408). Other members of executive management held in total stock options at year-end representing 57,676 (51,578) shares. No allocation was made during 2005.

AGREEMENTS REGARDING SEVERANCE PAY

The President has a termination period of six months and is entitled to one year salary as severance pay if terminated by the Company. Other members of executive management have a mutual termination period of up to six months and are entitled to severance pay of up to two years salary.

NOTE 3 PENSION COSTS

Commitments for retirement and family pension under the ITP plan are secured through an insurance arrangement with Alecta Pension Insurance (Alecta). Premiums regarding pension insurance written 37 (5,030).

Alecta's surplus may be allocated to the insurance holders and the insured. At year-end, Alecta's surplus in the form of total consolidation level amounted to 128.5 percent (128.0). The total consolidation level is defined as the market value of Alecta's assets as a percentage of the actuarial commitments determined as per Alecta's assumptions, which are different from IAS 19 Employee benefits.

Also, please see accounting principles regarding pensions above.

NOTE 4 OPERATING EXPENSES BY NATURE

Operating expenses are distributed on expense type as follows.

	GROUP		PARENT COMPANY	
	2005	2004	2005	2004
Depreciation	–7 233	–12 369	–6 175	–19 496
Personnel costs	–71 315	–73 922	–71 315	–73 313
Facilities costs	–9 433	–11 912	–9 433	–11 698
External costs	–71 817	–57 233	–72 854	–59 241
Other operating income and expenses	–804	2 140	–804	2 140
	–160 602	**–153 296**	**–160 581**	**–161 608**

NOTE 5 DEPRECIATION AND AMORTIZATION

Depreciation and amortization costs are allocated to the Company's functions and types of assets as follows.

	Note	GROUP 2005	GROUP 2004	PARENT COMPANY 2005	PARENT COMPANY 2004
Function					
Administrative expenses		1,657	2,045	1,657	2,045
Research and development expenses		5,576	10,324	4,518	17,451
		7,233	**12,369**	**6,175**	**19,496**
Type of asset					
Licenses	12	78	3,905	78	12,045
Equipment	13	7,155	8,464	6,097	7,451
		7,233	**12,369**	**6,175**	**19,496**

NOTE 6 OTHER OPERATING INCOME AND EXPENSES

Other operating income and expenses include success fees paid, royalty to the Swedish Industrial Development Fund (for further information see note 22), and exchange gains and losses on transactions in foreign currency. Net exchange gains and losses amount to kSEK 236 (1,920).

NOTE 7 INTEREST INCOME AND OTHER SIMILAR INCOME

	GROUP 2005	GROUP 2004	PARENT COMPANY 2005	PARENT COMPANY 2004
Interest income	3,111	2,371	3,111	2,369
Capital gains and dividends from short-term investments	185	2,768	185	2,768
Fair value gains and losses	–149	–	–149	–
Exchange differences	–5,208	2,368	–5,208	2,368
	–2,061	**7,507**	**–2,061**	**7,505**

NOTE 8 INTEREST EXPENSE AND OTHER SIMILAR EXPENSES

The Parent Company interest expense includes inter-company interest expense amounting to kSEK 1,425 (540).

NOTE 9 TAX

Because the Company is reporting losse
forward from prior years have not been assigned a value in the financial statements, since it is not likely that they will be utilized in the next few years.

At year-end, the Parent Company's unutilized tax losses carried forward amounted to MSEK 1,018 (891). In addition, there are losses carried forward of MSEK 23 (23) in subsidiaries. The tax losses carried forward in the US subsidiary expire after 15 years and may be subject to limitations under the rules regarding a change in ownership as determined by the Internal Revenue Code. There is no statutory time limit for Swedish companies to utilize tax losses.

Unrecognized temporary differences relating to investments in subsidiaries in accordance with IAS 12 Income Taxes amount to MSEK 679 (681) for the Group. These differences, which are deferred tax assets ying
amount in financial statements is affected
with IAS 12 Income Taxes, are not recognized. The corresponding amount for the Parent Company is MSEK 695 (695).

RECONCILIATION BETWEEN ACTUAL AND NOMINAL TAX

	GROUP		PARENT COMPANY	
	2005	2004	2005	2004
Reported loss before tax	–111,007	–107,298	–112,282	–115,992
Tax at nominal tax rate 28%	31,082	30,043	31,439	32,478
Tax effect from deductible items not recorded as expenses	4,276	1,740	4,276	1,740
Tax effect from other non-deductible items		–121	–79	–121
Tax effect from temporary differences	–1,278	–519		
Effect from variance in tax rates	226	671		
Tax effect of deficits for which tax assets are not considered	–34,306	–31,814	–35,636	–34,097
Tax on reported loss	**0**	**0**	**0**	**0**

NOTE 10 LOSS FOR THE YEAR

The entire loss is related to the Parent Company's shareholders, no minority interest exist.

NOTE 11 LOSS PER SHARE

Warrants are non-dilutive as exercise of warrants would decrease the loss per share reported for 2004–2005.
Per share data is calculated based on the following number of shares.

Number of shares outstanding (000)	2005	2004
Weighted-average during the year	46,802	31,510
At year-end	77,413	43,918

The number of

NOTE 12 LICENSES AND SIMILAR RIGHTS

Licenses and similar rights consist of exclusive rights to technologies licensed from Duke University, Durham, North Carolina in 2001 and licenses from University of California, San Francisco for scientific rights that were acquired in 1996.

In May 2001, Karo Bio reached an agreem
at Duke University Medical Center. The Cellular Braille™ technology further expands the capabilities of the Molecular Braille® technology that was previously developed by Karo Bio USA in collaboration with scientists at Duke University Medical Center. The amount capitalized represents the net present value of the determinable payments according to the agreement. Payments were made over a four-year period and the last payment was made in May 2005. Additional payments, of lower amounts, contingent on patents being received and milestones being achieved are provided for in the agreement.

In 2001, as part of the Company's transfer pricing policy, the Parent Company acquired certain rights to technologies from the wholly-owned subsidiary Karo Bio USA, Inc.

	GROUP		PARENT COMPANY	
	2005	2004	2005	2004
Opening balance acquisition cost	30,319	30,319	71,259	71,259
Acquisitions	–	–	–	–
Closing balance acquisition cost	**30,319**	**30,319**	**71,259**	**71,259**
Opening balance depreciation	–30,241	–26,336	–71,181	–59,136
Depreciation for the year	–78	–3,905	–78	–12,045
Closing balance accumulated depreciation	**–30,319**	**–30,241**	**–71,259**	**–71,181**
Net book value	**0**	**78**	**0**	**78**

NOTE 13 EQUIPMENT

	GROUP		PARENT COMPANY	
	2005	2004	2005	2004
Opening balance acquisition cost	85,178	89,565	80,535	80,392
Acquisitions	1,775	4,114	1,775	1,642
Sales and discards	–3,459	–8,677	–3,459	–1,499
Exchange difference	–	176	–	–
Closing balance acquisition cost	**83,494**	**85,178**	**78,851**	**80,535**
Opening balance depreciation	–66,647	–65,649	–65,248	–59,178
Sales and discards	3,432	7,619	3,431	1,381
Depreciation for the year	–7,155	–8,464	–6,097	–7,451
Exchange difference	–	–153	–	–
Closing balance accumulated depreciation	**–70,370**	**–66,647**	**–67,914**	**–65,248**
Net book value	**13,124**	**18,531**	**10,937**	**15,287**

NOTE 14 SHARES IN GROUP COMPANIES

	PARENT COMPANY	
	2005	2004
Opening balance acquisition cost	722,340	722,340
Closing balance acquisition cost	**722,340**	**722,340**
Opening balance write-downs	-699,240	-699,240
Closing balance accumulated write-downs	**-699,240**	**-699,240**
Net book value	**23,100**	**23,100**

Subsidiary	Domicile	Reg.no.	Holding	No. of Shares	Book value
Karo Bio USA, Inc.	North Carolina, USA	56-1966375	100%	1,000	23,000
Karo Bio Research AB	Huddinge, Sweden	556588-3641	100%	1,000	100
					23,100

NOTE 15 PREPAID EXPENSES AND ACCRUED INCOME

	GROUP		PARENT COMPANY	
At December 31	2005	2004	2005	2004
Prepaid rent	1,940	1,991	1,940	1,991
Accrued interest income	1,235	2,657	1,235	2,657
Other	2,756	2,743	2,756	2,743
	5,931	**7,391**	**5,931**	**7,391**

NOTE 16 OTHER SHORT-TERM INVESTMENTS

Other short-term investments consist of investments in liquid bonds with maturities of more than 90 days but less than five years at the time of acquisition.

NOTE 17 LIQUID ASSETS

Liquid assets at the end of the year consist of the following assets.

	GROUP		PARENT COMPANY	
	2005	2004	2005	2004
Short-term investments with maturities less than 90 days	261,505	51,108	261,505	51,108
Cash and bank balances	45,765	14,482	45,755	14,470
Liquid assets	**307,270**	**65,590**	**307,260**	**65,578**

NOTE 18 SHAREHOLDERS' EQUITY

Share capital consists of 77,412,795 (30,965,118) shares at a par value of SEK 2 (5). The par value of the shares was reduced from SEK 5 to 2 through a resolution by the general meeting in April 2005 that was subsequently approved and registered by the Swedish Companies Registration Office in May 2005. Following amendments to the Swedish Companies Act effective January 1, 2006, there is no par value defined for the shares.

Accumulated currency translation difference amounts to kSEK –9,222 (–14,037).

Proceeds from new share issues, in excess of par value, were credited to the share premium reserve as required by the Swedish Annual Accounts Act. The Share Premium Reserve is not available for distribution to shareholders as dividend, but can be utilized by the general shareholders' meeting to cover accumulated losses. Due to amendments to the Swedish Companies Act, the share premium reserve is transferred to statutory reserve as of December 31, 2005. The statutory reserve can be utilized in the same way as the share premium reserve.

A rights issue of 46,447,677 new shares was carried out in 2005. The issue generated kSEK 263,413 net of transaction costs amounting to kSEK 15,273.

During 2004, a new share issue with preferential rights to existing shareholders was carried out, resulting in 11,260,043 new shares. An additional 2,815,010 shares were issued based on the authorization granted at the special general meeting August 30, 2004. In total, kSEK 113,422 was generated net of transaction costs amounting to kSEK 6,216.

The effect from changes in accounting principles relates to the implementation of IAS 39 Financial Instrument: Recognition and Measurement. The difference between the measurement according to IAS 39 and previously adopted principles are in the balance sheet as at January 1, 2005, reported in the shareholders' equity in accordance with the transition rules in IFRS 1. The effect amounts to kSEK 249 and consists of kSEK 171 regarding currency forward contracts and kSEK 78 regarding short-term investments. The amounts have increased other current assets and short-term investments, respectively, as of January 1, 2005.

At year-end, warrants representing 1,014,470 shares were outstanding. The warrants were issued in conjunction with the implementation of the Stock Option Program 2001 (warrants representing 612,000 shares) and Stock Option Program 2003 (warrants representing 402,470 shares). The remaining warrants issued in conjunction the acquisition of Karo Bio USA, Inc. in 2000 (warrants representing 3,219 shares) were cancelled in May 2005. No warrants were exercised during 2005.

In accordance with the Board's policy for dividend, the Board of Directors and the President will propose to the Annual Shareholders' Meeting on May 3, 2006, that no dividend be paid for the financial year 2005.

NOTE 19 NON-CURRENT LIABILITIES

None of the non-current liabilities falls due more than five years after the balance sheet date.

NOTE 20 CAPITAL LEASES

The present value of future minimum lease payments is reported as a liability in the balance sheet. Such payments fall due as outlined below.

	GROUP	
At December 31	2005	2004
Within one year	1,051	1,051
Later than one but within five years	1,644	2,573
Later than five years	–	–
	2,695	**3,624**

Variable fees, which means the difference between the interest when entering into the agreement and paid interest, included in operating expenses during the year amounts to kSEK –22 (–13). Equipment with a total cost of kSEK 0 (2,472) was financed with leasing contracts during the year.

The capital lease contracts pertain to laboratory equipment with a carrying value of kSEK 2,499 (3,430).

The interest rate in the contracts is variable and linked to the Swedish general interest rate. Karo Bio has the right to extend the leasing period or acquire, direct or indirectly via another entity, the equipment at a predetermined price upon expiration of the contract.

NOTE 21 ACCRUED EXPENSES

	GROUP		PARENT COMPANY	
At December 31	2005	2004	2005	2004
Accrued social security expenses	1,409	1,327	1,409	1,327
Accrued vacation	6,349	6,976	6,349	6,976
Other	6,541	8,317	6,541	8,317
	14,299	**16,620**	**14,299**	**16,620**

NOTE 22 CONTINGENT LIABILITIES

Between 1995 and 1997 the Swedish Industrial Development Fund provided partial financing amounting to MSEK 24 for Karo Bio's research regarding pharmaceutical compounds for the treatment of hypercholesterolemia. The amount received was recorded as revenue during this period. This amount including interest will be repaid through royalties on the revenues fro
accrued interest after deduction of royalties expensed.

NOTE 23 ADDITIONAL INFORMATION CASH FLOW STATEMENTS

	GROUP		PARENT COMPANY	
	2005	2004	2005	2004
Interest received	5,741	2,217	5,741	2,215
Interest paid	–11	–11	–11	–11
Income taxes paid	–	–	–	–

NOTE 24 OPERATING LEASES

Leasing costs for the year amounted to kSEK 7,605 (10,381) for the Group and kSEK 8,663 (10,128) for the Parent Company.
Future minimum lease payments on non-cancelable lease contracts fall due as follows.

	GROUP		PARENT COMPANY	
At December 31	2005	2004	2005	2004
Within one year	6,834	6,557	7,889	7,620
Later than one but within five years	5,100	11,524	6,662	14,163
Later than five years	–	–	–	–
	11,934	**18,081**	**14,551**	**21,783**

The leasing agreements relate to laboratory and office space, laboratory equipment and cars.

NOTE 25 INTER-COMPANY PURCHASES AND SALES

During the year Karo Bio AB purchased services from subsidiaries for kSEK 0 (1,769).

NOTE 26 REMUNERATION TO AUDITORS

	GROUP		PARENT COMPANY	
	2005	2004	2005	2004
PricewaterhouseCoopers				
Auditing	354	382	354	381
Other assignments	122	305	122	298
	476	**687**	**476**	**679**

NOTE 27 STOCK OPTION PROGRAMS

Karo Bio has introduced two stock option programs in accordance with decisions made at the Annual Shareholders' Meeting in April 2001 and 2003, respectively. The programs are stock option programs and cover permanent employees of Karo Bio.

The financial exposure from the stock option programs is hedged by warrants issued to a wholly-owned subsidiary. A specified portion of the warrants is reserved to cover payroll taxes and other related costs and is transferred to a bank under separate agreements. The agreements stipulate for the bank to provide cash to facilitate payment of such payroll taxes and other related costs. Cash will be generated from the reserved lot of warrants, which are held by the bank.

The terms of the stock option programs provide for adjustments of the exercise price and number of shares for each stock option if new shares are issued with preferential rights to shareholders. The figures below are adjusted accordingly, unless otherwise indicated.

PROGRAM 2003

The program originally involved 190,000 stock options, representing 317,300 shares. Additional warrants representing 85,170 shares are reserved to cover payroll taxes. Maximum allocation of stock options represents 33,400 shares to the President, a maximum 8,350 shares per person to executive management and key employees, and maximum 3,340 shares per person to other employees.

102,136 stock options, representing 170,567 shares, were allocated to employees in 2004, based on their performance during 2003. They were issued in four series and at no cost to employees. The stock options vest and become exercisable in one series per year over a four-year period until May 2008. Stock options may vest earlier in certain situations predefined in the terms of the program, such as long-term disability and employment terminated by the employer. Last date for exercise is in April 2011 for all series, provided continued employment. The exercise price is to SEK 20, 22, 24 and 26 for each series, respectively. Stock options representing 130,699 shares were outstanding at year-end.

Ernst & Young has been engaged to carry out a valuation of the stock options allocated. The valuation was made in accordance with IFRS 2 Share-based Payments. The Black-Scholes model for option pricing has been used for the valuation with an anticipated volatility of 50 percent and the share price as of April 30, 2004, which was SEK 23.50. Factual circumstances and expectations relevant to Karo Bio have been considered in accordance with the accounting standard, such as restrictions for exercise, vesting periods and expected life of stock options. Based on the foregoing, the value of the allocated stock options is MSEK 0.4. The valuation serves as the basis for financial reporting in accordance with IFRS effective January 1, 2005.

PROGRAM 2001

The program originally involved 270,000 stock options, which represent 486,000 shares. Additional warrants representing 126,000 shares are reserved to cover payroll taxes. Options representing 185,230 shares were outstanding at year-end.

Stock options vest annually over four years and are exercisable between May 31, 2002 and April 30, 2008, provided continued employment. Stock options may vest earlier in certain situations predefined in the terms of the program, such as long-term disability and employment terminated by the employer. They were issued at no cost to employees. The stock options have an exercise price ranging between SEK 178 and 184.

According to the transition rules for implementation of IFRS, this program is not covered by IFRS 2 Share-based Payments.

EFFECT ON FINANCIAL STATEMENTS

The accounting principles for stock option programs are described above.

The cost charged to the income statement in 2005 for Program 2003 amounts to kSEK 126 (118) with a corresponding entry to equity.

Future exercise of stock options will have a positive effect on the Company's financial position, as plan participants will pay monies to the Company to exercise options in accordance with the exercise price. Additional costs occurring as an effect of the program, consisting primarily of payroll taxes levied upon exercise, will be covered by exercise of the additional warrants held by an external party. There will be no adverse effect on the Company's financial position from the program, provided that the percentage at which payroll taxes are levied does not change significantly during the remainder of the exercise period.

INCREASE IN NUMBER OF SHARES

Exercise of all options outstanding under the two plans would lead to an increase of the number of shares by 0.5 percent, including warrants required to cover payroll taxes. The issued warrants would not imply dilution of earnings per share in 2001–2005, as a conversion to shares would lead to a decrease in the reported loss per share.

STOCK OPTION PROGRAMS IN ACQUIRED COMPANIES

At the time of acquisition, the now wholly-owned subsidiary Karo Bio USA, Inc. sponsored stock option programs for its employees. In conjunction with the acquisition of Karo Bio USA, Inc., Karo Bio AB issued warrants to cover shares to be issued in the event of the exercise of stock options. The exercise price of the stock options outstanding under the Karo Bio USA, Inc. plans, convertible into one Karo Bio AB share, ranges from USD 0.48 to USD 1.43. As of December 31, 2004, there were no further stock options outstanding. Consequently, no more of these warrants can be exercised. The remaining warrants were cancelled in may 2005.

ALLOCATION OF STOCK OPTIONS (CORRESPONDING NUMBER OF SHARES)

	2005	2004
Outstanding at January 1	298,838	235,571
Allocated	–	102,136
Effect from new share issue	127,944	54,271
Exercised	–	–12,011
Forfeited	–110,853	–81,129
Outstanding at December 31	**315,929**	**298,838**
Vested	217,905	150,119

WEIGHTED AVERAGE EXERCISE PRICE FOR STOCK OPTIONS, SEK

	2005	2004
Outstanding at the beginning of the year	123	172
Forfeited during the year	149	149
Exercised during the year	–	6
Outstanding at the end of the year	114	123
Exercisable at the end of the year	154	177

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Weighted average share price for stock options exercised on the day of exercise was SEK – (23). The weighted average remaining period for stock options outstanding at year-end was 3.6 years (4.4) with exercise prices ranging from SEK 20 to 184.

NOTE 28 FINANCIAL INSTRUMENTS AND RISKS AND SENSITIVITY ANALYSIS

Karo Bio, like any other company engaged in business, is exposed to various risks varying from time to time. The relevant risks to Karo Bio can be broken down into commercial risks and financial risks.

Karo Bio's financial policy determines allocation of responsibility for the finance operations, which financial risks the Company is willing to assume and guidelines for how such risks are to be reduced and managed. The policy, which is reviewed and approved annually by the Karo Bio Board of Directors, is developed to control and manage the following risks.

- Foreign currency risk
- Funding risk
- Liquidity risk
- Interest rate risk
- Credit risk in investments

Financial risk management is centralized in the Company and is the responsibility of the chief financial officer.

FOREIGN CURRENCY RISK

Changes in foreign currency rates have an impact on Karo Bio's earnings and equity in different ways:

- Earnings are affected when revenues and expenses are denominated in different currencies – transaction risk.
- Earnings are affected when assets and liabilities are denominated in different currencies – translation risk.
- Earnings are affected when the income statements of foreign subsidiaries are converted into Swedish kronor – translation risk.
- Shareholder's equity is affected when the balance sheets of foreign subsidiaries are converted into Swedish kronor – translation risk.

Operational risks

Karo Bio is operating in an international industry. Most of the Company's revenues are denominated in US dollars and approximately 79 (86) percent of expenses are incurred in Swedish kronor. The remainder of Karo Bio's expenses is mainly denominated in euros and US dollars. This leads to an exposure to currency fluctuations, a combination of both translation and transaction risks. Karo Bio's reporting currency is Swedish kronor.

The diagram indicates the effect on Karo Bio's earnings and operating result, if Swedish kronor strengthen by 10 percent. Both translation and transaction risks have been considered. The total effect on the operating result would be MSEK –2 (–1).

CURRENCY EFFECT ON (MSEK)

Currency	Revenues	Operating result
USD	–5.2	–4.3
Other	–	2.3
Total	**–5.2**	**–2.0**

Effect on consolidated revenues and operating result before hedging transactions if Swedish kronor strengthen by 10 percent.

The Company's financial policy provides that the cash flow exposure shall be hedged. Currency hedging is accomplished primarily through currency forward contracts. Between 50 and 90 percent of forecasted cash flows for a twelve month period shall be hedged. In this respect, a certain level of assurance must exist in order to consider possible transactions and related cash flows. Contracted cash flows such as research funding received in accordance with research collaboration agreements, are hedged for the contracted period of up to 36 months. However, not more than 50 percent of contracted cash flows are hedged to take into consideration future expenses related to the cash receipts. The effect of the policy is that the impact from currency fluctuation is delayed.

There were no currency forward contracts at year-end. The total nominal value of currency forward contracts at the end of 2004 amounted to MSEK 1, with an average remaining life of two months. Unrealized gains on these contracts amounted to MSEK 0 at the end of 2004. Currency forward contracts that matured in 2005 affected the operating result with MSEK 0 (2).

Translation of financial statements of foreign subsidiaries

The consolidated financial statements are affected by currency fluctuations when the income statements and balance sheets of foreign subsidiaries are translated into Swedish kronor to be included in the consolidated financial statements of Karo Bio. The Company's policy is not to hedge such exposure.

Shareholders' equity was credited with MSEK 5 (–2) in 2005 from such currency translation differences.

Financial risks

Currency risks in financial flows related to liabilities and investments is reduced by making investments in Swedish kronor, unless an investment in a foreign currency would serve as a hedge of an existing exposure. Karo Bio's liabilities that are classified as non-operating for financial reporting purposes consist of an inter-company payable from the Parent Company to Karo Bio USA, Inc. and a payable to Duke University. The inter-company payable is not hedged. The payable to Duke University is considered by including the payments in the forecasted operating cash flow to be hedged. Consequently, the currency translation of both these payables leads to currency effects in the financial net amounting to MSEK –5 (2) in 2005.

FUNDING RISK

The risk that the Company will not have access to necessary financing at all times is defined as funding risk. From time to time, the Company has raised additional funds in the capital market to secure sufficient funds for the operations and stability of the Company. A recurring review of funding needs is carried out in combination with an assessment of capital market developments to evaluate financing strategies.

LIQUIDITY RISK

Liquidity risk refers to the risk that the Company will not have sufficient monetary assets readily available to pay current foreseen or unforeseen expenditures. The risk is associated with the supply and maturity of short-term investments and the risk that there is no market for a specific instrument that the Company needs to sell. Liquidity risk is managed by structuring the maturities of investments based on cash flow forecasts and also limiting investments in bonds with low liquidity on the second-hand market. Weighted remaining duration of short-term investments was two (nine) months at year-end.

INTEREST RATE RISK

Interest rate risk is the risk that a change in interest rates will cause a negative impact on the value of interest-bearing assets. In accordance with the policy, investments are made with variable terms and maturities. The immediate impact on short-term investments if the interest rate would decrease by one percentage is 0.15 (0.61) percent or MSEK 0.5 (1.0).

CREDIT RISK IN INVESTMENTS

Credit risk refers to the risk that Karo Bio will not receive payment for an investment. The credit risk is divided into issuer's risk and counterpart's risk.

Issuer's risk is the risk that the securities, which Karo Bio has in its possession, will lose their value because the issuer cannot meet its commitments in the form of interest payments and payments on the due date.

Counterpart's risk is the risk that the party that Karo Bio buys investments from or sells investments to cannot provide securities or make payment in accordance with what has been agreed.

The policy manages credit risk by regulating which parties Karo Bio can do business with and what credit ratings are required for investments. There is no material concentration of credit risks.

FAIR VALUE OF ASSETS AND LIABILITIES

The fair value, defined as the quoted price in the market, for short-term investments amounts to MSEK 301 (167) while book value amounts to MSEK 301 (167). Fair value for currency forward contracts, defined as the value generated if the contract would be closed through a counter-contract, amounted to MSEK -(0), with no book value. For other assets and liabilities is book value corresponds to market value.

NOTE 29 SEGMENT INFORMATION

Revenues, assets and investments in equipment and intangible assets are distributed among secondary segments as follows.

	GROUP	
	2005	2004
Revenues		
NAFTA	51,913	38,953
	51,913	**38,953**
Assets		
Europe	374,815	214,129
NAFTA	–	2
	374,815	**214,131**
Investments in equipment and intangible assets		
Europe	1,775	4,114
	1,775	**4,114**

NOTE 30 TRANSACTIONS WITH RELATED PARTIES

Karo Bio has no transactions with related parties as defined in IAS 24 Related party disclosures to disclose other than those disclosed in note 2 regarding remuneration to members of the Board and executive management.

NOTE 31 EVENTS AFTER THE BALANCE SHEET DATE

There are no events after the balance sheet date to report.

The income statements and balance sheets will be presented for the annual general meeting on May 3, 2006 for adoption.

HUDDINGE FEBRUARY 7, 2006

Per-Olof Mårtensson
Chairman

Dana M. Fowlkes | **Lars Ingelmark** | **Ulla Litzén**

Leon E. Rosenberg | **Per Olof Wallström**
President | **Bo Carlsson**

OUR AUDIT REPORT WAS ISSUED FEBRUARY 23, 2006.

PricewaterhouseCoopers AB
Claes Dahlén
Authorized Public Accountant

Audit Report

TO THE ANNUAL MEETING OF THE SHAREHOLDERS OF KARO BIO AB (PUBL.)
CORPORATE IDENTITY NUMBER 556309-3359

We have audited the annual report, the consolidated financial statements, the accounting records and the administration of the board of directors and the managing director of Karo Bio AB (publ.) for the year 2005. The board of directors and the managing director are responsible for these financial statements and the administration of the company as well as for the application of the Annual Accounts Act when preparing the annual report and the application of international financial reporting standards IFRSs as adopted by the EU and the Annual Accounts Act when preparing the consolidated financial statements. Our responsibility is to express an opinion on the annual report, the consolidated financial statements and the administration based on our audit.

We conducted our audit in accordance with generally accepted auditing standards in Sweden. Those standards require that we plan and perform the audit to obtain reasonable assurance that the annual report and the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and their application by the board of directors and the managing director and significant estimates made by the board of directors and the managing director when preparing the annual report and consolidated financial statements as well as evaluating the overall presentation of information in the annual report and the consolidated financial statements. As a basis for our opinion concerning discharge from liability, we examined significant decisions, actions taken and circumstances of the company in order to be able to determine the liability, if any, to the company of any board member or managing director. We also examined whether any board member or managing director has, in any other way, acted in contravention of the Companies Act, the Annual Accounts Act or the Articles of Association. We believe that our audit provides a reasonable basis for our opinion set out below.

The annual report has been prepared in accordance with the Annual Accounts Act and gives a true and fair view of the company's financial position and results of operations in accordance with generally accepted accounting principles in Sweden. The consolidated financial statements have been prepared in accordance with international financial reporting standards IFRSs as adopted by the EU and the Annual Accounts Act and give a true and fair view of the group's financial position and results of operations. The statutory administration report is consistent with the other parts of the annual report and the consolidated financial statements.

We recommend to the annual meeting of shareholders that the income statements and balance sheets of the parent company and the group be adopted, that the loss of the parent company be dealt with in accordance with the proposal in the administration report and that the members of the board of directors and the managing directors be discharged from liability for the financial year.

STOCKHOLM FEBRUARY 23, 2006
PricewaterhouseCoopers AB

Claes Dahlén
Authorized Public Accountant

Corporate Governance

INTRODUCTION

Corporate governance for Karo Bio is based on Swedish law, primarily the Swedish Companies Act, the Listing Agreement with the Stockholm Stock Exchange and the rules and recommendations issued by relevant Swedish organizations.

In December 2004, a Swedish Code of Corporate Governance (the Code) was presented. According to the Listing Agreement with the Stockholm Stock Exchange, companies listed on the A-list and larger companies on the O-list (market capitalization exceeding 3 billion SEK) are to implement the Code beginning July 1, 2005. Since Karo Bio's market capitalization does not exceed the threshold, Karo Bio does not explicitly follow the Code.

Narratives and documents in relation to corporate governance are also to be found on Karo Bio the website www.karobio.com.

The Annual General Meeting of the Shareholders (AGM) is Karo Bio's highest decision-making body. The Annual General Meeting is to be held not more than six months after the close of the financial year. The annual report including the financial statements for the preceding year is approved by the General Meeting. Board of Directors and auditors are elected at the General Meeting and other statutory matters are addressed. Special General Meetings can be held when deemed appropriate. Between General Meetings, the Board of Directors is the company's highest decision-making body. The Board appoints a President to head the management of the company.

THE WORK OF THE BOARD OF DIRECTORS FOR THE FINANCIAL YEAR 2005

The work of the Board of Directors is dictated by a board policy, which sets standards for the frequency and agenda of board meetings, pre-circulation of material for meetings, and matters to be brought to the board for information or decision. A section of the policy also regulates the division of responsibility between the Board, the Chairman of the Board and the President, as well as defines the President's authority. The Chairman prepares the board meetings together with the President. Presentations are made by the President and executive management at each scheduled board meeting on operational matters, including development and progress within research and business development, and financial reports and forecasts. The Board makes decisions in important areas such as strategy; scientific, marketing and financial plans; material agreements; budget; finance policy and other significant corporate policies as well as larger capital expenditures. In addition, the Board reviews the development and performance of the company. The Board held six scheduled and five additional board meetings during 2005.

The company's independent auditor reports directly to the Board on selected board meetings as well as to the Audit Committee.

A Compensation Committee, consisting of three board members including the chairman of the board, is handling questions regarding executive management's compensation and benefits, including that of the President. Per-Olof Mårtensson, Chairman, Lars Ingelmark and Dr Leon E. Rosenberg served on the Committee during 2005. The Committee prepares remuneration matters for board approval and makes decisions in compensation matters of lesser significance. The Board makes all policy decisions regarding remuneration of executive management and the salary of the President.

AUDIT

Auditors are elected by the General Meeting for a period of four years. The auditors are to audit the company's financial statements and management.

The Board has appointed an audit committee to handle certain matters regarding audit and internal control. The committee consists of the board directors Ulla Litzén (chairman), Lars Ingelmark and Per-Olof Mårtensson.

PricewaterhouseCoopers AB were elected auditors at the general meeting in April 2003 for the period until the annual general meeting 2007. Auditor-in-charge is authorized public accountant Claes Dahlén, Sollentuna. Claes Dahlén has been auditor-in-charge for Karo Bio since 2001.

NOMINATING COMMITTEE

At the general meeting on April 13, 2005 it was resolved to appoint a nominating committee as per the following.

The four largest shareholders as of August 31, 2005, not being represented in the board of directors, shall appoint one representative each, which together with the chairman of the board shall be members of the nominating committee in respect of the 2006 annual general meeting. The representatives shall be appointed and announced no later than in conjunction with the company's quarterly report for the third quarter 2005. The nominating committee shall appoint chairman among themselves, whereby the chairman of the board of directors not shall be chairman. Should a shareholder decline to participate in the nominating committee or leave the nominating committee before its work is completed, the right to appoint a representative shall turn to the closest largest shareholder not represented in the nominating committee. Should the ownership structure significantly change subsequent to the establishment of the nominating committee shall the composition of the nominating committee be changed in accordance with the above principles.

The nominating committee shall work out proposals to be presented the annual general meeting 2006 for resolution as regards chairman at the general meeting, chairman and other members of the board of directors, remuneration to the board of directors et cetera, fees to the auditors, and principles for appointment of nominating committee. If the nominating committee finds it necessary, it may utilize reasonable resources of external consultants at the account of the company.

The nominating committee 2006 consists of Thomas Ehlin, appointed by Nordea's funds, Björn Franzon, Fourth Swedish National Pension Fund, Ragnhild Wiborg, Pecunia, and Carl Rosén, Second Swedish National Pension Fund, as well as Per-Olof Mårtensson, chairman of the Karo Bio board of directors.

Karo Bio Share and Ownership Structure

Karo Bio has been traded on the O-List of the Stockholm Stock Exchange since April 3, 1998 with the ticker KARO.

SHARE CAPITAL

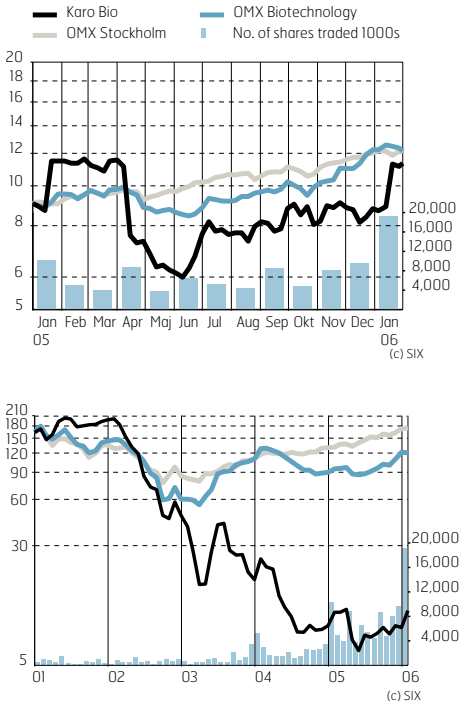
The number of shares increased during the year by 46,447,677 from the new share issue carried out. Karo Bio's share capital of SEK 154,825,590 as of year-end was divided among 77,412,795 shares at par value of SEK 2 after a reduction of the par value from SEK 5. There were also warrants outstanding representing 1,014,470 shares, of which 612,000 shares relate to the stock option program 2001 and 402,470 shares relate to the stock option program 2003.

WARRANTS

At the annual general meeting in April 2000, it was resolved to issue a subordinated debenture at a nominal value of SEK 1,000, with 88,064 detachable warrants. The warrants were issued in connection with the acquisition in 2000 of Karo Bio USA, former Novalon Pharmaceutical Corporation ("Novalon"), to compensate for the existing stock option plan in Novalon. The subordinated debenture was repaid during 2000. In May 2005, the remaining outstanding warrants, representing 3,219 shares, were canceled. Consequently, no warrants are outstanding under this program.

At the annual general meeting in April 2001, it was resolved to issue a subordinated debenture (series 2001/2008) at a nominal value of SEK 10,000, with 340,000 detachable warrants now representing 612,000 shares. The warrants entitles to subscription of shares at a subscription price of SEK 178 during the period May 31, 2001–May 31, 2008. The warrants, of which 70,000 representing 126,000 shares are to cover payroll taxes, are held by Karo Bio's wholly-owned subsidiary Karo Bio Research AB. The subordinated debenture was repaid in June 2001. The warrants serve as a hedge for stock options, representing 486,000 shares, of which 446,260 were issued by Karo Bio to employees of

SHARE PRICE AND TRADING VOLUME



CHANGES IN SHARE CAPITAL

Year	Transaction	Increase in number of shares	Total number of shares	Total share capital (SEK)	Issue payment (SEK) [1]
	As of January 1, 1998	–	3,943,586	39,435,860	–
1998	Stock split 2:1	3,943,586	7,887,172	39,435,860	–
1998	New issue – IPO	1,050,000	8,937,172	44,685,860	96,600,000
1998	New issue – IPO [2]	240,000	9,177,172	45,885,860	22,080,000
2000	New issue in kind	2,206,198	11,383,370	56,916,850	699,759,830 [3]
2000	New issue - directed placement	600,000	11,983,370	59,916,850	196,868,448
2000	Exercise of warrants	15,731	11,999,101	59,995,505	78,655
2001	Exercise of warrants	26,970	12,026,071	60,130,355	134,850
2002	Exercise of warrants	26,586	12,052,657	60,263,285	132,930
2003	New issue – rights issue [4]	4,821,850	16,874,507	84,372,535	118,578,253
2003	Exercise of warrants	3,547	16,878,054	84,390,270	17,735
2004	Exercise of warrants	12,011	16,890,065	84,450,325	60,055
2004	New issue – rights issue [5]	11,260,043	28,150,108	140,750,540	90,737,898
2004	New issue [6]	2,815,010	30,965,118	154,825,590	22,684,468
2005	Reduction of share capital [7]	–	30,965,118	61,930,236	–
2005	New issue – rights issue	46,447,677	77,412,795	154,825,590	263,413,134

1) Issue amount, net of any transaction costs
2) Consequent to over-allotment option
3) New share issue in kind, no cash issue amount

the Group at no cost. The exercise price for the stock options equals or exceeds the subscription price for the underlying warrants.

At the annual general meeting in April 2003, it was decided to issue four debentures (series 2003/2011:A–D), each with a nominal value of SEK 1,000, together with in total 241,000 detachable warrants for subscription of currently 402,470 shares. Each debenture has 60,250 such detachable warrants. The warrants, of which 51,000 representing 85,170 shares are to cover payroll taxes, are held by the wholly-owned subsidiary Karo Bio Research AB. The warrants serve as a hedge for stock options representing 317,300 shares, of which 170,567 were issued at no cost to Karo Bio employees. The subordinated debentures were repaid in June 2003. The warrants gives the holder the right to subscribe for new shares in Karo Bio during the period June 1, 2003–May 31, 2011 at the price SEK 20, 22, 24, and 26 for each respective series. The exercise prices for the stock options are identical to the subscription prices for underlying warrants.

Full utilization of all outstanding warrants will lead to an increase in the number of shares corresponding to 1.3 percent and an increase of the share capital by kSEK 2,029. Full utilization of all underlying outstanding stock options, including warrants required for payroll taxes, will lead to an increase in the number of shares by 0.5 percent.

SHARE PRICE TREND

Karo Bio's price per share declined 2005 from SEK 9.06 (adjusted for the new share issue) to SEK 8.80, a decrease of 2.9 percent. During the same period, the Stockholm Stock Exchange´s index (OMX Stockholm) increased by 33 percent and its biotechnology index (OMX Stockholm Biotechnology) increased by 37 percent. As of year-end 2005, Karo Bio's market capitalization was MSEK 681.2 compared to MSEK 397.9 at the beginning of the year. Based on a last price paid of SEK 11.35 on January 31, 2006, the market capitalization was MSEK 878.

DIVIDEND POLICY

Karo Bio has not distributed dividends since the company was founded in 1987. The board of directors does not intend to propose the distribution of dividends until the company receives significant royalty revenues or generates significant profits and cash flows by other means.

PRINCIPAL SHAREHOLDERS AS OF DECEMBER 31, 2005

Owner	No. of shares	Share of capital and votes, %
Nordea Funds	4,467,678	5.8
Fourth Swedish National Pension Fund	3,454,665	4.5
The Pecunia Fund	3,407568	4.4
Eikos	2,125,000	2.7
Second Swedish National Pension Fund	2,031,907	2.6
Skandia	2,000,256	2.6
Banco Funds	1,961,500	2.5
Sixth Swedish National Pension	1,830,520	2.4
Bliwa Livförsäkring	1,793,329	2.3
SEB Funds	1,392,500	1.8
Claesson, Johan	978,582	1.3
Carnegie Funds	877,970	1.1
Health Cap	869,689	1.1
Leksell, Laurent	850,000	1.1
Apoteket's Pension Trust	784,491	1.0
Fowlkes, Dana	735,847	1.0
Other shareholders	47,851,293	61.8
Total	**77,412,795**	**100.0**

Source: The Swedish Securities Register Centre (VPC AB) and information from shareholders. Shareholdings include family members and shares held through companies.

OWNERSHIP STRUCTURE AS OF DECEMBER 31, 2005

Shareholding No. of shares	No. of shareholders	Percentage of shareholders	No. of shares	Percentage of share capital
1–500	2,550	34.4	460,740	0.6
501–1,000	1,032	13.8	883,777	1.1
1,001–5,000	2,445	32.7	6,813,987	8.8
5,000–10,000	658	8.8	5,307,544	6.9
10,001–50,000	661	8.8	13,975,393	18.1
50,001–100,000	68	0.9	4,840,410	6.2
100,001 – 500,000	51	0.7	11,646,881	15.0
500,001–	24	0.3	33,484,063	43.3
Total	**7,489**	**100.0**	**77,412,795**	**100.0**

INVESTMENT BANKS COVERING THE KARO BIO SHARE

Investment bank	Analyst and city
ABG Sundal Collier	Alexander Lindström, Peter Östling, Stockholm
Alfred Berg ABN AMRO	Mattias Häggblom, Stockholm
D. Carnegie	Angelica Fatouros, Stockholm
Handelsbanken Capital Markets	Ole Peter Nordby, Oslo
Kaupthing Bank	Benjamin Nordin, Stockholm
Lehman Brothers International	Sam Williams, London
Nordea Markets	Stefan Wikholm, Stockholm
Redeye	Björn Andersson, Stockholm

Five Year Summary[1)]

	GROUP				
(MSEK, unless otherwise indicated)	2001	2002	2003	2004	2005
INCOME STATEMENTS					
Net sales	136.9	177.7	85.1	39.0	51.9
Administrative expenses	–58.7	–54.7	–45.4	–31.9	–34.6
Research & development expenses	–160.6	–175.6	–166.8	–123.5	–125.2
Other operating income and expenses	–10.1	–6.2	2.3	2.1	–0.8
Operating loss before goodwill expenses	**–92.5**	**–58.8**	**–124.8**	**–114.3**	**–108.7**
Goodwill amortization and write-down	–241.8	–241.8	–94.3	–	–
Operating loss	**–334.3**	**–300.6**	**–219.1**	**–114.3**	**–108.7**
Financial net	13.4	16.1	10.4	7.0	–2.3
Loss after financial items	**–320.9**	**–284.4**	**–208.7**	**–107.3**	**–111.0**
BALANCE SHEETS					
Licenses and similar rights	23.7	13.8	4.0	0.1	–
Goodwill	336.1	94.4	–	–	–
Equipment	38.8	30.1	23.9	18.5	13.1
Total non-current assets	**398.6**	**138.3**	**27.9**	**18.6**	**13.1**
Other current assets	7.4	11.0	17.1	14.5	14.8
Cash, bank balances and short-term investments	282.3	201.1	184.0	181.0	346.9
Total current assets	**289.7**	**212.1**	**201.1**	**195.5**	**361.7**
Total assets	**688.3**	**350.4**	**229.0**	**214.1**	**374.8**
Shareholders' equity	557.7	269.1	174.9	179.0	336.6
Non-current liabilities	13.9	8.1	4.7	2.5	1.6
Other current liabilities	116.7	73.2	49.4	32.6	36.6
TOTAL SHAREHOLDERS' EQUITY AND LIABILITIES	**688.3**	**350.4**	**229.0**	**214.1**	**374.8**
CASH FLOW STATEMENTS					
Cash flow from operating activities	–11.9	–70.9	–128.6	–111.7	–89.9
Net investment in fixed assets	–34.9	–10.3	–7.1	–4.9	–6.4
Net investment in other short-term investments	–	–	–	–57.2	74.6
Cash flow from investing activities	–34.9	–10.3	–7.1	–62.1	68.2
Cash flow from financing activities	**0.1**	**0.1**	**118.6**	**113.5**	**263.4**
Cash flow for the year	**–46.7**	**–81.1**	**–17.1**	**–60.3**	**241.7**
Operating cash flow	–46.8	–81.2	–135.7	–116.6	–96.3
KEY RATIOS AND DATA					
Equity	557.7	269.1	174.9	179.0	336.6
Return on equity, %	–44.6	–68.8	–94.0	–60.6	–43.1
Return on capital employed, %	–39.1	–54.6	–71.6	–47.6	–37.2
Operating margin before goodwill expenses, %	–67.6	–33.1	–146.7	–293.1	–209.4
Operating margin, %	–244.2	–169.2	–257.5	–293.1	–209.4
Profit margin, %	–234.4	–160.1	–245.2	–275.1	–213.9
Equity ratio, %	81.0	76.8	76.3	83.6	89.8
Interest-bearing assets (net)	282.3	201.1	184.0	181.0	346.9
Investment in licenses and similar rights	10.7	5.1	3.9	3.8	3.7
Net capital investments	24.2	5.3	3.2	1.1	2.7
Average number of employees during the year	122	133	117	85	77
Of which engaged in research and development	104	110	97	74	68

1) International Financial Reporting Standards (IFRS) are applied for the financial years 2004 and 2005. Figures for 2001 – 2003 are presented in accordance with the accounting principles applied by Karo Bio for the financial year 2004. See the section on accounting principles on page 29. For a description of the accounting policies applied for the years 2001-2003, please refer to the 2004 annual report.

	GROUP				
	2001	2002	2003	2004	2005
PER SHARE DATA (SEK) [2) 3)]					
Loss per share					
– average number of shares	–15.14	–13.39	–8.30	–3.41	–2.37
– shares at end of year	–15.12	–13.38	–7.46	–2.44	–1.43
Cash flow from operating activities per share					
– average number of shares	–2.20	–3.82	–5.40	–3.70	–2.06
– shares at end of year	–2.20	–3.82	–4.85	–2.65	–1.24
Equity per share, year-end	26.28	12.65	6.25	4.08	4.35
Share price at end of year [4)]	197.17	47.21	18.04	9.06	8.80
Share price/equity per share, year-end, % [4)]	750	373	289	222	202
NUMBER OF SHARES (millions) [2) 3)]					
Average number of shares	21.2	21.3	25.1	31.5	46.8
Average number of shares including warrants	21.7	21.9	26.0	32.5	47.8
Number of shares, year-end	21.2	21.3	28.0	43.9	77.4
Number of shares, year-end including warrants	21.9	21.9	29.0	44.9	78.4

1) International Financial Reporting Standards (IFRS) are applied for the financial year
financial year 2004. See the section on accounting principles on page 29. For a description of the accounting policies applied for the years 2001-2003, please refer to the 2004 annual report.

2) Warrants are non-dilutive as exercise of warrants would reduce losses and improve cash flow per share for each respective year.

3) The number of sha

4) Information on share price has been adjusted for new share issues.

DEFINITIONS

OPERATING CASH FLOW
Cash flow from operating activities and cash flow from investments in equipment and licenses

EQUITY
Shareholders' equity

RETURN ON EQUITY
Loss after financial items as a percentage of average equity

RETURN ON CAPITAL EMPLOYED
Operating loss and financial income as a percentage of the average total assets less non interest bearing liabilities

OPERATING MARGIN BEFORE GOODWILL AMORTIZATION
Operating loss before goodwill amortization as a percentage of net sales

OPERATING MARGIN
Operating loss as a percentage of net sales

PROFIT MARGIN
Loss for the year as a percentage of net sales

EQUITY RATIO
Equity as a percentage of total assets

INTEREST BEARING ASSETS (NET)
Cash, bank balances and short-term investments

NET CAPITAL INVESTMENTS
Capital investments in equipment net of disposals

LOSS PER SHARE
Loss in relation to the number of shares

OPERATING CASH FLOW PER SHARE
Cash flow from operating activities and cash flow from investments in equipment and licenses per share

EQUITY PER SHARE
Shareholders' equity in relation to outstanding shares at year-end

SHARE PRICE/EQUITY PER SHARE
Share price as a percentage of shareholders' equity per share at year-end

AVERAGE NUMBER OF SHARES
Weighted-average number of shares outstanding during the year

AVERAGE NUMBER OF SHARES, INCLUDING WARRANTS
Weighted-average number of shares, including warrants, outstanding during the year

NUMBER OF SHARES, YEAR-END
Number of shares outstanding at the end of the year

NUMBER OF SHARES, YEAR-END, INCLUDING WARRANTS
Number of shares, including warrants, outstanding at the end of the year

Glossary

ABSORPTION Uptake of an active compound in the body, eg through the gastro intestinal tract or the skin

ADMET Preclinical testing of a compound, addressing the properties Absorption and Distribution in the body, as well as Metabolism, Excretion and Toxicity

AGONIST A compound that has a stimulating effect

ANTAGONIST A compound that has inhibiting/blocking effect

ATHEROSCLEROSIS Atherosclerosis originates from deposits of fatty substances such as cholesterol and calcium. The atherosclerotic process may begin early in life and over time lead to a build-up known as plaque, which hardens as people get older. The consequences are restricted blood flow, especially in arteries and areas where the blood vessels branch. There is also in creased risk of blood clot formation. When this occurs in the heart, the result is a heart attack and, in the brain, a stroke. Blood flow in the extremities may also be restricted, which causes pain during exercise

BIOAVAILABILITY Describes how much an active compound is taken up in the body

CARDIOVASCULAR DISEASE Examples of diseases that fall within this category are congestive heart failure and cardiac arrhythmia (any deviation from the normal sinus rhythm of the heart). Elevated lipids in the blood, hyper-cholesterolemia, is a risk factor associated with cardiovascular diseases

CD Candidate drug. A compound which has desired effects in relevant animal models and which therefore is further developed towards clinical development

CLINICAL STUDY Testing and evaluation of pharmaceuticals in humans

DOUBLE BLIND Neither patient, doctor or nurse in a clinical study is aware about what is administered to the patient (generally placebo or active compound but can also be other pharmaceuticals for comparison)

DYSLIPIDEMIA Imbalance in lipid/cholesterol metabolism

ER BETA A new form of the estrogen receptor. The discovery of this receptor can lead to new treatment principles in women's health care

ESTROGEN Female sex hormone

GLUCOCORTICOID The hormone that is the natural ligand to the glucocorticoid receptor hormone and is produced in the adrenal cortex, and thus also referred to as adrenocortical hormone. The hormone regulates the body's use of carbohydrates, fat and protein and is a normal response to stress

GLUCOCORTICOID RECEPTOR The receptor for glucocorticoid hormone.

GR Glucocorticoid receptor

INDICATION Disease and patient category intended for medical treatment

INSULINE Hormone responsible for uptake of blood sugar in tissues

HORMONE Compound secreted from the body's glands and transported through the blood to the organ in which it has its effects

HYPERCHOLESTEROLEMIA (HIGH CHOLESTEROL) Elevated levels of blood lipids, cholesterol

HYPERLIPIDEMIA High levels of blood lipids

IND Investigational New Drug Application. An application to the FDA or corresponding authority for permission to start testing a pharmaceutical in human beings

LDL Low Density Lipoprotein particles (the "bad cholesterol")

LEAD COMPOUND A compound that has the desired activity in vitro and in relevant animal models

LIGAND A substance, for example, a hormone or compound that binds with a receptor protein

LIPIDS Fat components

LIVER SELECTIVE A compound which preferentially acts in the liver

LXR Liver X Receptor, regulates cholesterol metabolism and is target for new drugs against atherosclerosis

METABOLIC SYNDROME Collective name for obesity, dyslipidemia, type 2 diabetes and hypertension

NCE New chemical entity

NDA New drug application

NUCLEAR RECEPTORS Receptors inside a cell that bind to ligands (often hormones) and regulate gene transcription

ORPHAN DRUG A drug intended for a rare indication with a great medical need and which receives fast track development status from the authorities and market exclusivity for a number of years

PHARMACOKINETICS Studies of uptake, break down and excretion of pharmaceuticals

PHASE IA A first clinical study phase where the compound is given as a single dose to healthy volunteers with the primary objective to study safety and pharmacokinetics

PHASE IB Has the same objective as Phase Ia but with repeated dosing under a few weeks time

PHASE II
First clinical studies in choosen patient category for which the drug is evaluated. The primary objective is to find a dose to secure effect and safety before Phase III studies

PHASE III Clinical studies conducted with a large patient population for which the drug is developed. The primary objective is to assure safety and confirm effect in a large data base of a selected patient category under long time treatment. The aim with this part of clinical development is to assure that the launched product is safe in clinical practice

PLASMA APHERESIS Method for cleaning the blood from excess lipid levels

PPAR "Peroxisome proliferator activated receptor", which exists in several forms and which is an important target for treatment of type 2 diabetes

PRECLINICAL DEVELOPMENT
These tests are required to gain the permission of the authorities to test the compounds on human beings

PROOF OF CONCEPT Proof for intended effect of a drug in patients

RECEPTOR A protein on the cell surface or inside the cell that recognizes and binds to ligands, for example, steroid hormones

STAD Selective Thyroid hormone Agonist for treatment of Dyslipidemia

STATIN Drugs used for lowering of elevated levels of blood cholesterol

STRUCTURE BIOLOGY Studies of the structure and function of proteins

STRUCTURE-BASED DRUG DESIGN
Design of novel compounds based on the three-dimensional structure of, for example, a receptor protein

SYNTHESIS Chemical production of a substance

THERAPEUTIC DOSE INTERVAL Dose interval for which a drug is expected to have effect without side effects

THERAPY Disease treatment method

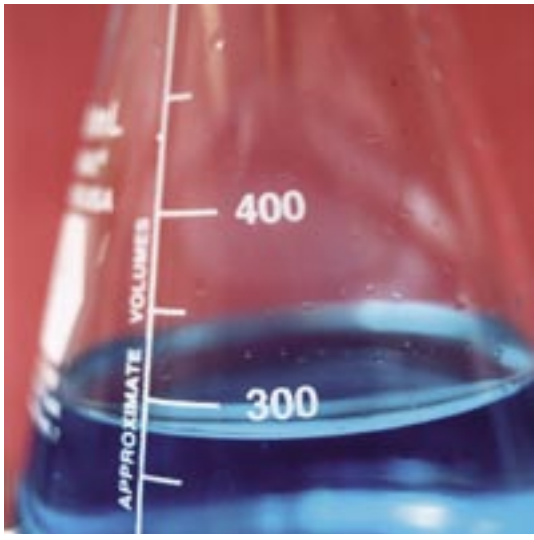
THYROID HORMONE An iodine-containing hormone synthesized and secreted by the thyroid gland, which is essential for normal metabolic processes and mental and physical development

TISSUE A collection of cells specialized to perform a particular function. The cells may be of the same type or of different types. Aggregates of tissue constitute organs

TRIGLYCERIDS Fat made up of glycerol and fat acids

TYPE 2 DIABETES A form of diabetes, which develops in adult and often obese patients

Annual General Meeting



The Annual General Meeting of Karo Bio AB (publ) will be held on Wednesday May 3, 2006 at 4.00 p.m. in Wallenbergsalen, IVA Conference Center, Grev Turegatan 18, Stockholm, Sweden. The Notice for the Annual General Meeting is available on Karo Bio's web site at www.karobio.com/agm.

RIGHT TO PARTICIPATE AND NOTICE

To be entitled to participate in the general meeting, shareholders must have their holdings registered in their names at the Swedish Securities Register Centre (VPC AB) by April 26, 2006, and must notify the company of their intent to participate in the meeting by no later than April 27, 2006 at 4.00 p.m.

Notice of intent to participate in the Annual General Meeting shall be made in writing, including name, address and telephone number, either via mail to Karo Bio AB, attention Eva Kruse, Novum, SE-141 57 Huddinge, Sweden, fax +46 8 774 52 80, e-mail agm@karobio.se or on Karo Bio's web site at www.karobio.com/agm.

SHARE REGISTRATION

Shareholders whose shares are registered under the name of a nominee through a bank notary department or other nominee must, to be entitled to participate in the general meeting, temporarily register their shares in their own names. Such registration must be in effect no later than Wednesday April 26, 2006, which means that shareholders must notify their nominee well in advance of that date.

Further information

Seheduled information events:

Quarterly Report – January–March	April 20, 2006
Annual General Meeting	May 3, 2006
Quarterly Report – April–June	July 13, 2006
Quarterly Report – July–September	October 19, 2006
Earnings Report for 2006	February 7, 2007

Financial reports, press releases and other information are available on Karo Bio's web site. Karo Bio's financial reports and press releases may be downloaded and subscribed to on the website at www.karobio.com/finance. Financial reports are available on the web site upon release.

Karo Bio has electronic distribution as the primary mean for distribution of financial reports. The annual report will be mailed to shareholders and others specifically subscribing to the printed version. Printouts of quarterly reports are mailed upon request. For further information, please contact Per Olof Wallström, President & CEO, phone +46 8 608 60 20, Per Otteskog, Senior Vice President Investor Relations, phone +46 8 608 60 18 or Bertil Jungmar, Chief Financial Officer phone +46 8 608 60 52, or e-mail: investor@karobio.com

NARVA, PRINTED BY: ALFA PRINT, 2006

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