LION BIOSCIENCE AG
Form 20-F
September 30, 2004
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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 20-F

¨ **REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934**

OR

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended March 31, 2004

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from _____ to _____

Commission file number: 000-30850

LION bioscience Aktiengesellschaft

(Exact name of Registrant as specified in its charter)

Federal Republic of Germany

(Jurisdiction of incorporation or organization)

Waldhofer Str. 98

D-69123 Heidelberg

Federal Republic of Germany

(Address of principal executive offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
NONE	**N/A**

Securities registered or to be registered pursuant to Section 12(g) of the Act:

Ordinary shares, no par value, but with a notional value of 1.00 per share.

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act: None

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The number of outstanding shares of each of the issuer s classes of capital or common stock as of March 31, 2004: 19,870,175 ordinary shares, no par value, but with a notional value of 1.00 per share.

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark which financial statement item the registrant has elected to follow: Item 17 ¨ Item 18 x

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* Omitted because the Item is not applicable or the answer is negative.
** The Registrant has responded to Item 18 in lieu of this Item.

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In this Form 20-F, references to our company are to LION bioscience Aktiengesellschaft, and references to our , we , us or LION bioscience a to LION bioscience Aktiengesellschaft and, unless the context otherwise requires, to its subsidiaries. References to Trega are to Trega Biosciences Inc., a San Diego, California based corporation acquired by our company effective March 14, 2001 and subsequently merged into our subsidiary LION bioscience Inc. References to NetGenics are to NetGenics, Inc., a corporation having its principal place of business in Cleveland, OH, USA until June 30, 2003, and, unless the context otherwise requires, to its subsidiaries. Our company acquired NetGenics effective January 30, 2002.

Our consolidated financial statements are prepared in accordance with U.S. GAAP. Our consolidated financial statements are expressed in euro, the currency of the European Economic and Monetary Union, which was introduced on January 1, 1999. In this annual report, references to euro or are to euro, references to DM are to Deutsche Mark and references to U.S. dollars or $ are to United States dollars. Our financial year ends March 31 of each calendar year. References to any financial year or to FY refer to the year ended March 31 of the calendar year specified.

Unless the context otherwise requires, references in this annual report to our company s shares are to the ordinary shares of LION bioscience AG without par value. References to our company s ADSs are to the American Depositary Shares of LION bioscience AG, each representing one ordinary share of our company.

By resolution adopted at our company s annual general shareholders meeting of May 15, 2000, all of the existing preferred shares of the company were converted into ordinary shares of the company on a share for share basis. The amount of subscribed capital for ordinary shares was therefore increased by the amount of the outstanding preferred shares on the effective date of the conversion.

On June 28, 2000, our company effected a division of our capital stock by means of a seven-for-one stock split of the ordinary shares. All share and related information in this annual report regarding shares of our company for periods prior to the effectiveness of the share split have been adjusted to give effect, retroactively, to the share split.

LION bioscience , the LION bioscience logo, iD3 , LION DiscoveryCenter , LION Target Engine , LION Lead Engine , LION Hosted Servic LION SolutionCenter , bioSCOUT , LeadNavigator , iDEA , Chem.Edition , iD3 and our other product and service names referenced in this annual report are trademarks or registered trademarks of our company in Germany and/or in other countries. This annual report also contains product and service names of companies other than LION bioscience that are trademarks of their respective owners.

We intend to make this annual report and other periodic reports publicly available on our Internet web site (http://www.lionbioscience.com) without charge immediately following our filing with the U.S. Securities and Exchange Commission (or SEC). We assume no obligation to update or revise any part of this annual report, whether as a result of new information, future events or otherwise, unless we are required to do so by applicable law.

FORWARD LOOKING STATEMENTS

This annual report contains certain forward-looking statements and information relating to us that are based on beliefs and current expectations of our management as well as assumptions made by us and information currently available to us about future events, including general economic and business conditions, our R&D efforts, our product and solution development activities and product releases, meeting requirements of our customers and collaborators, competition by other companies and the internal IT departments of our customers, and the implementation of our

business strategy.

Any statements contained in this annual report that are not historical facts are forward-looking statements as defined in the U.S. Private Securities Litigation Reform Act of 1995 or other applicable law. When used in this document, the words anticipate , believe , estimate , expect , intend , plan , project , continue , count on , is confident , forecast , may , predict , should , wants , will , would and similar e us or our management, are intended to identify forward-looking statements. Such statements are subject to risks, uncertainties and assumptions.

Many factors could cause our actual results, performance or achievements to be materially different from future results, performance or achievements that may be expressed or implied by these forward-looking statements, including the factors discussed more fully under Item 3: Key Information on the Company Risk Factors , as well as elsewhere in this annual report and in our other filings with the SEC.

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You are cautioned not to place undue reliance on these forward-looking statements, which speak only as of their respective dates. Should one or more of these risks materialize, or should underlying assumptions prove incorrect, our actual results may vary materially from those described in our forward-looking statements. We do not intend, and do not assume any obligation, to publicly update or revise any forward-looking statements.

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PART I

Item 1: Identity of Directors, Senior Management and Advisers

Not applicable.

Item 2: Offer Statistics and Expected Timetable

Not applicable.

Item 3: Key Information on the Company

Selected Consolidated Financial and Statistical Data

The table below presents our selected historical consolidated financial data derived from our historical consolidated financial statements for the periods indicated. You should read this selected consolidated financial data in conjunction with our audited consolidated financial statements, the related notes and Item 5: Operating and Financial Review and Prospects , all of which appear elsewhere in this annual report.

The selected consolidated financial data for the financial years ended March 31, 2000, 2001, 2002, 2003 and 2004 are derived from and are qualified by reference to our consolidated financial statements and notes thereto for these periods.

Our audited consolidated financial statements for these periods were prepared in accordance with United States generally accepted accounting principles (US-GAAP) and audited by Ernst & Young AG, our independent registered public accounting firm.

The audited consolidated statements of operations, consolidated statements of cash flows and consolidated statements of shareholders equity for the years ended March 31, 2004, 2003, and 2002, and the consolidated balance sheets at March 31, 2004 and 2003 are included in Item 18. Financial Statements.

Our consolidated financial statements are expressed in euros, the currency of the European Economic and Monetary Union. The euro was introduced on January 1, 1999. Prior to March 31, 2000, our financial statements were prepared in Deutsche Marks. After that date, our consolidated financial statements were prepared in euros. All Deutsche Mark amounts appearing in or derived from our consolidated financial statements have been translated into euros at the official fixed exchange rate of 1.00 = DM 1.95583.

For convenience, this annual report contains unaudited translations of euro amounts into U.S. dollars at the rate of 1.00 = $1.2292, the noon buying rate published by the Federal Reserve Bank of New York for euros on March 31, 2004. The noon buying rate for euros on September 24, 2004 was 1.00 = $1.2256. For more information regarding exchange rates, see the section entitled Exchange Rate Information below.

For all periods, we have presented our consolidated financial statements and selected consolidated financial data including our accounts and those of our wholly-owned subsidiaries. The revenue and expense items of our consolidated statements of operations are translated at a weighted average of exchange rates during the relevant fiscal year. Our consolidated balance sheet accounts are translated into euros at the exchange rates in effect at the end of the reporting period, except for shareholders equity which is translated at the rates in effect at the time the underlying transactions are reported. Our consolidated balance sheet as of March 31, 2004 was prepared by translating dollar amounts into euro amounts at the rate of 1.00 = $1.2224, the exchange rate published by the European Central Bank on March 31, 2004.

On March 14, 2001, our company acquired Trega Biosciences Inc., a corporation, which, at the time was located in San Diego, California, whose common stock was listed on the Nasdaq National Market. We consolidated Trega s accounts commencing on March 31, 2001 under the purchase method. Trega s most recent fiscal year prior to the acquisition ended on December 31, 2001. Trega s operations for the interim period from March 14 through March 31 were not included in our statement of operations for FY 2001 but were fully included in our statement of operations for FY 2002.

On January 30, 2002, our company acquired NetGenics, Inc., a corporation, which, at the time had its principle place of business in Cleveland, Ohio. We consolidated NetGenics accounts commencing on January 31, 2002 under the purchase method. NetGenics operations for the period from January 31, 2002 through March 31, 2002 were included in our statement of operations for FY 2002.

We reclassified certain amounts in our financial statements for FY 2000, 2001, and 2002 to conform to the financial presentation for FY 2003 and FY 2004. For example, effective December 31, 2002, we closed down our internal drug discovery activities called iD^3. Accordingly, we show the revenue and expenses relating to iD^3 as a separate item in our consolidated statement

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of operations for FY 2003 and FY 2004 under discontinued operations. We have reclassified revenue and expenses relating to our iD[3] activities for FY 2002 as discontinued operations to enable comparisons to the information set forth for FY 2003 and FY 2004. No revenues or expenses were generated or incurred in FY 2000 or FY 2001 related to iD[3] activities. Likewise, we show the assets relating to our iD[3] activities as a separate item under assets held for sale in our consolidated balance sheet as of March 31, 2003.

We established a global professional service organization in FY 2003 to provide expert guidance in design, implementation and ongoing optimization of our IT solutions. Accordingly we have reclassified revenue amounts for FY 2000, FY 2001, and FY 2002 to show revenue from our professional services as a separate item and to enable comparisons to the information set forth for FY 2003 and FY 2004.

As part of our strategy to focus on our core competencies, our business activities are now centered around our IT business rather than our internal drug discovery activities (iD[3]), which we have discontinued. Our IT business is primarily responsible for the development of our IT solutions and products as well as for providing professional services to customers related to these solutions and products. Starting with our consolidated statement of operations for FY 2003, we accordingly show these and other costs of sales as a separate item. We have also reclassified amounts for FY 2000, FY 2001 FY 2002 as costs of sale to enable comparisons to the information set forth for FY 2003 and FY 2004.

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SELECTED CONSOLIDATED FINANCIAL DATA

	As of and for the fiscal year ended March 31(1) (in thousands except for per share data)					
	2000	2001	2002	2003	2004	2004(2)
						($)
Selected Consolidated Statement of Operations Data						
Revenues:						
Drug discovery	3,459	2,391	2,898	1,531	980	1,205
Licenses	1,437	5,151	9,503	12,450	8,174	10,047
Professional services	4,850	13,317	18,307	12,681	7,518	9,241
Maintenance and support	223	536	1,314	2,697	3,003	3,691
Total revenues	9,969	21,395	32,022	29,359	19,675	24,184
Cost-of-sales	1,326	9,184	11,395	18,677	9,466	11,636
Costs and expenses:						
Selling costs	1,795	5,719	12,546	11,229	8,276	10,173
General and administrative costs	4,967	7,501	18,369	21,490	9,272	11,397
Research and development costs	11,068	17,688	33,900	34,225	12,507	15,374
Other operating income and expenses	542	(727)	(1,104)	(1,733)	(1,759)	(2,162)
Conversion of preferred into ordinary shares		8,743				
Total costs and expenses (incl. cost-of-sales)	19,698	48,108	75,106	83,888	37,762	46,417
Operating results before depreciation and amortization	(9,729)	(26,713)	(43,085)	(54,529)	(18,087)	(22,234)
Depreciation of property, plant and equipment and amortization of intangible assets	3,060	4,218	11,885	14,021	4,625	5,685
Impairment of goodwill				58,526		
Operating results	(12,790)	(30,931)	(54,970)	(127,076)	(22,712)	(27,918)
Interest income/(expense), net	8	5,234	6,302	3,654	1,355	1,666
Results from marketable securities and other long-term investments			(3,493)	(13,594)	227	279
Loss before taxes from continuing operations	(12,781)	(25,697)	(52,161)	(137,016)	(21,130)	(25,973)
Tax expense	(22)	(127)	(261)	(313)	(326)	(401)
Net loss for the year from continuing operations	(12,803)	(25,824)	(52,422)	(137,329)	(21,456)	(26,374)
Income/(Loss) on discontinued operations (net of tax of 0).			(9,549)	(15,465)	698	858
Net loss for the year	(12,803)	(25,824)	(61,971)	(152,794)	(20,758)	(25,516)
Preferred stock dividend	(99)	(25)				
Deemed preferred stock dividend		(14,410)				
Net loss attributable to ordinary shares after preferred stock dividend and after deemed preferred stock dividend	(12,902)	(40,259)	(61,971)	(152,794)	(20,758)	(25,516)

Basic and diluted net loss per share from continuing operations (3)	(2.01)	(2.64)	(2.77)	(6.91)	(1.08)	(1.33)
Basic and diluted net income /(loss) per share from discontinued operations (3)			(0.50)	(0.78)	0.04	0.05
Basic and diluted net loss per share from total operations after preferred stock dividend and deemed preferred stock dividend (3)	(2.01)	(2.64)	(3.27)	(7.69)	(1.04)	(1.28)
Selected Consolidated Balance Sheet Data						
Cash and cash equivalents	6,648	67,197	19,184	60,102	29,294	36,008
Marketable securities		114,139	104,839	12,762	13,812	16,978
Assets held for sale			4,735	322		
Property, plant and equipment, net	7,398	16,896	13,403	6,890	2,793	3,433
Long-term investments, at cost	13,080	19,695	10,760	549	549	675
Total assets	31,495	277,871	237,990	93,296	53,114	65,288
Deferred income and advance payments	4,389	13,539	15,215	12,945	8,334	10,244
Long-term debt	4,641	3,129	2,560	1,991		
Shareholders equity/(deficit)	15,729	239,203	206,923	59,377	37,400	45,972
Selected Consolidated Cash Flow Statement Data						
Net cash used in operating activities	(4,680)	(13,371)	(51,377)	(43,911)	(26,304)	(32,333)
Net cash (used in) provided by investing activities	(20,033)	(127,917)	5,044	86,694	(584)	(718)
Net cash (used in) provided by financing activities	30,509	201,522	(1,586)	(703)	(2,588)	(3,181)

(1) Columns may not add due to rounding.

(2) Amounts in the column are unaudited and translated for the convenience of the reader at 1.00 = U.S.$1.2292, the noon buying rate published by the Federal Reserve Bank of New York for euros on March 31, 2004.

(3) Net loss per share data for FY 2000 assume that 6,433,882 shares, the weighted number of shares outstanding immediately prior to our initial public offering in August 2000, after giving effect to the stock-split referred to above, were outstanding for the period presented. During FY 2001, the weighted average number of our company s shares outstanding was 15,247,146 (basic and fully diluted). During FY 2002, the weighted average number of our company s shares outstanding was 18,940,029 (basic and fully diluted). During FY 2003 and FY 2004, the weighted average number of our company s shares outstanding was 19,870,175 (basic and fully diluted). At March 31, 2004, the number of our company s shares outstanding was 19,870,175.

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Exchange Rate Information

The prices for ordinary shares traded on German stock exchanges are denominated in euros. Fluctuations in the exchange rate between the euro and the U.S. dollar will affect the U.S. dollar equivalent of the euro price of the ordinary shares traded on the German stock exchanges and, as a result, may affect the price of our company s American Depositary Shares traded in the United States, each representing one ordinary share (ADSs). In addition, our company will pay any dividends in euros so that exchange rate fluctuations will also affect the U.S. dollar amounts received by the holders of our company s ADSs on the conversion into U.S. dollars of cash dividends paid in euros on the ordinary shares represented by the ADSs.

A significant portion of our revenue and expenses is denominated in U.S. dollars rather than in euro. Therefore, movements in the exchange rate between the euro, on the one hand, and the U.S. dollar, on the other hand, may materially affect our consolidated financial position, results of operations and cash flows. See Risk Factors , Item 5: Operating and Financial Review and Prospects and Item 11: Quantitative and Qualitative Disclosure About Market Risk Foreign Currency Exchange Risk below.

Since the euro did not exist prior to January 1, 1999, we cannot present actual exchange rates between the euro and the U.S. dollar for earlier periods in our audited consolidated financial statements and in the other financial information discussed in this annual report. To enable you to ascertain how the trends in our financial results might have appeared had they been expressed in U.S. dollars, the table below shows the average exchange rates of U.S. dollars per euro for the periods shown. For all periods prior to the creation of the euro on January 1, 1999, this information has been calculated using the Federal Reserve Bank of New York s noon buying rates for the Deutsche Mark per $1.00 for each period, as translated into euro at the official fixed rate of 1.00 = DM 1.95583. The average is computed using the Federal Reserve Bank of New York s noon buying rate for the Deutsche Mark, for periods prior to January 1, 1999, and for the euro, for periods after January 1, 1999, on the last business day of each month during the period indicated.

Average exchange rates of U.S. dollars per euro

	Average
Financial year ended March 31, 2000	1.0235
Financial year ended March 31, 2001	0.9114
Financial year ended March 31, 2002	0.8800
Financial year ended March 31, 2003	1.0033
Financial year ended March 31, 2004	1.1752

The table below shows the high and low exchange rate of U.S. dollars per euro for each of the six months from March 2004 to August 2004:

Recent exchange rates of U.S. dollars per euro

	High	Low
March 2004	1.2431	1.2088

April 2004	1.2358	1.1802
May 2004	1.2274	1.1801
June 2004	1.2320	1.2006
July 2004	1.2437	1.2032
August 2004	1.2368	1.2025

The noon buying rate on September 24, 2004 was 1.00 = $1.2256.

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Risk Factors

We operate in a dynamic and rapidly changing environment that involves numerous risks and uncertainties, many of which are beyond our control. You should carefully consider the risks described below before purchasing our company s ordinary shares or ADSs. The occurrence of any of the following events could harm us. If these events occur, the trading price of our company s ordinary shares or ADSs could decline, and you may lose all or part of your investment. Additional risks not currently known to us or that we currently deem immaterial may also harm us and affect your investment.

Risks Relating to Our Business

We have incurred net losses to date and may not become profitable.

Our company was formed on March 4, 1997 and has a limited operating history. Our consolidated net losses amounted to 20.758 million in our fiscal year ended March 31, 2004, 152.794 million in our fiscal year ended March 31, 2003, and 61.971 million in our fiscal year ended March 31, 2002. We expect that we will continue to incur net losses for the foreseeable future. We face significant and potentially costly challenges in simultaneously pursuing key R&D goals and attracting customers for our products and services. As a result, we may not become profitable in the future. Even if we become profitable, we may not be able to maintain profitability, as our results of operations are, and will continue to be, difficult to predict and may vary from quarter to quarter.

Substantial, prolonged declines in the biotechnology and pharmaceutical industries across Europe, North America and Asia may cause our revenues and cash flows to suffer.

Implementation of our information technology and software (or IT) products and solutions can constitute a significant portion of our customer s research and development, or R&D, and/or information technology, or IT, budgets, and the amount customers are willing to invest in acquiring and implementing our products and solutions and the timing of our customers investment has tended to vary due to business conditions existing in the biotechnology and pharmaceutical industries. There has been a slowdown in the biotechnology and pharmaceutical industries as a result of general economic weakness and circumstances specific to these industries. Continued weakness in these sectors could undermine our efforts to obtain new customers and encourage existing customers not to renew or to seek to renegotiate existing contracts with us resulting in less favorable terms than those currently in place. Either outcome could have a material adverse effect on our business and cash flows as we derive our revenue primarily from software licenses and professional services in those markets.

We must retain existing customers, add new customers and achieve milestones under existing customer contracts if we are to achieve our goals.

We have a small number of customers, the revenues from which offset only a portion of our expenses. In order to generate significant additional revenues, we must retain our existing customers and add additional customers. Our ability to do so depends upon our customers belief that our products, solutions and services can help accelerate their life science R&D activities, particularly in the areas of drug discovery and development. We must also expand our existing customer relationships to include new products, solutions and services. Although various of our customer agreements have multi-year terms, we cannot assure you that any of them will be renewed upon expiration or that our customers will not terminate them on short notice. Nor can we assure you that our existing customers will enter into new agreements with us for additional

products or upgrades of licensed products, solutions or services.

In addition, future revenues under our customer agreements may depend in whole or in part upon our ability to meet milestones set out in those agreements. We may not meet these milestones on a timely basis or at all. We will not receive milestone payments if we fail to meet any of these milestones and this failure could result in the termination of one or more of these agreements. The failure to receive milestone payments or the termination of an agreement with a customer could adversely affect our business, results of operations and/or financial condition.

Delays in release of new software products or solutions or undetected errors in our software products or solutions may result in increased costs to us, delayed market acceptance of our products and delayed or lost revenues.

To achieve market acceptance, new IT products or solutions and product or solution enhancements can require long development and testing periods, which may result in delays in scheduled introduction. Any delays in the release schedule for new IT products or solutions and product or solution enhancements may delay market acceptance of these products or solutions and may result in delays in new customer orders for these new products or solutions or the loss of customer orders. In addition, new IT products or solutions and enhancements may contain a number of undetected errors or bugs when they are first released. As a result, in the months following the introduction of certain releases, we generally devote significant resources, primarily consulting and development services, to work with early customers to correct these errors. There can be no assurance, however, that all of these errors can be

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corrected to the customer s satisfaction, with the result that certain customers may bring claims for damages, refunds or replacement software. Although we test each new product and solution and enhancement release before introducing it to the market, there can be no assurance that significant errors will not be found in existing or future releases of our IT products or solutions, with the possible result that significant resources and expenditures may be required in order to correct such errors or otherwise satisfy customer demands. Significant undetected errors or delays in the release of new IT products or solutions or enhancements may affect market acceptance of our IT products and solutions, significantly increase our development costs and result in delayed or lost revenue. Any of these outcomes could have a material adverse effect on our business, results of operations and/or financial condition.

The market in which we compete continues to evolve and, if it does not grow rapidly in the future, our business will be adversely affected.

We have invested, and continue to invest, significant resources in further developing and marketing new and enhanced products and solutions. In FY 2004, we released our new biology solution called LION Target Engine, and a new module of our SRS data integration system, the SRS Gateway. In FY 2005, we released a new version of our SRS software, our new cheminformatics tool, LeadNavigator, and a new version of our LION Target Engine. In addition, we plan to release another enhanced version of SRS, one new version of LION Target Engine and our new chemistry solution called LION Lead Engine in FY 2005. Demand and market and customer acceptance for these recently introduced and future products and solutions are subject to a high level of uncertainty. We expect to derive a substantial portion of our future revenue from these products and solutions. In February 2004, we announced that we would no longer offer our integration platform LION DiscoveryCenter as a stand alone product due to unsatisfactory market acceptance, which also adversely affected our ability to market our LION Target Engine, which was designed to function with our LION DiscoveryCenter integration platform. A delay in market acceptance of our new and enhanced products and solutions could result in delayed or lost revenue and lost development costs.

We depend on a few key customers, and our revenue could be negatively affected by the loss or early termination of a contract with one of these customers.

We derive a significant portion of our revenue from a small number of customers. Although we generally have multi-year contracts with our customers, our customers may cancel their contracts on short notice, including in circumstances where we fail to accomplish contractual milestones. Our business and cash flows would be adversely affected if one or more of our key customers were to unexpectedly discontinue or significantly reduce the use of our products, solutions or services. For example, Bayer accounted for approximately 39% of our revenue in FY 2004, 33% of our revenues in FY 2003 and 58% of our revenues in FY 2002. One of our multi-year software development collaboration agreements with Bayer expired in the summer of 2004 in accordance with the terms of the contract. Our second multi-year software development collaboration agreement with Bayer is close to completion as we have delivered the final software-development milestone under that agreement for acceptance. Bayer did not renew either of these agreements. If we are unable to make up the revenue lost from the expiration of these collaboration agreements with Bayer with revenue from a new software development agreement with Bayer or from other customers, our business and future revenue growth and cash flows could be adversely affected.

If we are unable to keep up with rapid technological changes, we may not be able to compete effectively.

Our future success will depend in part upon our ability to:

- continue to enhance and expand our existing products and services;

provide quality, high performance products, solutions and services; and

develop and introduce new products and provide new services that satisfy increasingly sophisticated customer requirements, that keep pace with technological developments and that are accepted in the market.

We continue to provide solutions for increasing efficiencies and speeding up the drug discovery process for biotechnology and pharmaceutical companies. There can be no assurance that we will be successful in anticipating and developing product enhancements or new solutions and services to adequately address changing technologies and customer requirements in the life science industry. Any such enhancements, solutions or services may not be successful in these markets or may not generate revenue. We may fail to anticipate and develop technological improvements, to adapt our products to technological change, emerging industry standards and changing customer requirements or to produce high-quality products, enhancements and releases in a timely and cost-effective manner in order to compete with applications offered by our competitors in the life science industry.

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Customer implementation and installation involves significant resources and is subject to significant risks.

Implementation of our IT products and solutions is a process that may involve a significant commitment of resources and time on the part of our customers and is subject to a number of significant risks over which we may have no control. Some of our customers have experienced protracted implementation times in connection with the implementation of our products. We can offer no assurance that similar delays and extra costs will not occur in the future in connection with the implementation of our products for other customers or with respect to our other products or solutions, despite the existence and support of our professional services staff. Excessive delays and pricing disparities could undermine our efforts to license our products and services in the life science industry.

We may be restricted in our ability to implement reductions of our company s workforce because a committee formed by our employees may object to termination of employees of our company, requiring us to enter into binding mediation before an independent third party with respect to any such work force reductions.

The employees of our company have formed an improvement committee, consisting of three active representatives elected by our company s employees on an annual or biannual basis. Members of our management generally meet with the improvement committee on a monthly basis and our management board briefs the committee at least once each quarter on our business activities. Our company has agreed with the improvement committee to keep the committee timely informed about our company s business activities and to afford the improvement committee an opportunity to discuss certain actions by our company, including changes to the company s operations or organizational structure, changes to salary or compensation structure, and employment terminations, disciplinary measures and resolution of employee disputes, prior to their implementation. The improvement committee does not represent or bind the employees of our subsidiaries and the committee s notice and participation rights do not extend to actions by our subsidiaries. Our company has also agreed to consult with the improvement committee in advance regarding workforce reductions and resulting compensatory measures. However, our company is not required to follow the committee s recommendations or to provide a redundancy plan.

The improvement committee s notice and participation rights are not intended to prevent our company from either creating or eliminating positions of employment. However, if the improvement committee expressly declines to endorse the termination of any employee of our company without cause, including as part of a workforce reduction, our company may not proceed with the termination unless urgent action is required. If the committee and management cannot reach a mutually acceptable resolution in mediation, including with respect to the termination of any employee without case, the matter will be referred to an independent mediator appointed by the local labor court in Heidelberg, Germany. The mediator s decision is binding on our company. Our company pays for the costs of the court-appointed mediation.

Our company bears the costs resulting from the activities of the improvement committee, including related travel and legal costs, and provides the necessary meeting and communications facilities. The members of the improvement committee have confidentiality obligations concerning management and employees. We may be restricted in our ability to restructure the activities of our company and to implement workforce reductions at our company, unless we can reach agreement with the improvement committee.

Our business model may prove unsuccessful.

The success of our business model and strategy will depend on:

our ability to develop and market IT solutions based on our technologies and those of our collaboration partners;

the degree to which the life sciences industry adopts our IT products, solutions and services in its R&D process; and

the performance of our technologies, solutions, products and services in accelerating the drug discovery process and the acceptance of these technologies, solutions, products and services.

The addition of new products, solutions and services will add further complexity to our organization and thus require additional management attention and resources as new markets are addressed. Our products and services involve a new approach to the conduct of business of organizations within the life science industry. Demand and market acceptance are therefore uncertain. While we will continue to pursue marketing and sales efforts to educate potential customers or the advantages of adopting our solutions for drug discovery, we can provide no assurance that a market will develop for such products and services.

We are subject to pricing pressure.

In response to competition and general adverse economic conditions, we may be required to modify our pricing practices. This development may adversely affect our revenue and earnings. We generally license our software products and solutions on a right to

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use basis pursuant to licenses over a specified period of time and providing for license fees based on the number and types of users or other applicable criteria. Changes in our pricing model or any other future broadly-based changes to our prices and pricing policies could lead to a decline or delay in revenue as our sales force and customers adjust to the new pricing policies.

Our revenue mix may vary and may adversely affect the amount of revenue and our ability to break-even.

We derive revenue from software licenses, software support and maintenance services for our customers, professional services engagements and collaborations with our customers and drug discovery activities that we have not terminated. Our revenue recognition policy is different for perpetual licenses than for our multiple-year licenses and services and drug discovery activities. We generally recognize revenue from perpetual licenses up-front whereas we recognize revenue from multiple-year licenses on a pro-rata, percentage-of-completion or milestone basis. Our revenue from support and maintenance services typically lags behind perpetual license fees. Therefore variances or slowdowns in our licensing activities may have an adverse impact on our revenue. In addition, growth in professional service revenue will depend on our ability to compete effectively in obtaining customer engagements or collaborations to provide services related to our products or solutions. Profit margins on professional service engagements are less than profit margins on revenue from software licenses. Our professional service engagements or collaborations with a customer may require us to develop complex customizations or software solutions for a customer over a lengthy period of time. Our service fees are typically tied to achieving certain milestones and delivering certain deliverables. We may be forced to expend additional efforts and resources to accomplish these milestones and deliver these deliverables. Given the smaller profit margins on these professional service engagements, we may be required to perform services for a customer at a net loss to us.

Our sales forecasts and/or revenue projections may not be accurate.

We use a pipeline system, a common industry practice, to forecast sales and trends in our business. Our sales personnel monitor the status of proposals, including the date when they estimate a customer will make a purchase decision and the potential revenue from the sale. We aggregate these estimates on a rolling six-month basis in order to generate a sales pipeline. We compare the pipeline at various points in time to look for trends in our business. While the pipeline process provides us with some guidance in business planning and budgeting, it is based on estimates only and is therefore subject to risks and uncertainties. A variation in the conversion of the pipeline into revenue or the pipeline itself could cause us to improperly plan or budget and thereby adversely affect our business, results of operations and financial condition. For example, softness in the general economy or in the life sciences market could negatively influence the capital spending decisions of a life science market participant, causing the customer to delay purchasing our products or solutions or reducing the amount of such purchase or canceling a purchase decision entirely. Any one of these outcomes could reduce the pipeline conversation rate for the relevant time period.

Terrorist attacks, war or other international hostilities could adversely impact our business.

Further terrorist attacks like those of September 11, 2001, war or other international hostilities could damage the world economy and adversely affect our customers investment and purchase decisions over an extended period of time. As a vendor of software solutions, which are effectively capital goods, we operate in a sector of the economy that may be impacted by the effects of any such attack.

Revenue recognition accounting pronouncements may adversely affect our reported results and operations.

We continuously review our compliance with all new and existing revenue recognition accounting pronouncements. Depending upon the outcome of these ongoing reviews and potential issuance of further accounting pronouncements, implementation guidelines and interpretations, we may be required to modify our revenue recognition policies and business practices which could have a material adverse effect on our results of operation. Our existing revenue recognition policy is described in Note of our consolidated financial statements included in Item 18: Financial Statements and in Item 5: Operating and Financial Review and Prospects - Revenue Recognition

Our management s use of assumptions and estimates may adversely affect our results of operations and financial condition.

Our financial statements are based upon the accounting policies as described in note A of our consolidated financial statements and included in Item 18. Financial Statements in this annual report on Form 20-F. Such policies may require management to make significant estimates and assumptions. Facts and circumstances which management uses in making estimates and judgments may change from time to time and may result in significant variations, including adverse effects on our results of operations or financial condition. For a description of these critical accounting policies, see Item 5. Operating and Financial Review and Prospects Critical Accounting Policies .

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We record revenues and expenses denominated in both euros and dollars. Fluctuations in the exchange rate between these two currencies could have the effect of decreasing our reported revenues or increasing our reported expenses.

We report our results of operations in euros. In our financial year ended March 31, 2004, approximately 70% of our revenues and approximately 50% of our expenses were denominated in U.S. dollars. As a result of our sales and marketing activities in the United States, an even greater proportion of our revenues may be denominated in U.S. dollars. Accordingly, our business and results of operations can be hurt by changes in exchange rates, particularly between the euro and the U.S. dollar. In addition, the balance sheet impact of translation adjustments may be material.

Our internal risk management policies and procedures may not be sufficient for us to identify, analyze and respond appropriately in a timely manner.

We cannot assure you that our risk management policies and procedures will identify, analyze or respond to all risks appropriately in a timely manner, especially those which are outside of our control.

Our competitive position may depend on trademark, patent, copyright, and license protection. If this protection is not sufficiently available, our business will be harmed.

Our ability to compete and achieve profitability may be affected by our ability to protect our proprietary technology and other intellectual property. We currently pursue copyright protection, and may also seek patent protection, for improvements of our various IT products and solutions.

Patent law affecting our business is uncertain and, as a result, we may not be able to prevent competitors from developing similar subject matter. Any issued patents that cover our proprietary technologies may not provide us with substantial protection or be commercially beneficial to us. Issuance of a patent is not conclusive as to its validity, enforceability or its scope. In addition, disputes may arise between us and our collaborators over ownership rights to intellectual property, know-how or technologies developed jointly with these collaborators or arrangements with collaborators may require us to provide identical technologies or information to multiple parties. Patents may not issue from our pending or future patent applications. In addition, third parties may have filed patent applications for technology that we use or that is covered by our pending patent applications without our being aware of these applications.

We are also dependent on protecting, through copyright law and contractual licensing agreements, our products and services, such as our IT systems, including our SRS data and application integration technology, to prevent other organizations from copying and reselling them. Copyright law and licensing law currently provides uncertain protections for some of our products and technologies. We are therefore uncertain whether it can prevent their copying or resale. Changes in copyright law, licensing law or patent law could reduce the extent to which we are able to protect our intellectual property, which could harm our business.

We are also the licensee or exclusive licensee of proprietary technology and other intellectual property of third parties that we rely on for our business. We have only limited control over these licensors and cannot assure you that these licensors have complied with and continue to comply with their contractual obligations and the license restrictions under these licensing arrangements. In the absence of this compliance, our commercial opportunities may be reduced and we may incur substantial costs in seeking to enforce or protect our rights under these licenses.

We have protected, or seek legal protection of, the trade names for our products and solutions, as well as for our company, including through applications to register these trade names as trademarks or service marks in our relevant markets. These applications may not be granted. In addition, a trademark or service mark registration is not conclusive as to infringement challenges by third parties concerning the use of a trade name. We recently entered into a delineation agreement with Lion Electronics International Computer Discount 2000 GmbH and Erwin Deutsch that restricts our use of the trade name LION in connection with our IT products. For more information concerning this agreement, see Item 4: Information on the Company Intellectual Property - Licenses .

The protection of our intellectual property and licenses may require us to pursue others, such as our licensees or licensors or other third parties, including through costly infringement or breach of license litigation or similar proceedings, to enforce our intellectual property rights or to invalidate intellectual property rights or licenses claimed by others. For example, we have entered into an exclusive license and distribution agreement with Sloan-Kettering Institute for Cancer Research pursuant to which we hold the exclusive rights to commercialize a human cell line commonly referred to as Caco-2 , including the right to enforce, license or use restrictions against third party licensees of the Caco-2 cell line. We cannot predict the outcome and effectiveness of any such litigation in protecting our intellectual property and licenses due to the uncertainty surrounding the applicable copyright, licensing and other intellectual property law. In addition, the cost to us of any such litigation could be substantial, could be protracted and may absorb significant management time. Moreover, pursuing any such litigation may not be an effective deterrent against the unauthorized use of our intellectual property or breach of our licenses.

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We also act as reseller or distributor of products owned or licensed by third parties, including products or components integrated into our products or solutions. We may depend on these third party owners or licensors to enforce their intellectual property rights to these products or solutions against others. If the owners or licensors of these products fail to enforce their intellectual property rights, or are unsuccessful in their enforcement efforts, our commercial opportunities from these reselling or distribution arrangements may be reduced.

Our competitive position may depend on our ability to protect trade secrets. If we are unable to protect our trade secrets, other companies may be able to compete more effectively against us, and our business could suffer.

We rely on trade secret protection for our confidential and proprietary information and procedures. We currently protect such information and procedures as trade secrets through recognized practices, including confidentiality agreements with employees, consultants, collaborators and customers. These confidentiality agreements may be breached, however, and we may not have adequate remedies for any breach. In addition, these trade secrets may otherwise become known to or be independently discovered by competitors, through the defection of employees to competitors or otherwise. If our trade secrets were to become known to, or be independently discovered by competitors, we could face more intense competition and our business could suffer.

We may infringe the intellectual property rights of third parties and may become involved in expensive intellectual property litigation. Any intellectual property litigation could impose a significant strain on our resources, and a finding that we have infringed the intellectual property rights of third parties could require us to limit our business activities or pay damages or license fees. In either case, our business, results of operations and financial condition could suffer.

The intellectual property rights of companies operating in the life sciences industry are generally uncertain and involve complex legal, scientific and factual questions. Our success in the markets in which we operate may depend on our ability to operate without infringing the intellectual property rights of others and to prevent others from infringing our intellectual property rights.

There has been substantial litigation regarding patents and other intellectual property rights in the life sciences industry. We may become a party to patent litigation or proceedings to determine our patent, copyright or other intellectual property rights with respect to third parties, including potentially our customers. Infringement proceedings may be necessary to establish which party was the first to discover such intellectual property. The cost to us of intellectual property rights litigation or similar proceeding could be substantial, and it may absorb significant management time. The pendency of any such intellectual property rights litigation may also adversely affect our company s ADS or share price. If infringement litigation against us is resolved unfavorably, we may be enjoined from providing some or all of our products or services without a license from a third party. We may not be able to obtain the requisite license on commercially acceptable terms or at all.

Our business requires personnel with substantial technical and management expertise. If we are unable to hire or retain personnel with the requisite expertise, our business could suffer.

Our products and services are highly technical. As a result, our key personnel must have specialized training or advanced degrees in order to develop and refine these products and services. There is a shortage of qualified scientific, management and software and IT development personnel who possess the technical background necessary to adequately understand and improve our products, solutions and services. The loss of any of these persons expertise may be difficult to replace.

Competition for the highly qualified personnel we require is intense, particularly in the areas of information technologies and life sciences. We compete for these persons with pharmaceutical and other biotechnology companies, software firms, academic institutions and government entities. The process of hiring suitably qualified personnel is often lengthy. We have in the past experienced, and may in the future experience, difficulties in recruiting the personnel our business requires on a timely basis.

The length of time between our initial contact with a customer and conclusion of a signed agreement can be lengthy. As a result, we may spend considerable resources on unsuccessful sales efforts or may not be able to make sales on the schedule anticipated. If we devote extensive resources to generate sales that do not materialize, our revenues could fall below expectations which could adversely affect our business and cash flows.

Our ability to obtain new customers for our products and services depends on our customer s belief that we can help accelerate their life science R&D efforts, particularly in the area of drug discovery and development. The length of time between our initial contact with a customer and conclusion of a signed agreement can be lengthy because our solutions, products and services are complex and cut across many aspects of a potential customer s organization. We therefore need to educate a variety of constituencies within potential customers about the benefits of our products and services in order to make a sale. In addition, many of the agreements that we enter into involve the negotiation of individual terms. We may therefore expend substantial funds and management effort with no assurance that an agreement will result.

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Our strategy contemplates the possibility of future investments, which may absorb significant resources. If future or existing investments are unsuccessful, our business, results of operations and financial condition will suffer.

As part of our strategy, we have pursued, and may continue to pursue, investments and other relationships and alliances. Transactions of this sort have involved and may involve significant cash expenditures, debt incurrence, additional operating losses, dilutive issuances of equity or convertible debt securities and expenses that could have a material adverse effect on our financial condition and results of operations. We have limited experience in concluding investments and similar transactions, and it may be difficult for us to complete such transactions quickly and to integrate these businesses efficiently into our current business. In addition, we may face difficulties in the assimilation of new technologies, the diversion of resources from our existing business, the maintenance of uniform standards, controls and procedures, and the impairment of relationships with our customers and employees. In addition, some of these companies may perform poorly, possibly resulting in the bankruptcy or liquidation of such companies. Any impairment of the carrying value of our investments that is other than temporary may require us to write-down the carrying value of the investment and record an amortization expense. For example, in FY 2003, we determined that the goodwill on our balance sheet from our acquisitions of Trega Biosciences and NetGenics was impaired such that this decline was other than temporary. Accordingly, we determined to write off the entire goodwill and recorded a one time amortization expense of 58.5 million on our consolidated statement of operations for FY 2003. See Item 5: Operating and Financial Review and Prospects-Critical Accounting Policies . Additionally, due to changes in German tax laws in 2000 and effective January 1, 2001, capital losses or write-downs of equity securities are no longer tax-deductible.

Most of our IT products or solutions require third party software and database components. If we are unable to procure licenses for the use of these third party software and database components for our customers or if our customers cannot obtain these licenses directly from these third parties, our business could suffer.

Most of our IT products require third party software or database components. If we are unable to continue licensing the use of these third party software and database components to our customers or if our customers cannot obtain these licenses directly from these third parties, we may be required to obtain similar licenses from other third party providers at higher costs or develop these software or database components by ourselves, which would delay our marketing and selling efforts with respect to these products or solutions.

Because our products and solutions are important to the R&D processes of our customers, we could incur substantial costs as a result of warranty or product liability claims.

The use of our IT products and solutions by customers in business-critical R&D applications and processes creates the risk that customers or other third parties may pursue warranty or other claims against us in the event of actual or alleged failures of our products, solutions or services provided by us. Any claim, regardless of its merits, could entail substantial expense and require the devotion of significant time and attention by key management and development personnel. In addition, certain of our Internet browser-enabled products include security features that are intended to protect the privacy and integrity of customer or third party data. Despite these security features, our products may be vulnerable to break-ins and similar problems caused by Internet users, such as hackers bypassing firewalls and misappropriating confidential information. Such break-ins or other disruptions could jeopardize the security of information stored in and transmitted through the computer systems of our customers.

Competition for our products, solutions and services is intense. If competitors develop products or solutions that are more competitive than ours, we may lose sales, and our commercial opportunity may be reduced or eliminated.

The industry in which we operate is highly competitive and is characterized by extensive research efforts and rapid technological progress. We face and will continue to face intense competition from the in-house software development teams of pharmaceutical and other life science companies as well as from a wide range of other competitors, such as third-party commercial software developers, bioinformatics, cheminformatics and genomics companies, universities and other academic research institutions, governmental agencies and other life science companies, including some of our customers. Our competitors may develop products or solutions that are more effective and/or less costly than any of our current or future products and solutions.

Many of our competitors have substantially greater capital resources, larger and more experienced R&D and other staffs, superior R&D facilities, greater experience in software development and greater marketing capabilities than we have.

To remain competitive, we must expand and enhance the capabilities of our IT products, solutions and professional services so that they remain more advanced than those of our competitors. We must also introduce enhancements and new systems, products and solutions faster than the potentially competing products, solutions and technologies of our competitors. If we are unable to do any of these things, our ability to obtain and retain revenues from customers would be adversely affected, and our commercial opportunity could be reduced or eliminated.

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We operate in rapidly evolving markets and we may have to change our business model or strategy, perhaps materially, to adapt to the changing needs of our customers. If we are unable to change our business model or strategy as required in a timely manner, our business, results of operations and financial condition will suffer.

We operate in rapidly evolving markets and we may have to change our business model or strategy, perhaps materially, to adapt to the changing needs of our customers. These changes may be rapid and significant and could materially affect how we operate. We cannot foresee these changes and may not be successful in changing our business model or strategy to meet the needs of our customers or markets. If we fail to modify our business model or strategy in response to these changes, our business could suffer. Changes in our business model or strategy may intensify the risks described in this annual report or subject us to new risks.

We may need to raise additional funds in the future. If such funds are not available to us, our business, results of operations and financial condition could suffer.

We believe that the net proceeds of our initial public offering, together with existing cash and cash equivalents and marketable securities, will be sufficient to fund our current operations and activities for at least FY 2006. Nevertheless, we may be required to raise additional capital to pursue expansion plans, in response to competitive pressures, to invest in new technologies or to develop and commercialize products, solutions or services.

This additional financing may not be available when needed or, if available, may not be available on favorable or even commercially reasonable terms. If adequate financing is not available, we may be required to significantly reduce or refocus our operations. We may also choose to raise additional capital due to market conditions or strategic considerations, even if we have sufficient funds for our current business plan. If additional financing is obtained through additional public or private equity offerings or convertible securities offerings, existing shareholders may suffer dilution.

Our insurance coverage may not be sufficient to avoid negative impacts on our financial position or results of operations resulting from claims or liabilities against us, and we may not be able to obtain insurance coverage in the future.

We maintain insurance coverage for protection against many risks of liability. The extent of our insurance coverage is under continuous review and is modified as we deem it necessary. Despite this insurance, it is possible that claims or liabilities against us may have a material adverse impact on our financial position or results of operations. We may not be able to obtain any insurance coverage, or adequate insurance coverage, when our existing insurance coverage expires. For example our insurance against claims for violation of the U.S. securities laws is renewed annually. After expiration of our existing insurance, we may be unable to renew our existing insurance nor obtain other insurance or we may be able to obtain such insurance only at an excessive cost or on unfavorable terms or for insufficient coverage. In addition, members of our supervisory and management boards may resign if we are unable to secure adequate insurance coverage for our supervisory board and management board.

Our sales are subject to quarterly fluctuations.

Our revenue and operating results vary, sometimes substantially, from quarter to quarter. Orders may increase in the fourth quarter of each calendar year, as business customers attempt to make full use of their IT purchase budgets before year end, and to a somewhat lesser degree in

the first quarter of each calendar year, as business customers attempt to make first use of their IT purchase budgets. Our revenue is difficult to forecast for a number of reasons, including the relatively long sales cycles for our products and solutions, the size and timing of individual license and consulting transactions, and the timing of the introduction of new products or product enhancements by us or our competitors.

The life sciences industry is consolidating, leading to greater competition to sell products, solutions and services to a reduced number of potential customers. This process could harm our efforts to market or sell our products and services.

Consolidation within the life sciences industry, particularly within the pharmaceutical and biotechnology industries, has heightened competition for products, solutions and services of the type we provide. If this trend toward consolidation continues, it may result in fewer customers for our products, solutions and services, price erosion and greater competition between us and our competitors. Any consolidation could shrink the available market for our products, solutions and services and adversely affect our ability to market our products, solutions and services.

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Use of information derived from genomics and/or proteomics research to develop or commercialize products is unproven. If genomics or proteomics-derived information proves unsuitable to develop or commercialize products, demand for our products, solutions and services will decline.

The development of new drugs based on information derived from genomics or proteomics research is unproven. Few therapeutic products based on discoveries in genomics or proteomics have been developed and commercialized, and to date, no one has developed or commercialized any therapeutic product based on our technologies. Development of new products by our customers may be subject to risks of failure, including that products will be found to be ineffective or toxic, fail to receive regulatory approvals, infringe the proprietary rights of others, or be subject to the successful marketing of similar products by competitors.

If our customers are unsuccessful in developing and commercializing products based on our products, solutions or services, we and our customers may be unable to generate sufficient revenues to meet our respective expenses. Our business may suffer as a result.

Health care reform and restrictions on reimbursement may affect the ability of pharmaceutical and biotechnology companies to purchase or license our products, solutions and services, which may affect our results of operations and financial condition.

The continuing efforts of government and third party payers in our markets to contain or reduce the costs of health care may reduce the profitability of pharmaceutical and biotechnology companies. For example, in some foreign markets, the government controls pricing or profitability of prescription pharmaceuticals. In the United States, we expect the continuation of federal and state proposals to implement similar governmental control. We cannot predict what actions federal, state or private payers for health care goods and services may take in response to any health care reform proposals or legislation. We currently expect to derive almost all of our revenues in the foreseeable future from the pharmaceutical and biotechnology industries. Accordingly, our success will depend, in part, upon the success of the companies within those industries and their demand for our products, solutions and services. Any reduction in the profitability of actual or prospective customers for our products, solutions and services could result in reduced revenues for us.

Security risks in electronic commerce or unfavorable Internet regulations may deter future use of our products and services.

Some of our customers use our SRS technology to make their proprietary databases available to their customers through Internet-based portals. Our ability and the ability of those who offer our products over the Internet to provide secure transmissions of confidential information over the Internet may limit on-line uses and purchases of products. A breach of security measures may result in the misappropriation of our customers or third party proprietary information or confidential information. The security measures we adopt may not be sufficient to prevent breaches, and we may be required to incur significant costs to protect against security breaches or to alleviate problems caused by breaches. Further, security breaches in general may result in customers not using the Internet to access our products. The U.S. federal or state governments could enact laws, rules and regulations that would affect our business and operations. The European Union, individual countries or other foreign jurisdictions could also enact laws regulating the use of the Internet. If enacted, these federal, state or foreign laws, rules and regulations could limit the growth and development of our Internet-enabled products and services.

The use of life science products can be subject to ethical, legal, social or privacy concerns among the public. If these concerns were to limit demand for our customers products, demand for our own products could suffer.

The use of genetic information in various areas of the life sciences industry, particularly in the areas of food production, medicine and pharmaceutical research, has raised issues regarding the appropriate uses of the resulting information. This could lead to governmental authorities calling for limits on or regulation of the use of genetic information or prohibiting testing for genetic predisposition to certain diseases, particularly for those that have no known cure. Any of these scenarios could reduce the potential markets for the products of our customers and could reduce the potential markets for our own products and services.

Risks Related to Holding Our Company s ADSs and Shares

We are considering amending our depositary agreement, terminating our ADS program and delisting our ADSs from the Nasdaq National Market. If we decide to proceed with these contemplated measures, our company s ADSs will no longer be traded on the Nasdaq National Market or any securities exchange or trading system in the United States and the depositary will sell our company s shares underlying the ADSs held by you following a relatively short holding period without your consent unless you withdraw the underlying shares during this holding period.

In June 2004, our company announced that it is considering whether to delist its ADSs from the Nasdaq National Market and terminate its ADS agreement. Our company s supervisory board has authorized our company s management board to review whether to proceed with these measures and to proceed with implementing these measures if the management board determines them to be in the best interest of the company. If our company determines to proceed with these measures and to delist our company s ADSs, our company s ADSs would no longer be traded on the Nasdaq National Market. If we direct the depositary of our ADS program to terminate the deposit agreement and all outstanding ADSs, you would no longer be able to hold or trade any of our company s ADSs following a period of thirty days after notice of this termination to our company s ADS holders. In addition, you would not be able to

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trade our company s ordinary shares underlying these ADSs on any U.S. stock exchange or U.S. trading system. In the event of this termination, you will be entitled to withdraw the ordinary shares underlying the ADSs held by you from deposit with the depositary during a one-year holding period following the termination. Our company may agree with the depositary to amend the deposit agreement to substantially shorten this holding period without your consent following a period of 30 days after notice of this amendment to the ADS holders. Following this holding period the depositary will sell the ordinary shares underlying the ADSs held by you without your consent and hold the proceeds from the sale in trust for your benefit unless you withdraw the underlying shares during the holding period.

If our company determines to proceed with these measures and to delist our company s ADSs and to terminate our ADS program, our company s shares may become beneficially owned by less than 300 shareholders that are U.S. residents. In that case, our company would no longer be subject to the SEC reporting requirements of the U.S. securities laws, including in particular the filing with the SEC of an annual report on Form 20-F and other quarterly or current reports that it has been required to file as a foreign private issuer under U.S. securities laws whose ADSs are listed on the Nasdaq National Market and are beneficially owned by at least 300 U.S. residents. In addition, the market price of our ordinary shares could decline further.

Our ADSs could be delisted from the Nasdaq National Market.

Our ADSs are currently listed on the Nasdaq Stock Market s National Market. Continued listing requirements of the Nasdaq National Market include maintaining a minimum bid price of $1.00 per listed security, a market capitalization of $5 million, $10 million in shareholders equity and at least two market makers in our ADSs. If these requirements are not met, our ADSs would be subject to delisting from the Nasdaq National Market which could depress our share price even further.

You may be subject to adverse U.S. tax rules as a holder of our company s shares or ADSs.

Special and adverse United States tax rules apply to qualified holders of our company s shares or ADSs if our company qualifies as a passive foreign investment company (PFIC). In general, a PFIC is any non-United States corporation, if 75% or more of the gross income of such corporation for the taxable year is passive income, or if the average percentage of assets (by value) held by such corporation during the taxable year that produce passive income (e.g., dividends, interest, royalties, rents and annuities) or that are held for the production of passive income is at least 50%.

We believe that our company qualified as a PFIC during FY 2004. Based on current projections concerning the composition of our company s income and assets, we believe that our company will also be treated as a PFIC during its current and future taxable years. If our company is treated as a PFIC for any taxable year during which a qualified holder holds shares or ADSs, the holder generally will be subject to a special and adverse tax regime with respect to any gain realized on the disposition of the shares and with respect to certain excess distributions made to the holder by the company. The adverse tax consequences include taxation of such gain or excess distribution at ordinary-income rates and payment of an interest charge on tax, which is deemed to have been deferred with respect to such gain or excess distributions. For more information concerning your possible tax treatment of our company as a PFIC and the potential adverse tax consequences to you, see Item 10: Additional Information Taxation United States Taxation Passive Foreign Investment Company Considerations .

You may be unable to enforce a judgment against our company or members of our company s management board or supervisory board.

Our company is a stock corporation organized under the laws of the Federal Republic of Germany. A German stock corporation may not give the same protections to shareholders or holders of ADSs as a corporation incorporated in the United States. None of the current members of our company s management board or supervisory board is a resident of the United States. The assets of these individuals may be located outside the United States. Likewise, all or substantially all of the assets of our company are located outside the United States. As a result, it may not be possible for you to enforce against these individuals or our company judgments obtained in U.S. courts based on the civil liability provisions of the U.S. securities laws. The enforcement in Germany of civil liabilities based solely upon U.S. securities laws in original actions or in actions for the enforcement of judgments of U.S. courts may encounter difficulties. In addition, awards of punitive damages in actions brought in the United States or elsewhere may be unenforceable in Germany.

Sales of ordinary shares by our principal shareholders could adversely affect the price of our capital stock.

Dr. von Bohlen und Halbach owns in excess of 10% of the outstanding ordinary shares in our company. His spouse and children may hold additional shares in our company. As of August 12, 2004, Bayer AG held 7% of the outstanding ordinary shares in our company. In addition, various individuals had significant shareholdings in our company prior to our company s initial public offering of its shares in August 2000. The sale of a large number of ordinary shares by any principal shareholder could have a negative effect on the trading price of our company s ADSs or ordinary shares. We are not aware of any restrictions on the transferability of the shares owned by the principal shareholders of our company, any of their immediate family members or any related entity.

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Our principal shareholders may be able to exert significant influence over our future direction and operations.

The amount of ordinary shares held by Dr. von Bohlen und Halbach and his family may enable Dr. von Bohlen und Halbach to exert influence over our future direction and operations, including by voting these shares at our company s shareholders meetings.

You will be subject to exchange rate risks, and the market price of our company s ADSs may decline if the value of the euro falls against the dollar.

Individuals and entities located in the United States who hold our company s ADSs and our company s shares will bear currency exchange rate risk. An increase in the value of the euro relative to the dollar will cause a decrease in the dollar value of our company s shares, which will also affect the market price of our company s ADSs on U.S. securities markets. You may receive a reduced dollar value upon the sale of our company s ADSs or shares held by you as the result of the dollar/euro exchange rate in effect at that time which may have no relation to the operations or prospects of our company.

You may have less access to information about our company and less opportunity to exercise your rights as a shareholder if you hold our company s shares through our company s ADSs.

There are risks associated with holding our company s shares through ADSs, as our company is a stock corporation organized under the laws of the Federal Republic of Germany. Our company is subject to German laws and regulations, and to its articles of association (*Satzung*). Your rights as a holder of our company s ADSs will differ in various ways from a shareholder s rights, and you may be affected in other ways, including:

- you will not receive dividends or other distributions directly from our company but from the depositary;
- you may not be able to participate in rights offerings or dividend alternatives;
- you may not receive copies of reports and may have to go to the office of the depositary to inspect any reports issued, or may only be able to request a report to be sent to you at your own expense;
- the deposit agreement may be amended by our company and the depositary, or may be terminated by our company or the depositary, without your consent in a manner that could prejudice your rights;
- the deposit agreement limits our company s obligations and liabilities and those of the depositary; and
- you have no right to vote in shareholders meetings unless you receive a power of attorney from the depositary bank.

The market price for our ADSs and ordinary shares may be volatile.

The trading prices of our company s ADSs and ordinary shares have experienced and may continue to experience significant volatility. The current trading price of our company s ADSs and ordinary shares reflect certain expectations about the future performance and growth of our company, particularly on a quarterly basis. However, our revenue and expenses can vary, sometimes substantially, from quarter to quarter, causing significant variations in operating results during certain quarters and in growth rates compared to prior periods. Any shortfall in revenue, expenses or net losses or earnings from levels projected or estimated by us or annual, quarterly or other projections or estimates made by securities analysts could have an immediate and significant adverse effect on the trading price of our company s ADSs or ordinary shares in any given period. Additionally, we may not be able to confirm any such shortfalls until late in the quarter or following the end of the quarter because license or service agreements are often executed late in a quarter. Finally, the stock prices for many companies in the software and biotechnology sectors have experienced wide fluctuations, which may not have been directly related to our company s operating performance. The trading price of our company s ADSs or ordinary shares may fluctuate in response to the announcement of new products or product enhancements by us or our competitors, technological innovation by us or our competitors, quarterly variations in our competitors results of operations, changes in revenue and revenue growth rates on a consolidated basis or for specific geographic areas, business units, products or product categories, speculation in the press or financial analyst community and general market conditions specific to particular industries. In the past, companies that have experienced volatility in the market price of their stock have been the subject of securities class action litigation. Any such securities class action litigation against us, with or without merit, could result in substantial costs to us and the diversion of management s attention and resources.

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Item 4: Information on the Company

Organization and History

The legal name of our company is LION bioscience Aktiengesellschaft. Our company, located in Heidelberg, Germany, was founded in March 1997 around a nucleus of six scientists from the European Molecular Biology Laboratory in Heidelberg, Germany and the University of Heidelberg, together with the former chairman of our management board, Dr. Friedrich von Bohlen und Halbach. Our company is a stock corporation (*Aktiengesellschaft*) organized in the Federal Republic of Germany under the Stock Corporation Act (*Aktiengesetz*) and was incorporated on March 4, 1997 by registration with the commercial register (*Handelsregister*) of the lower court (*Amtsgericht*) in Heidelberg, Germany, under entry number HRB 5706. We have subsidiaries in the United Kingdom and the United States of America and in addition to our headquarters in Heidelberg, Germany, we maintain sites in Cambridge, United Kingdom and Cambridge, Massachusetts, USA.

We offer and develop software products and solutions for use by research organizations of life sciences companies, including in particular data and application integration technologies as well as data analysis and predictive modeling tools and applications for the biology and chemistry stages of the drug discovery process. Our products and solutions are designed to accelerate drug discovery and development. We also offer global professional services to customers related to these products and solutions.

In August 2000, our company completed the initial public offering of its ordinary shares and ADSs consisting of public offerings in Germany and the United States and an offering to institutional investors outside the United States and Germany. The net proceeds to us from these offerings totaled approximately 209.29 million. Our ordinary shares are listed on the Frankfurt Stock Exchange in the market segment Geregelter Markt with additional qualifications (Prime Standard). From August 11, 2000 until December 31, 2002, our ordinary shares were listed in the market segment *Neuer Markt* of the Frankfurt Stock Exchange. Our company s ADSs have been quoted on the Nasdaq National Market since August 11, 2000. For further information concerning our company s initial public offering and the stock market listings of our company s securities, see Item 9: The Offer and Listing .

On March 14, 2001, we acquired Trega, which was merged into our subsidiary LION Bioscience Inc. On January 30, 2002, we acquired NetGenics. We ceased our internal drug discovery activities, which we called iD^{3TM}, in FY 2003.

The principal office of our company is located at Waldhofer Str. 98, 69123 Heidelberg, Germany. Our company s telephone number is: +49 (0) (6221) 4038-100. The principal office of LION bioscience Inc., our main U.S. subsidiary, is 101 Main Street, 17th floor, Cambridge, MA 02142. Our agent for service in the United States is CT Corporation System located at 111 Eighth Avenue, New York, NY 10011. Our Internet address is http://www.lionbioscience.com. None of the information on our Web site is incorporated by reference into this annual report.

Industry Challenges

The life sciences industry the principal market for our products, solutions and services has undergone major changes in the past years. Life sciences companies face significant pressures to develop new drugs that can generate substantial return on research and development (R&D) costs while also contributing to improved human health and life expectancy. As the product pipelines of pharmaceutical and other life sciences companies have begun to dry up, and several key product patents have either already expired or are drawing close to expiration, the pressure to increase drug discovery research productivity and accelerate the entire drug development process has intensified greatly. The cost of drug

development has risen dramatically. According to the U.S. Department of Health and Human Services, the rollout of a successful new product cost approximately 1.1 billion dollars from 1995 to 2000; since then, the costs per drug have risen to approximately to 1.7 billion dollars. Thus, as productivity has dropped, costs have sharply risen.

Life sciences companies face the following pressures: to reduce the time (and therefore the cost) of developing new drugs, and, at the same time, to develop a greater number of new drugs or, to have a greater number of their drug candidates emerge from their R&D pipeline as approved and successful therapeutic products. Many large pharmaceutical companies are not currently meeting these objectives, as they lack the requisite number of blockbuster chemical entities in their product pipeline, and as patents on existing blockbuster drugs expire, generic drug manufacturers are generating increasing market pressure.

The demand for our IT products, solutions and services is driven by these fundamental changes in the business of the largest pharmaceutical companies, as our offerings are designed to accelerate the biology and chemistry stages of the drug discovery process at large pharmaceutical and other life sciences companies. We believe that through the use of effective IT products and solutions in the drug discovery process, companies in the life sciences industry may be able to evaluate scientific data faster, more cost-effectively and more comprehensively to create new product candidates and to select the more promising candidates at the earlier stages of the discovery and development process.

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Our Strategy

We have adjusted our strategy to respond to the current market need for IT-driven solutions designed to accelerate the early phases of the drug discovery process. As a result, we have moved away from offering comprehensive IT solutions for the drug discovery process, such as our so-called i-biology® and our pharmacophore solutions, which we had implemented for Bayer under two multi-year collaborations, and our proprietary data and application integration platform LION DiscoveryCenter. For more information concerning our collaborations with Bayer, see -Customers Our Customer Relationship with Bayer .

Our LION DiscoveryCenter platform was designed to integrate disparate data analysis and IT applications that are used throughout the life sciences R&D process, in particular bioinformatics and cheminformatics tools and applications, and the diverse data structure and databases, in particular biological and chemical data. LION DiscoveryCenter was thus designed to enable R&D organizations to manage the enormous volume, diversity and complexity of their data and to integrate this data with the disparate analysis tools and applications across the different R&D departments.

We developed LION DiscoverCenter as a comprehensive IT platform in response to a key bottleneck facing R&D organizations at the large pharmaceutical companies when using IT systems for their R&D processes: the integration of diverse, complex and voluminous data from the various phases of the drug discovery process (biological, chemical, pre-clinical and clinical phase) as well as the integration of the large number of disparate data analysis tools and software applications used in these various phases. LION DiscoverCenter offered a comprehensive solution that cut across many aspects of a potential customer s R&D organization. In addition, we also created LION Target Engine as a comprehensive solution for the biology phase of the drug discovery process.

However, because of the shift in focus by the large pharmaceutical companies to the later stages of the R&D process as discussed above, and a corresponding slowdown in investments by life science companies in comprehensive IT solutions, demand for LION DiscoveryCenter remained below our expectations. At the same time, we noted steady demand for individual IT applications for use in the early stages of the R&D process.

As a result of current market demand, we have thus adjusted our strategy away from offering complete or comprehensive solutions and to focus on our core product offerings, namely our industry-leading SRS data and application integration technology and stand-alone IT applications, such as our LION Target Engine software application suite, which we launched in FY 2003, as well LION Lead Engine, our software application suite for the chemistry phase of the drug discovery process which we launched in August 2004 with LeadNavigator as the main product component. We will continue to provide complete solutions to customers upon demand.

While we no longer offer LION DiscoveryCenter as an individual solution, we continue to service and maintain existing LION DiscoveryCenter installations at our customer sites. Individual modules of LION DiscoveryCenter will be used in our existing and future core. In addition, our professional services organizations may use LION DiscoveryCenter technologies in individual customer projects.

We pursue a customer focused strategy designed to respond to the demands of the R&D organizations of life sciences companies. We will therefore strive to continue to improve our industry-leading SRS technology in accordance with customer requirements on the basis of available technologies. For example, we are currently exploring the development of full text searching and text mining capabilities as part of a new version of SRS. In addition, our development activities are focused on modularizing our LION Target Engine solution into a suite of software applications or by separating out individual components. These modules are expected to run independently of one another and be made available to our customers on a stand-alone basis. However, the full potential of these modules could only be exploited when used in conjunction with one another.

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The following graphic illustrates our IT development strategy. The shaded areas of the graphic are areas of need in the drug discovery process for which we intend to develop new products in the future:

The architecture of our core products is open, scalable and modular in other words they are suited to a growing number of users and designed to meet increasing technological and content requirements. Their open environment allows customers to continue using their internally developed or licensed IT applications and databases. Our professional service team can assist our customers with integrating their own or third-party solutions and databases as well as our IT applications and technologies, as illustrated by the arrows in the above graphic.

We have identified the following two key strategic goals for the current financial year:

- To increase market penetration of our products; and
- To enter into the market for IT applications for use in the chemistry phase of the drug discovery process with our own software offering.

Our first strategic goal is to increase market penetration, especially in the United States. Since we have only been active in this geographic market with a significant presence for approximately three years, a substantial opportunity to increase market share exists in the United States. We expect to gain market share in the North American market though our refocused product strategy as well as our U.S. operations which we have restructured to focus on sales, marketing and professional services for the U.S. market.

In FY 2004, we entered the market for IT applications to be used in the chemistry phase of the drug discovery process. We initially entered this market through a strategic alliance with DeltaSoft and its sister company ChemCart, pursuant to which we became the preferred reseller of the IT applications offered by these collaboration partners. In addition, we recently became the exclusive global distributor of ChemNavigator s products. We have also gained experience in this market as a result of our multi-year collaboration with Bayer in the area of pharmacophore informatics as well as through our iDEA predictive modeling software which we originally developed for predicting relevant absorption, distribution, metabolism, and excretion (or ADME) characteristics of potential drugs during the preclinical phase of the drug discovery process. With LION Lead Engine we offer our own software application suite for the chemistry phase of the drug discovery process. This software suite offers components from our own product developments, applications developed in the course of our pharmacophore informatics collaboration with Bayer as well as components and technologies from various collaboration partners, such as DeltaSoft and ChemCart, ChemNavigator, and BioByte. We recently released LeadNavigator as a component application of LION Lead Engine.

Finally, we plan to expand our collaborations with leading academic institutions, such as the European Bioinformatics Institute (EBI) of the European Molecular Biology Laboratory (EMBL), in order to explore new trends and developments in academia and to further strengthen our position as a leading supplier of IT solutions for the life sciences. In addition, we expect these projects with academic organizations to promote a knowledge transfer designed to compensate for the workforce reductions in our R&D organization as a result of our restructurings in recent years.

Our business model is essentially that of a traditional software company. We generate revenue from the sale of software licenses, maintenance and support of our software products, and from offering professional services with respect to software development projects. An important

distinguishing characteristic of our business model is the interdisciplinary collaboration of IT experts, natural scientists and process specialists in one team.

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Our Technologies, Solutions, and Products

Data and Application Integration Technologies

One of our core competencies is the development of data integration and application integration technologies for managing the volume, diversity and complexity of data generated in the life sciences R&D process and integrating disparate data analysis tools and software applications used to process such data.

SRS Software Suite

SRS is a software suite for the collection, integration and administration of data during the early phases of the drug discovery process. SRS is capable of integrating the diverse universe of biological data from heterogeneous data sources by connecting customers internally developed and licensed third party databases with over 400 public domain databases through a single query and navigation interface without losing data in file and format conversions. SRS is designed to query and integrate data from so-called flat file databases, as the vast majority of biological databases contained flat file database structures. SRS is also capable of integrating and querying databases containing data in the XML format. SRS provides customers with an expandable framework for their data integration needs. Using SRS extensive platform, researchers can integrate new databases into the system and exploit the links between different databases. SRS is designed to grow with the increasing volume and complexity of biological data. SRS also enables bioinformaticians to develop applications and algorithms on top of SRS. The SRS software is regarded as a market leader for biological data integration and is used by over 280 commercial and academic customers. With the SRS Relational module, users can access and integrate relational data. With SRS Gateway for Oracle module, Oracle users have access to SRS. Since chemical structures are, to a large extent, managed in relational databases, SRS creates an effective link between chemical and biological data.

We provide value-added modules as part of the SRS software suite to enable our customers to expand the SRS system.

We offer the entire SRS software suite, including all different modules, together with a professional services package for software installation and customization.

Research Software Applications

We offer a number of IT products designed for use in the earlier stages of the drug discovery process. Our core IT software application suites, LION Target Engine and LION Lead Engine, which is still under development, include components from collaboration partners and other licensors. In addition, we act as preferred resellers for a number of applications for use in the chemistry phase of the R&D process.

LION Target Engine

LION Target Engine, which was released in June 2003, is a stand-alone application suite for use in the biology research phase of the drug discovery process. We plan to release a new version of LION Target Engine during the current fiscal year. LION Target Engine is designed to speed up the identification, prioritization, and validation of biological targets for further development by offering an extensive range of functions from targeted data analyses and visualization through analysis and interpretation of biological information. LION Target Engine consists of different application modules that we also offer separately.

Each application uses a Summary Sheet feature as a sharable and easy-to-understand web-based report containing all essential target related data. In addition, advanced user management and data sharing capabilities are always provided to assist research scientists to further interpret data.

Major application modules of the LION Target Engine suite include:

Gene Hub. The central data-unifying Gene Hub brings together all target related information.

Pathway and Interaction. The Pathway and Interaction application enables users to import, modify, create and share any kind of network information. This application offers a user friendly interface with extensive editing and note taking capabilities complemented by import and export functionality. This application enables research scientists on the relevance of specific biological targets.

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Registration Module. The Registration Module allows registration of sequences, in a similar fashion as the registration of chemical compounds. Templates allow users to store target information in a standardized way, and target information can be shared with other users.

Annotation Module. The Annotation Module allows manual and high throughput automated annotation of sequences. Multiple workflows use expert reasoning to predict functions of proteins and nucleic acids. Workflows can be modified to address specific customer needs.

LION Target Engine Annotation is the successor application to our bioSCOUT® software, which provided easy-to-use automated methods for the comprehensive and simultaneous annotation of single or multiple gene and protein sequences, eliminating the tedium of repetitive manual sequence analysis. We no longer offer bioSCOUT® but continue to support existing customer installations of bioSCOUT®. Like its predecessor bioSCOUT®**,** LION Target Engine Annotation is specifically designed for automated, comprehensive analysis of sequences, but extends this functionality with additional workflows, optimized viewers and editing capabilities.

In addition to these applications, LION Target Engine also offers:

A Genome Viewer to visualize the genomic organization and all related information;

An Assay Viewer to view numerical experimental data;

A Text Mining component to filter for relevant target related information in texts;

A Protein Structure component to find matching structures; and

A Target Tracking component to investigate the progress of targets in a customer s R&D pipeline.

LION Target Engine can be connected to on site legacy tools and databases of a customer s R&D organization to transfer data between disparate applications and products

LION Lead Engine

The first module of our LION Lead Engine, LeadNavigator, was released in August 2004. We expect to release additional modules in the future. Through the LeadNavigator interface, users have a single point of access to all relevant databases, graphical views, calculators and tools.

Major application modules of the LION Lead Engine suite will include:

LeadNavigator . LeadNavigator is a chemically aware spreadsheet that allows research scientists to visualize and analyze large sets of chemical, numerical and textual data from one easy to use interface. By providing access to calculators and other tools used for compound prioritization and optimization, and offering synchronization between the spreadsheet and a range of graphical views, LeadNavigator provides the scientist with decision support for chemical compound lead identification and optimization. The spreadsheet provides a single point access to both standard statistical methods as well as algorithms used for compound identification, prioritization and optimization, including structure clustering, maximum common substructure calculation, R-group deconvolution, and Lipinski Rule value calculations that better assist research scientists in determining their compounds of interest. Synchronization between the spreadsheet and a range of linked graphical views, including scatter plots, histograms, and dendograms, help scientists find trends amongst the data. LeadNavigator also includes a dataset of small molecule active compounds in FDA approved drugs, including prescription, over the counter, and discontinued chemical entities and their associated data derived from the FDA Orange Book, published by the U.S. Food & Drug Administration.

LeadNavigator can be integrated with an organization s existing cheminformatics infrastructure, as well as be combined with leading commercial interfaces for accessing chemical and biological data, such as ChemCart of DeltaSoft and ChemCart or the MDL® ISIS product suite. In addition, third party or in-house computational algorithms and tools can be integrated into the spreadsheet to provide additional functionality.

LeadNavigator leverages the technology developed by us as part of our pharmacophore informatics collaboration with Bayer. In addition, we licensed the cLogP calculation software from BioByte for incorporation into LION s LeadNavigator. BioByte s cLogP software provides accurate hydrophobic estimations and calculations based on established chemical interactions, not solely on statistics, thereby providing valuable and precise information to the user. In addition, we licensed with custom software modules from ChemNavigator for integration into LeadNavigator.

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iDEA pkEXPRESS . iDEA pkEXPRESS is a comprehensive software program developed to predict relevant pharmacokinetic and ADME characteristics of potential drugs. We released iDEA pkEXPRESS in May 2003. The system can be deployed as a desktop application or as an ADME compute engine in a larger IT system. The program s physiological models were trained using a diverse data set of internally generated in vitro data, human physiological pharmacokinetic data from successful and failed clinical trials, and chemical structures.

ChemCart . ChemCart provides a web-based interface to chemical data cartridges. Scientists can display structures, data and images in a customized report form. Through ChemCart, users can access chemical data stored in Oracle® databases, and biological data stored in databases accessible through our SRS data integration system. ChemCart is owned and developed by our collaboration partners DeltaSoft and ChemCart. We act as preferred global distributor of ChemCart.

Compute Engine Framework. Through the compute engine framework, customers can integrate additional third party tools and calculators.

Research Software Applications for Resale by Us

In addition to our own research software applications, we act as preferred global distributor of ChemCart, CRISTAL and DeltaBook, the research software applications of DeltaSoft Inc., a leading software provider specializing in software applications for the chemistry research phase of the drug discovery process, and its sister company ChemCart L.L.C. In addition, we act as the exclusive global distributor of the databases, software applications and services of ChemNavigator Inc.

Professional Services

We provide professional services in respect of our products and solutions through our LION SolutionCenter. The Center is a global professional services organization designed to enable companies to transition from conventional R&D processes to efficient and productive IT-driven R&D processes. In this connection, our professional services staff provides expert guidance in design, implementation and optimization of new solutions based on our products and technologies. In addition, we offer training and on- and off-site installation and configuration assistance.

Caco-2

In 1997, NaviCyte, Inc., a subsidiary of Trega Biosciences, entered into exclusive license agreement with the Sloan-Kettering Institute for Cancer Research concerning the exclusive commercial use and distribution rights of the Caco-2 cell line. The Caco-2 cell line originated in the laboratories of the Memorial Sloan-Kettering Cancer Center in 1974 and was deposited with the American Type Culture Collection (ATCC). This deposit was made subject to the condition that Caco-2 cells would not be utilized for commercial purposes by any person without Sloan-Kettering s prior approval. Sloan-Kettering granted to NaviCyte the exclusive license to utilize the Caco-2 cell line for commercial purposes, including the right to grant sublicenses to commercial entities for the use of the Caco-2 cell line. Following our acquisition of Trega Biosciences, we entered into a Restated Exclusive License Agreement with the Sloan-Kettering Institute for Cancer Research in January 2004, to extend our exclusive commercial use rights of Caco-2 for an additional period of up to ten years. Under this restated agreement, we hold the exclusive right to use, license and distribute Caco-2 to for-profit entities, including the right to enforce Sloan-Kettering s rights arising from unauthorized, infringing or unlawful uses or exploitation of the Caco-2 by third parties. We have agreed to pay Sloan-Kettering an annual license fee as well as royalties from our distribution and commercialization of Caco-2, including from any enforcement of Sloan-Kettering s rights. If we fail to make the annual license fee, our rights under this agreement become non-exclusive and we will no longer be entitled to

license or distribute Caco-2.

We have entered into agreements with a number of large pharmaceutical and biotechnology companies granting the right to use Caco-2 for commercial purposes.

Internal Drug Discovery Activities

We conducted a variety of internal drug discovery activities using our own IT products prior to the end of calendar year 2002. We pursued these efforts to not only test our IT products and solutions and establish the validity of an IT-driven R&D approach for drug discovery, but also to discover promising drug candidates from our own R&D program, which we called *i*D^3, particularly in the areas of nuclear receptor research and diagnostic analysis of various chemical compounds stemming from our acquisition of Trega s Chem.Foli® compound libraries.

Consistent with our strategy to focus on our core competencies and to respond to demands and opportunities in the life sciences industry, we decided to focus solely on providing IT products and solutions to external life sciences companies. Accordingly, we ceased our internal drug discovery program by the end of calendar year 2002. We have licensed intellectual property and results of our

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research from our *i*D^3 activities to PheneX AG, a Heidelberg based company founded by former *i*D^3 employees, on an exclusive basis. PheneX also held an option to purchase specified intellectual property from us, which PheneX has exercised. Since PheneX exercised the option, we are entitled to receive a specified portion of the net proceeds from any sale of this intellectual property by PheneX at any time prior to September 30, 2005.

We sold our remaining inventory of Chem.Folio® libraries of chemical compounds that we obtained from Trega in connection with our acquisition of that company during FY 2004. At the end of FY 2004 we ceased selling our arrayTAG and arrayBASE products, although we may in the future market and sell these products primarily or exclusively through third party distributors. arrayTAG is a collection of clones of mouse, rat and dog cDNA, which are generated by a novel technology developed as a result of our *i*D^3 activities to specifically tailor cDNA clones for chip technology. These clones facilitate the production of high-quality microarrays. arrayTAG is directly linked to our integrated annotation database arrayBASE to speed up access to in-depth information about differentially expressed genes.

Customers

We currently have more than 100 for-profit customers throughout the global life science and health care industries. In FY 2004 and in the current fiscal year, we completed multi-year software development projects for Bayer and Schering AG.

Our Customer Relationship with Bayer

For more information on our arrangements with Bayer, see Overview under Item 5 and Material Contracts under Item 10 of this annual report.

Our i-biology® Arrangement with Bayer

From July 1, 1999 until June 30, 2004, we implemented a customized solution for Bayer, which we call *i*-biology®, which involved the development and application of IT systems for high-throughput identification and validation of new drug targets, diagnostic markers and SNPs from genomics sources as an integral part of Bayer s own gene discovery activities. In addition, we identified a number of potential drug target genes, annotated the function of a number of drug target candidates provided by Bayer, and identified and validated certain genetic markers. We also established and expanded an intranet-based research information management framework for all of Bayer s research sites in North America, Europe and Japan and set up an organizational infrastructure to implement a new model of gene-based drug discovery based on this IT infrastructure. In June 2000, we expanded this arrangement with Bayer into the areas of plant protection and animal health. In June 2003, we agreed with Bayer to modify our delivery requirements for drug targets and our software development obligations. Pursuant to this agreement, we were no longer required to deliver any novel drug targets. Instead, we agreed to use our best efforts to analyze a specified number of genes as drug targets that belong to certain gene classes known to be successful in drug development as specified further in a Target Validation Plan and provide certain analysis and annotation services relating to these targets. We established LION bioscience Research, Inc., a wholly owned subsidiary in Cambridge, Massachusetts, to perform this *i*-biology arrangement, including the development of these customized IT solutions for Bayer. Following the completion of our *i*-biology® collaboration, we closed down the operations of LION bioscience Research, Inc.

All rights and title to all information technology developed by LION bioscience Research, Inc., will belong to our company, subject to a grant to Bayer of a license to use such information technology for Bayer s internal purposes only. Our company has agreed not to market or distribute any resulting IT products or solutions commercially for a period of one year from the time the relevant information technology becomes workable

and has been tested and accepted by Bayer.

Our Pharmacophore Informatics Project for Bayer

In August 2004 we delivered the final software development milestone to Bayer, which is still subject to acceptance by Bayer, under a project in the areas of pharmacophore informatics and cheminformatics that commenced in October 2000. Under a separate collaboration agreement, we had agreed to provide Bayer with an integrated pharmacophore and informatics technology platform to speed Bayer s identification of lead candidates for its drug and agricultural chemical programs. Under this arrangement, we delivered and developed information technology and software, such as pharmacophore and informatics tools, for Bayer to significantly enhance Bayer s lead identification and optimization capabilities for pharmaceutical and agrochemical discovery.

Our performance under this project was originally divided into four successive milestones and the collaboration was to expire when Bayer accepted our performance of the fourth milestone, which was originally due on March 1, 2003. We then entered into a number of amendments to the collaboration agreement. We have delivered the final milestone, which is still subject to acceptance by Bayer. Any software developed or invented under this collaboration and all other developments, inventions, know-how, whether patentable or not, will be owned by our company. We will grant to Bayer and the Bayer group an irrevocable, non-transferable, non-exclusive,

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worldwide license to use this software, inventions and know-how for internal purposes only for the maximum period of time legally possible. Following Bayer s acceptance of the final milestone, we have the unrestricted right to commercialize this software, inventions and know-how.

Following acceptance of the final milestone, we may have to pay to Bayer limited royalties for new products created or services performed in the field of pharmacophore and informatics.

Our Customer Relationship with Schering

In March 2003, we entered into a Corporate Gene Database Project Agreement with Schering AG for the development of a corporate gene database for Schering that restated and replaced the original Software License and Project Agreement between Schering and NetGenics, a company that we had acquired in January 2002. Under the agreement, we agreed to continue performing the corporate gene database project which Schering had originally contracted for with NetGenics in May 2001 by developing and delivering to Schering the remaining software deliverables under the project using our LION DiscoveryCenter and SRS software platforms. Schering agreed to make an aggregate payment of approximately $1.2 million to us for all deliverables under this project in installments based upon achievement of project milestones. Schering made the final payment of $0.2 million after final acceptance by Schering of the third software deliverable on March 31, 2003.

In March 2003, we entered into Non-Exclusive License Agreements and Maintenance and Support Agreements with Schering for a combined term of six years, subject to Schering s right to terminate the agreements effective at the end of the third year of the term. Under these agreements, Schering has licensed the software deliverables developed under the project agreements, which comprise customized and standard components of LION DiscoveryCenter and SRS, to be used for a limited number of Schering users and purchased software maintenance and support services from us. In addition, as part of our maintenance and support obligations, we delivered to Schering a maintenance release comprising corrections and software functionalities to the software solutions developed under the Corporate Gene Database Project Agreement. The aggregate license and maintenance and support fees for the first three years of the license term are slightly in excess of $1.5 million. Schering has agreed to pay an additional $1.6 million in license and support and maintenance fees for years four through six of the six year term (unless Schering has elected to terminate the agreement early as described above). License and maintenance and support fees would also increase if Schering added additional users for this software solution.

Revenue by Geographic Region

For information regarding a distribution of revenues by geographic market, see Item 5: Operating and Financial Review and Prospects FY 2004 Compared with FY 2003 Revenues .

Revenue Categories

The information regarding a distribution of revenues into categories, see Item 5: Operating and Financial Review and Prospects FY 2004 Compared with FY 2003 Revenues .

Research and Development

In-house activities

We are actively engaged in R&D programs to develop new software products and provide additional value-added solutions to customers in the broader life sciences industries. Our research and development expenses related to the development of our IT products and solutions have remained high compared to our selling and general and administrative expenses. Excluding R&D expenses from our internal drug discovery program, which we discontinued by the end of calendar year 2002, our R&D expenses totaled 12.507 million in FY 2004, 34.225 million in FY 2003 and 33.900 million in FY 2002.

Our R&D activities focus primarily on the continued development of our integration platform technologies and the related application suites for the biological, chemical and pre-clinical phases of the drug discovery process. The increased R&D expenses in FY 2003 were due primarily to our efforts to complete our LION DiscoveryCenter integration platform, our LION Target Engine and iDEA pkEXPRESS application suites and a new version of our SRS system. In addition, these increased costs reflect the restructuring of our global R&D organization.

In FY 2003, we commenced an integration and restructuring program of our global R&D organization. The goal of this program was to streamline the operational structure of our R&D organization, reduce organizational complexity and concentrate development efforts for products and solutions in individual centers of excellence dedicated to those technologies. We completed this process in FY 2004. Accordingly, we closed all of our IT development sites in the United States in FY 2003 and FY 2004 and transitioned our IT development work to our sites in Heidelberg, Germany and Cambridge, United Kingdom.

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As a result of this integration and restructuring program, we have reduced the number of employees working in our worldwide IT development organization. As of March 31, 2004, a total of 53 full-time equivalent employees worked in our global IT development organization, compared with 177 full-time equivalent employees in R&D as of March 31, 2003. This number has markedly declined as a result of the workforce reduction at our Heidelberg site and the closing of our Cleveland, Columbus and San Diego development sites. Our development activities with respect to our SRS data and application system continue to be located at our site in Cambridge, UK, while our research software applications, such as LION Target Engine and LION Lead Engine, are developed at our site in Heidelberg, Germany.

Alliances

As part of our strategy, we have maintained or entered into a number of strategic alliances and collaborations with other leading industry participants for the creation and development of our IT solutions and for the application of our solutions to new areas of life science R&D. The following are the more significant of our current arrangements. We terminated our joint venture with Paradigm Genetics for the performance of a multi-year development project funded in part by an Advanced Technology (ATP) grant from the U.S. National Institute of Standards and Technology (NIST) by written notice given in June 2004. We have not received confirmation from NIST that we are released from the project. We do not expect to incur any further obligations under this project.

DeltaSoft and ChemCart

In October 2003, we entered into a license agreement, a reseller agreement and a professional services agreement with DeltaSoft Inc., a privately owned developer of software for use in the chemistry phase of the drug discovery process, and its sister company ChemCart LLC. DeltaSoft and ChemCart appointed us as the preferred global reseller and distributor of their ChemCart, CRISTAL and DeltaBook software products, including as bundled with other software products owned or licensed by us. We have agreed to pay DeltaSoft and ChemCart royalties with respect to resales of these software products and have committed to payment of a minimum guaranteed royalty during the first twelve months of this preferred reseller agreement. DeltaSoft and ChemCart have also agreed to provide our customers with technical support with respect to these software products. As a preferred reseller, we hold the worldwide exclusive resell and distribution rights to these software products except for distribution rights DeltaSoft and ChemCart granted to another distributor under a pre-existing distribution agreement. The preferred reseller agreement runs for an initial term of two years.

We also entered into an exclusive license agreement to incorporate these software products into our products and other software applications owned or licensed by us. We have agreed to pay DeltaSoft and ChemCart royalties with respect to sale of our software products integrated with their software products. The exclusivity of our license is subject to limited bundling rights of another distributor of DeltaSoft and ChemCart under a pre-existing agreement. In addition, we enjoy more favorable pricing and royalty terms than this other distributor. DeltaSoft and ChemCart have agreed to provide us with technical back-up support with respect to these software products. The preferred reseller agreement runs for an initial term of two years. DeltaSoft and ChemCart have agreed to develop the necessary integration software to integrate their software products with ours pursuant to a separate consulting and professional services agreement.

Under this two-year consulting and professional services agreement, DeltaSoft and ChemCart have agreed to provide cheminformatics software development and consulting services to us and our customers on projects defined by us. We have agreed to engage DeltaSoft and ChemCart as our preferred consultants and have agreed to restrictions in engaging third parties to provide these services. We will own the software and intellectual property resulting from any of these services.

We also have a right of first refusal with respect to any of the following transactions involving DeltaSoft or ChemCart: sale of all or substantially all assets, merger with another entity, transfer of control over the capital stock to a third party or issuance of new capital stock or ownershipinterests to a third party.

ChemNavigator

In July 2004, we entered into a license and reseller agreement with ChemNavigator, Inc., a privately owned developer of software and databases for use in the chemistry phase of the drug discovery process. This collaboration consists of a perpetual non-exclusive license agreement to incorporate certain ChemNavigator software components into our LION Lead Engine and other software applications owned or licensed by us, and a distribution agreement giving us the exclusive worldwide rights to distribute ChemNavigator s iResearch Library database and iResearch System as well as ChemNavigator s 3DPL software, including as bundled with other software products owned or licensed by us. We paid a one-time perpetual license fee to ChemNavigator for our perpetual non-exclusive use and integration rights to these software components. In addition, we have agreed to pay ChemNavigator royalties

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with respect to resales of ChemNavigator s database and software. Our exclusive distribution rights may terminate after an initial twelve months period, if we do not meet certain minimum royalty thresholds. For additional information concerning our relationship with ChemNavigator, see Item 7: Major Shareholders and Related Party Transactions Related Party Transactions Relationship with ChemNavigator .

IBM

In November 2001, we entered into a strategic alliance with International Business Machines Corporation (or IBM) for the development and marketing of joint life sciences informatics solutions based on our and IBM product offerings and joint enterprise-wide drug discovery solutions and services, including enterprise-wide solutions and services to specified customers, which will combine IBM and our technologies to expedite the drug discovery process. As part of this strategic alliance, we agreed to collaborate with IBM to combine our SRS data integration system with IBM s DiscoveryLink data integration software. We granted IBM a limited developer license to SRS that allows IBM to use SRS to provide integration services for integrating SRS and DiscoveryLink to joint integration customers and for integrating IBM middleware with SRS with our consent. IBM has granted us a developer license to DiscoveryLink. We have also agreed to port and make SRS and other specified IT product offerings available on IBM hardware platforms and integrate them with IBM middleware, including IBM s WebSphere® Internet infrastructure software. In FY 2003, we successfully ported SRS to IBM s AIX operating system. In addition, we developed the software to combine SRS with DiscoveryLink during FY 2003. Our strategic alliance with IBM will end in November 2004. However, we have agreed with IBM to continue to support current and future versions of SRS on IBM s AIX operating system through July 1, 2006.

In financial year 2004, we terminated our relationship with IBM with respect to our discontinued LION Hosted Services (or LHS) offering. Under that arrangement, IBM had acted as the hardware and hosting services provider for our LHS offering and as reseller of LHS.

TEMIS

In July 2004, we entered into a license and a reseller agreement with TEMIS S.A., a privately owned developer of text-mining software. Pursuant to the license agreement, we have the right to incorporate certain text-mining software components into our SRS system, our research software applications and other software owned or licensed by us, and a distribution agreement giving us worldwide preferred reseller rights. We have agreed to pay TEMIS royalties with respect to resales of TEMIS software subject to guaranteed minimum payments per resale. The initial term of our reseller and licensing rights is three years. TEMIS has agreed to provide us and our customers with technical back-up support with respect to these software products.

Production

Our software production operations consist of assembling, packaging on CD-ROMs and shipping our software products and documentation as needed to fulfill orders. CD-ROM duplication, printing of documentation and product assembly are conducted in-house. Customers may also download some of our software, such as our SRS data integration suite, as well as software updates or patches, from our servers.

Sales, Marketing and Distribution

We use a variety of channels to market and distribute our solutions, products and services.

We market and sell our solutions, products and services through our direct sales force in all markets other than Japan, Taiwan, Singapore and India, where marketing and distribution are handled by distributors and external sales consultants. As of March 31, 2004, our sales and marketing organization consisted of approximately 32 full-time equivalent employees. Our sales and marketing organization maintains offices in the United States, the United Kingdom, and Germany and a representative in France.

As part of our global marketing strategy to establish SRS as the standard biological database integration platform in the life sciences industry, and pursuant to the terms of our exclusive SRS licensing arrangement with the European Molecular Biology Laboratory (EMBL), we have made SRS available to academic institutions free of charge for their internal research purposes. Leading academic and research institutions around the world take advantage of SRS, including the Institute Pasteur, the German Cancer Research Center, the Sanger Centre, and the EMBL. Under the terms of our academic license agreements, academic institutions may typically enable free online access to SRS to non-commercial users and through SRS provide free access to public databases and their content to researchers at not-commercial organizations. Under the terms of our license agreement with the EMBL, we authorized the EMBL to offer limited free online access to SRS to commercial users as well for the purpose of general research but did not allow excessive use by commercial companies as determined in our sole discretion.

As part of our marketing strategy and to demonstrate the powerful search capabilities of SRS, we agreed in principle with the EMBL in March 2004 to authorize academic licensees to make online access to basic versions of SRS available on the Internet for

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users from commercial organizations as well and to enable these commercial users to conduct unsecured online queries of third party databases free of charge. In addition, we agreed with the EMBL in principle that the SRS server operated by EMBL s subsidiary, the European Bioinformatics Institute (EBI), will be set up as a public reference server for worldwide access by researchers from commercial and non-commercial organizations. We are currently in the process of negotiating amendments to our academic license agreements with the EMBL and these other academic institutions to reflect our commitment to enable them to provide this free online access to SRS to researchers from non-commercial as well as commercial organizations.

We exhibit our products and services at various scientific conferences and trade exhibitions. Our scientists publish and present results of original research at these and other conferences throughout the world.

Competition

Our principal competitors include third-party commercial software developers, bioinformatics, cheminformatics and genomics companies, academic institutions and in-house software development teams at life science companies. Our competitors with respect to our SRS integration system and our research software applications include Tripos, MDL, Accelrys, IBM, and SimulationPlus. In addition to direct commercial competitors, the most important other source of competition comes from IT development teams within life science companies. Large pharmaceutical and biotechnology companies maintain software development teams that rival, or surpass in size, those at commercial IT development companies.

Many of these companies, either alone or together with their collaborative partners, have substantially greater financial resources and larger research and development staffs than we do. In addition, many of these competitors, either alone or together with their collaborative partners, have significantly greater experience than we do in developing IT-products and solutions. Accordingly, our competitors may succeed in developing or commercializing products or obtaining patent or other intellectual property protection before us. In-house IT development departments of our customers may develop IT solutions that are similar to ours or customized to their R&D organizations needs, thereby reducing the demand for our IT solutions or products by these R&D organizations. Developments by others may render our product candidates or technologies obsolete or noncompetitive.

Intellectual Property

Our business and competitive position is dependent, in part, upon our ability to protect our proprietary technologies, processes, databases and information systems. Additionally, we may seek protection for inventions that do not belong to our core business when they promise to be of commercial or strategic interest. We protect our intellectual property primarily through trade secret and copyright law as well as non-disclosure, license and other contractual arrangements.

Patents, Copyrights and Trade Secrets

Our intellectual property strategy focuses on ensuring copyright and trade secret protection for our IT products and solutions. As a result, it is our general policy not to disclose the source code of our software to third parties. Our customers and collaborators typically receive our software in object code only. Our software license agreements with customers customarily contain provisions to strengthen the copyright and trade secret protection of our IT products and solutions.

In addition, we may apply for patent protection of certain IT products, solutions or technologies, covering our core markets in the United States, Europe and, on a case-by-case basis, Japan. Our patent applications seek the broadest possible patent protection for inventions related to our IT platform.

We have licensed granted patents and patent applications filed on the research results from our internal drug discovery activities to PheneX. For more information concerning our transaction with PheneX, see - Internal Drug Discovery Activities above. We are seeking licensees or purchasers for other granted patents and patent applications filed on these research results. These patents and patent applications involve inventions related to drug targets, diagnostic substances and/or procedures as well as novel targets and lead compound series with a potent activity against one or more specific nuclear receptors.

As of September 1, 2004, we held 5 granted or allowed IT patents and 44 pending IT patent applications related to our IT development activities that we may continue pursuing. The granting of patents on software and genomics is uncertain worldwide, currently under review and revision in many countries and may be difficult to enforce. We cannot give any assurances that any changes to, or interpretations of, the patent laws will not adversely affect our intellectual property. In addition, we cannot give you any assurances that the validity of any patent granted to us will not become subject to a successful legal challenge from a third party. We may decide not to pursue some or all of the patent applications related to our IT development activities. We may also abandon granted patents on our IT development activities in the future, if we do not believe that these patents serve to protect our IT developments.

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Licenses

We grant software licenses pertaining to our IT solutions and products to our customers. For a description of our licensing policies, see Overview Sales and Customers and Critical Accounting Policies Revenue Recognition under Item 5 below. We do not charge license fees to academic licensees of our SRS software.

We have also granted select customers the right to use our SRS technology for their Internet portals. In March 2002, we developed and licensed a customized solution to Incyte Genomics based on our SRS technology that gives Incyte customers a user-friendly web-based interface to access and analyze the wealth of genomic and proteomic data and technology that Incyte provides through its information product offerings. Customers of the Incyte database offering must license this customized SRS solution directly from us. SRS also serves as the web portal platform for the Celera Discovery System, established in March 2000, of the Celera Genomics Group at Applera Corporation, which allows for rapid access to human genome data. Pursuant to an an arrangement with Derwent that ends on December 31, 2004, We also host Derwent s GeneSeq databases on an SRS server installation which enables Derwent customers to query the Geneseq databases using our SRS system.

We license software and other important technology from third parties, including in particular all earlier versions of SRS from EMBL pursuant to a worldwide exclusive license, as well as EMBL s Gene Quiz software pursuant to a worldwide non-exclusive license. EMBL s Gene Quiz software is a predecessor of our bioSCOUT® software. For a discussion of our exclusive SRS license from EMBL, see Item 10: Additional Information Material Contracts Exclusive License Arrangement with EMBL Concerning SRS .

In addition, we have licensed software and databases that are embedded in, or necessary to use, our LION Target Engine and LION Lead Engine software application suites, including our LeadNavigator application, such as from BioByte and our collaboration partners DeltaSoft and ChemCart as well as ChemNavigator and TEMIS. We are either entitled to sublicense this software or these databases to end-users, or end-users must obtain a license for these databases or software directly from the third-party licensor.

In July 2001, we licensed a wide range of chemical informatics applications and databases from MDL Information Systems, Inc, including MDL s ISIS, Assay Explorer, Apex, Afferent and CrossFire Beilstein software. We obtained the right from MDL to develop and commercialize software applications that can interface with these software products of MDL, which allows us to enable our customers to integrate our research software applications with the cheminformatics products of MDL.

In May 2003, we entered into a three-year agreement with Silicon Genetics pursuant to which each party granted the other party a limited license to use certain specified software solely for internal developmental purposes.

We have entered into a Delineation Agreement with Lion Electronics International Computer Discount 2000 GmbH and Erwin Deutsch with respect to the use of the trade name LION. Pursuant to the terms of this agreement, we have agreed not to derive any rights arising from our use of the LION name against the rights to the LION mark of Lion Electronics International and Erwin Deutsch and to allow Electronics International and Erwin Deutsch to renew their trademark filings and to file derivative trademark applications except for certain trademarks owned by us, such as the LION name with the paw image, LION Solution Center, LION Lead Engine, LION Target Engine, and LION bioscience. In addition, we agreed to limit the use of the LION trademark to computer software and services with respect to software development and data management services in the area of biotechnology and life sciences and to use the LION mark only together with the paw logo. In return, Lion Electronics International and Erwin Deutsch has agreed not to oppose the registration of our trademarks with these use restrictions and to dismiss oppositions already filed against the LION trademarks. This agreement covers trademark applications in countries where LION Electronics International and/or Erwin Deutsch hold prior use rights to the LION trademark. In countries where we hold a prior use

right, we will not oppose the filing by Lion Electronics International or Erwin Deutsch of the trademark LION with respect to uses outside the area of biotechnology or life sciences.

Governmental Regulation

Our IT solutions, products, and services are not currently regulated by governmental agencies, such as the Food and Drug Administration in the United States (FDA) or similar agencies in the jurisdictions in which we do business. Nonetheless, the products of many of the life science research companies to which we market these products are regulated by the FDA and similar agencies.

Seasonality

As is the case with other companies distributing software products, there may be a seasonal variability to our business relating to the receipt of orders for our IT products and solutions. Orders may increase in the fourth quarter of each calendar year, as business customers attempt to make full use of their IT purchase budgets before year end, and to a somewhat lesser degree in the first quarter of each calendar year, as business customer attempt to make first use of their IT purchase budgets.

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Facilities

We do not own any real estate, but lease all of our facilities. We believe that our existing facilities are adequate for our current needs and that additional space, should it be needed, will be available.

Our principal administrative, sales and marketing facilities are located in leased premises of 35,573 square feet in Heidelberg, Germany. The lease expires on December 31, 2006. In FY 2004, we reduced our office space by approximately 8,000 square feet. We currently pay a monthly base rent of 32,000 and estimated monthly operating and maintenance expenses of 18,000. The base rent and operating expenses are subject to periodical adjustments. In October 2002 our company terminated a lease agreement for office space of approximately 30,345 square feet in Heidelberg in return for a one-time termination payment of 900,000. Our iD activities in Germany were based in another leased facility in Heidelberg, with some 23,994 square feet of laboratory space. The lease for this facility was terminated in its entirety in February 2003 as a result of the discontinuation of our internal drug-discovery activities. We paid monthly base rent equal to 20,500 and monthly operating and maintenance expenses equal to 25,000. In consideration for the early termination of this lease, we transferred ownership of tenant improvements to the facility to the landlord.

We have a facility in Cambridge, United Kingdom, which is the center for developing our SRS system and related products. Our initial lease for the facility runs until July 17, 2005. We have leased a total of 8,392 square feet, which includes space rented under a second lease that runs until at least July 17, 2005. We currently pay monthly base rent equal to approximately 13,500 British pounds for the entire facility and quarterly operating and maintenance expenses equal to approximately 10,000 British pounds. The base rent and operating expenses are subject to periodical adjustments. In addition, we leased a small facility in Oxford, United Kingdom until January 2003 at a monthly base rent equal to 2,300 British pounds and estimated monthly operating and maintenance expenses equal to 648 British pounds.

We maintained offices in leased premises in Cambridge, Massachusetts for the performance by our subsidiary LION bioscience Research Inc. of our multi-year *i*-biology collaboration with Bayer and for our U.S. sales and marketing and professional services operations until August 31, 2004. We paid a monthly base rent of approximately $51,000 and monthly operating and maintenance expenses of $5,500 for 16,188 square feet of space under that lease. Following the expiration of our year *i*-biology collaboration with Bayer effective July 30, 2004, and the closing of LION bioscience Research Inc. s operations we leased new office space in Cambridge, Massachusetts for our U.S. operations, primarily our U.S. sales and marketing and professional services activities. The lease term runs from August 22, 2004 until August 31, 2009. We pay a monthly base rent of approximately $15,500 and monthly operating and maintenance expenses of approximately $1,800, which are subject to annual adjustments, for 7,449 square feet of space at this new location.

Effective February 2004, we terminated our lease for a facility in San Diego (La Jolla), California, of 71,510 square feet, including approximately 55,000 square feet of laboratory and office space. The original lease was to run until April 30, 2008. As part of our restructuring activities, we entered into an amendment to the original lease agreement in June 2003, which became effective in July 2003. Under the amendment, we agreed to deliver a letter of credit for the benefit of the landlord in an amount equal to approximately $3.7 million for the purpose of satisfying all of our payment obligations under the lease, including payments for base rent and additional rent, from August 1, 2003 until February 2004. The landlord drew upon this letter of credit to satisfy our monthly payment obligations during this period. In accordance with this amendment, we exercised an early lease termination option in February 2004. In consideration for the grant of this option, we agreed to transfer the security deposit under the lease of approximately $161,000 to the landlord. Following the exercise of our early termination option, the landlord retained the balance of the $3.7 million deposit not drawn upon under the letter of credit by then to cover our payment obligations under the lease as a termination fee.

We also terminated our sublease of approximately 23% of this facility in San Diego to MediGene Inc. pursuant to a sublease and services termination agreement entered into with MediGene in May 2003. The original sublease ran until 2005. Pursuant to the terms of the termination

agreement, MediGene continued to make monthly payments for rent, its share of additional rent, and services under the sublease and a services agreement until January 31, 2004. In addition, MediGene paid to us an early lease and services termination fee in the amount of $300,000 in March 2004.

We have entered into a Letter of Agreement for Technical Development Space Collaboration with ChemNavigator, one of our collaboration partners. Pursuant to that agreement, effective December 1, 2003, we have a limited right to use office space and common areas as well as related services at ChemNavigator s premises in San Diego, California, to accommodate six to eight employees. This agreement may be terminated by either party upon 30 days prior notice. We have also agreed to indemnify and hold harmless ChemNavigator s landlord, Arena Pharmaceuticals, from any damage to property or injury to persons caused by us, our employees, contractors or invited guests and that we will vacate the premises upon 30 days prior written notice by Arena Pharmaceuticals. In addition, we had leased 3,120 square feet of office space in San Diego (La Jolla), California, under a lease agreement that expired on July 31, 2003.

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The lease for our offices in Cleveland, Ohio expired effective June 30, 2003 and we did not renew this lease due to the discontinuation of our IT development activities in Cleveland, Ohio as part of our restructuring. We had leased 26,666 square feet of office space and paid monthly base rent of approximately $43,000 and monthly operating and maintenance expenses of approximately $16,000. We also leased 2,549 square feet of office space, in Columbus (near Worthington), Ohio, under a lease that expired on May 31, 2003. We paid monthly base rent of approximately $2,900 and monthly operating and maintenance expenses of approximately $1,000 under that lease in FY 2004. As of June 1, 2003, the monthly base rent decreased to approximately $1,500 and the expiration date was originally extended to May 31, 2005. Effective August 1, 2003, we relocated our offices, leasing different space from the same landlord at a location near the space in Columbus (near Worthington), Ohio that we previously leased. The new lease, which originally ran until June 14, 2006, replaced the prior lease and provided for monthly base rent of approximately $4,700 for 6,550 square feet of space. We ceased operations in Columbus, Ohio effective September 30, 2003 as part our restructuring but continued to pay monthly rent. In March 2004, we found a successor tenant for our space in Columbus and were able to terminate the lease agreement effective April 1, 2004 in consideration for a one-time termination fee payment of $112,389.80 to the landlord.

Subsidiaries

We currently have two wholly-owned subsidiaries with active business operations. The following table shows information relating to each of these subsidiaries:

Group Structure as of March 31, 2004

Corporate name	Country of incorporation	Field of activity
LION bioscience Ltd.(1)	United Kingdom (Wales)	SRS development
LION bioscience Inc.(1)	United States (Delaware)	Marketing and sales, distribution, professional services

(1) Wholly owned by LION bioscience AG.

Capital Expenditures

Our capital expenditures for intangible assets and property, plant and equipment, were 0,090 million for FY 2004, 1,835 million for FY 2003, and 7,904 million for FY 2002. Principal areas of investment during FY 2004 related to the purchase of software and hardware. See Item 5. Operating and Financial Review and Prospects Liquidity and Capital Resources for further details regarding capital expenditures

Item 5: Operating and Financial Review and Prospects

You should read the following discussion of our financial condition and results of operations in conjunction with our audited consolidated financial statements and the related notes and the other financial information included elsewhere in this annual report.

Executive Summary

For the financial year ended March 31, 2004, our revenue and net loss were 19,675 million and -20,758 million, respectively, as compared to 29,359 million and -152,794 million, respectively, for the financial year ended March 31, 2003.

We focus on the global life sciences and pharmaceutical industries, in particular on the research and development organizations of companies operating in the life sciences and pharmaceutial markets. Our principal sources of revenue are sales of IT products and services. Product revenue consists primarily of software license fees and maintenance fees. License fees are derived from the licensing of our software products to customers. We provide optional maintenance for a percentage calculated on the basis of the initial license fee paid by the customer. Maintenance entitles the customer to software updates, upgrades and enhancements through new product releases, versions and correction levels, telephone support on the use of the products and assistance in resolving problems, and remote support. Our service revenue consists of software customization and development, consulting and training revenue, which is derived primarily from the services rendered with respect to implementation of our software products.

We operate worldwide and define the following three geographic regions: Germany, the United States of America and other countries. We have four lines of business that constitute one reporting segment: licenses, professional services, maintenance and drug discovery.

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The following discussion is provided to enable a better understanding of our operating results for FY 2004, including:

- key factors that impacted our performance during FY 2004;
- overview and
- discussion of our operating results for FY 2004 and FY 2003.

This executive summary should be read in connection with the more detailed discussion and analysis of our financial condition and results of operations in this Item 5, Item 3: Key Information Risk Factors, and Item 18: Financial Statements.

Key Factors

World economy performs below expectations in 2003

The actual performance of the world economy in calendar year 2003 was far below original predictions. In May 2004, the Organization for Economic Cooperation and Development (OECD) lowered the forecasts it had made at the end of 2002 for 1.8% growth in calendar year 2003 for the so-called Eurozone; it calculated a rise in gross domestic product of just 0.4% for 2003. Although global development was hampered in the first months of 2003 by such factors as the Iraq conflict and the SARS disease outbreak, in the second quarter overall economic production in the industrialized nations showed the first signs of recovery. The upswing was led by the United States and Asia. Private consumption in the United States was the main contributor to the upswing of their economy. After more than a decade of weak economic activity, the Japanese economy also began to recover. Strong economic growth was reported in other Asian countries such as China and in Russia as well. In the Eurozone, on the other hand, the economy was stagnant. Germany even reported a 0.1% drop in economic performance.

IT investments in pharmaceutical and life sciences industries bottoms out

The global market for information technology (IT) investments in the pharmaceutical and life sciences industries reflected the general economic trend. The reluctance to invest in IT, shown by pharmaceutial and life sciences companies in previous years, continued in calendar year 2003. In many cases, IT budgets were cut, investments were postponed, and the trend of the previous year toward smaller business transactions continued. The unwillingness to invest in IT is all the more surprising since productivity in drug development has continued to decline and pharmaceutical companies have come under increasing pressure to fill their product pipelines. The financial situation of the biotechnology sector, with the exception of the U.S. market leading companies, remained difficult, and this was reflected in their spending on R&D. Increased success in drug development by a few biotechnology companies, the less restrictive approval policy of the FDA (Food and Drug Administration) in the United States and the improved stock market situation brightened the mood in the sector by the year s end and improved conditions for equity financing.

Shifting Customer Demand

As discussed under Item 4: Information on our Company Industry Challenges and Item 4: Information on our Company Our Strategy , there was a shift in focus by the large pharmaceutical companies to the later stages of the R&D and a corresponding slowdown in investments by life science companies in comprehensive IT solutions in favor of individual IT applications for use in the early stages of the R&D process.

Overview

General

We have organized our business activities around our IT development business. Our IT development business is primarily responsible for the development of our IT solutions and products as well as for providing professional services to customers related to these solutions and products. As is the case with many other companies in the life sciences industry, we receive grants from third parties, including the German government. Depending on the structure of the grant, we account for grant money as revenue or as a subsidy that reduces related expenses. Government grants that are intended to reimburse us for general costs of a program such as salaries, equipment, and general and administrative expenses are recorded as drug discovery revenues in the period earned. Accordingly, grant money we received under the Advanced Technology Program (ATP) from the U.S. National Institute of Standards and Technology (NIST) is shown as revenue from drug discovery activities In FY 2004, we recognized revenue from the ATP grant in a total amount of 0.045 million and in FY 2003, we recognized total revenue of 0.105 million from the ATP grant. Government grants to defray the costs of research and development are offset on receipt against the related expenses. The total amount of subsidies

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came to 0.212 million in FY 2004 compared to 0.631 million in FY 2003 and 1.317 million in FY 2002. We have reduced our R&D expenses for these fiscal years by these amounts. We also adjusted R&D expenses for FY 2003 and FY 2002 to reflect the reclassification of some R&D expenses to cost-of-sales and discontinued operations as a result of the closing of iD³.

We capitalize software development costs incurred after technological feasibility of the technology to be developed has been established. Under our software development process, technological feasibility is established when a working model has been completed. Once technological feasibility has been established, the related development expenses are capitalized until market launch of the software. For further information see financial statements on page F-14.

We granted stock options to our management board and our employees during FY 2001 and FY 2002 pursuant to our 2000 Stock Option Plan and our 2001 Stock Option Plan. We did not grant any stock options under our 2002 Stock Option Plan. No stock options were granted in FY 2003 or FY 2004. For a discussion of these stock option plans and the options we have granted, please see Item 6: Directors, Senior Management and Employees Share Ownership . We accounted for options granted under our stock option plans under the fair-value method according to SFAS 123. As a result, we recorded non-cash compensation expense based on the fair value of the option on the date of grant until the option vested. We therefore allocated the expenses of these outstanding stock options, which amounted to 4.2 million in FY 2002, and 1.7 million in FY 2001 among cost-of-sales, R&D and selling and general and administrative expenses as non-cash compensation.

In FY 2003, all option holders under our 2001 Stock Option Plan and 2002 Stock Option Plan irrevocably waived their rights to exercise their options. Subject to approval by our shareholders, we paid the holders the then current market value of their options in return for these waivers. Total cash payments to the option holders came to approximately 0.2 million. Our company s shareholders approved the payment at the annual general shareholders meeting on August 7, 2003. Our company s shareholders also approved the termination of all of our stock option plans and the cancellation of our company s conditional capital previously reserved for the issuance of shares under these stock option plans. As a result of the waiver of all outstanding options and the early termination of all of our stock option plans, we allocated the remaining outstanding value of these stock options, which amounted to 4.361 million among cost-of-sales, R&D, selling and general and administrative expenses for FY 2003 as non-cash compensation expense.

Our reporting currency is the euro. Balance sheet accounts are translated to the euro at the exchange rates in effect at the end of the reporting period, except for shareholders equity, which is translated at the rates in effect when the underlying transactions were originally recorded. Revenue and expense accounts are translated at a weighted average of exchange rates during our fiscal year. In FY 2003, approximately 70% of our revenues and approximately 50% of our expenses were denominated in U.S. dollars. The relative strength of the euro compared to the U.S. dollar during FY 2004 compared with FY 2003 thus had the effect of decreasing our reported revenue and our reported expenses for FY 2004. We did not engage in any active currency hedging measures to reduce risks resulting from changes in exchange rates between the euro and the U.S. dollar in FY 2004, FY 2003 or FY 2002.

We have reclassified various amounts in our balance sheet, statements of operations and statements of cash flows for the financial years prior to FY 2004 to enable comparisons to the information set forth in our financial statements for FY 2004.

Sales and Customers

Our revenues consist of fees from our licensing activities, maintenance and support, drug discovery activities that we have not discontinued, and our professional services. Our licensing revenue is derived from licensing fees for our IT products and solutions. Our revenues from maintenance and support consist of fees for support and maintenance provided to customers related to our IT solutions and products. Revenues

generated from drug discovery activities comprise fees from the licensing or sale to customers of biological or chemical products created by our drug discovery activities, such as the sale of our arrayTAG clone collections, the sale of compounds from our Chem.Folio® chemical compound libraries, and from our commercial licensing activities with respect to the Caco-2 cell line. Revenue from our professional services is derived from fees for professional services related to our IT products and IT solutions and also includes revenues generated from our collaboration and service agreements, such as our recently concluded *i*-biology and pharmacophore informatics collaborations with Bayer and our collaboration with Schering AG to develop a comprehensive corporate gene database and gene data integration solution for Schering, which concluded in FY 2004. We established a global professional service organization to provide expert guidance in design, implementation and ongoing optimization of our IT solutions. Starting in FY 2003, we accordingly show revenue from our professional services as a separate item in our consolidated statement of operations. We have also reclassified revenue amounts for FY 2002 and FY 2001 to enable comparisons to the information set forth for FY 2003 and FY 2004. For a description of our revenue recognition policies, please see the discussion under Critical Accounting Policies Revenue Recognition below.

For our IT products and solutions, professional services and customer collaboration arrangements, the length of time between our initial contact with a customer and conclusion of a signed agreement can be lengthy because our products, services and solutions are complex and may cut across several aspects of a potential customer s business. Accordingly, a substantial period of time may elapse between the time we make initial contact with that customer and the time we generate revenues from such customer. Because many of the agreements that we conclude are individually negotiated with the customer, the length of time before we recognize revenues under any contract, and the terms of each contract, vary substantially from customer to customer.

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Our most important customer is Bayer AG, revenues from which accounted for 39% of our total revenues from continuing operations in FY 2004, 33% of our total revenues from continuing operations in FY 2003, and 58% of our total revenues from continuing operations in FY 2002. We receive revenues from Bayer for a number of different projects. For more information on these projects, see the section entitled Customers under Item 4 of this annual report. The outstanding accounts receivable from Bayer as of March 31, 2004 amounted to 0 and 0.376 million as of March 31, 2003.

As part of our strategy to focus on our core competencies, our business activities are now centered around our IT development business, including the professional services we provide to customers related to our IT solutions and products. Starting in FY 2003, we accordingly show these and other costs of sales as a separate item in our consolidated statement of operations. We have also reclassified amounts for FY 2002 and FY 2001 as costs of sales to enable comparisons to the information set forth for FY 2003 and FY 2004.

Investments

Effective March 14, 2001, we acquired Trega Biosciences, Inc., located in San Diego, California, by means of a stock-for-stock merger accounted for using the purchase method of accounting. Trega s results of operations were first consolidated with ours commencing on March 31, 2001, and, accordingly, Trega s results of operations were not included in our results of operations for FY 2001 but are included in our results of operations starting with FY 2002. Effective January 30, 2002, we acquired NetGenics Inc., which had its principal place of business in Cleveland, OH until June 30, 2003, by means of a stock-for-stock merger accounted for using the purchase method of accounting. NetGenics operating results are included in our results of operations for the period from January 31, 2002 until March 31, 2002 of FY 2002. Of the total acquisition costs in the amount of 23.723 million, we allocated 2.665 million to intangible assets in form of software and technology with useful lives of up to two years from January 31, 2002, 0.695 million to customer relationships, with useful lives of up to two years from January 31, 2002 and 0.695 million to in process R&D. The remaining net acquisition costs of 19.668 million were allocated to goodwill. During FY 2003, the goodwill of NetGenics was adjusted subsequently in the amount of 0.137 million due to adjustment to the final purchase price allocation. We determined the amortization periods based on our management s assessment of the expected benefit and related future cash flows from the assets.

SFAS No. 142 changed the accounting for goodwill and other intangible assets by, among other things, requiring companies to cease amortizing goodwill and certain intangible assets with an indefinite useful life created by business combinations accounted for using the purchase method of accounting. In lieu of amortization, we are required to perform an impairment review of our goodwill during each financial year and at other times during the financial year when indicators of impairment exist.

We adopted SFAS No. 142 effective April 1, 2001 and did not amortize the goodwill created by our acquisitions of Trega Biosciences and NetGenics. As of March 31, 2002, we had recorded goodwill in the aggregate amount of 58.663 million from these transactions. This accounting rule required us to assess the impairment of this goodwill whenever events or changes in circumstances indicated that this carrying value may not be recoverable. In particular, we were required to perform this review in the event our company s share price declined significantly for a sustained period and our market capitalization fell below our net book value. For more information on the application of this accounting rule, see Critical Accounting Policies Goodwill below.

Due to the decline in our company s share price since the beginning of FY 2003, our market capitalization continued to be well below our net book value. In addition, no clear indicators existed that the share price would recover by the end of the FY 2003. As a result, we performed an impairment review in connection with the preparation of our results of operations for the six months ended September 30, 2002. Based on this review, we determined that the goodwill created by the Trega Biosciences and NetGenics acquisitions was impaired and that this decline was other than temporary. Accordingly, we determined to write off the aggregate goodwill from both acquisitions and recorded a one-time, non-cash amortization expense in the aggregate amount of 58.526 million. In addition, we reviewed the recoverability of all of our long-lived assets according to SFAS No. 144 in connection with the preparation of our results of operations for the six months ended September 30, 2002. Based

on this review we determined the value of our intangible assets resulting from our acquisitions of Trega Biosciences and NetGenics to be zero and decided to fully write off the remaining book values of these assets in the amount of 3.485 million.

During FY 2004 and FY 2003, we reviewed our various shareholdings in other companies and our investments in available-for-sale securities. For a description of our accounting policies with respect to our investments, please see Critical Accounting Policies Marketable Securities and Other Financial Assets below. Based on our reviews, we did not record any losses from these shareholdings and investments in FY 2004 but we determined to adjust the value of these shareholdings and investments and to record the following losses in FY 2003:

We recorded losses from marketable securities and other long-term investments in FY 2003 as follows:

We recorded a loss in the amount of 8.509 million from our shareholding in Geneva, Switzerland based GeneProt Inc. As part of our collaboration with GeneProt, we had acquired 681,818 preferred shares issued by GeneProt in March 2002, representing approximately 2% of all outstanding shares of GeneProt on a fully diluted basis. Based on GeneProt s performance, we determined the fair value to be zero and to completely write off this investment.

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We recorded a loss in the amount of 1.374 million from our shareholding in ChemNavigator, based in San Diego, California. We acquired ownership in ChemNavigator held by Trega Biosciences as a result of our acquisition of Trega Biosciences. Based on ChemNavigator s performance, we determined the fair value to be zero and to completely write off this investment.

We lowered the value of our investments in available-for-sale securities in the form of fixed income securities. In previous years, we invested approximately 47.750 million in these securities. Based on the performance of these securities, we reduced the value of our investments in these funds by 1.388 million, which we recorded as a realized loss as we determined that this decline was other than temporary.

We hold 400,000 shares in Paradigm Genetics, which we had acquired in January 2000 for a total purchase price of $2 million. At the end of fiscal year 2002 we reviewed the value of our Paradigm Genetics stock and concluded that the reduction in its value was permanent. Based upon the trading price for Paradigm Genetics shares on the Nasdaq National Market of $ 1.62 per share at the end of FY 2002, we lowered the value of our shareholding in Paradigm Genetics by 1.237 million, which we recorded as a realized loss as we determined that this decline was other than temporary. At December 31, 2002, Paradigm Genetics stock had a fair market value of $0.29 per share. Because of the ongoing decline in the stock price during the previous nine months we concluded that this reduction in value is other than temporary. As a result, we recorded a decrease in the fair market value of 0.632 million in our results from marketable securities and other long-term investments. As of March 31, 2003, Paradigm Genetics share price increased to $0.65. We reported the corresponding increase in the market value of the Paradigm stock held by us in the amount of 0.128 million in other comprehensive income on our balance sheet. As of March 31, 2004, Paradigm Genetics share price increased further to $1.26 and we reported the corresponding increase in the market value in the amount of 0.174 million in other comprehensive income.

In early February 2000 we purchased 409,091 shares of convertible preferred stock from Tripos Inc. for a total purchase price of $9 million. In late January 2002, we converted these shares into 818,182 shares of Tripos common stock. At that time, Tripos paid us an accrued dividend on the shares of convertible preferred stock of more than $0.890 million (0.982 million). In early February 2002, we sold all of our shares of Tripos common stock. The net proceeds to us from this sale after deducting the sales commission and related expenses were approximately $21.6 million. We thus recorded income of approximately $13.5 million (14.536 million) from this transaction in FY 2002.

Since the beginning of FY 2003 we have classified all of our marketable securities previously classified as held-to-maturity as available-for-sale marketable securities and report all of these securities as short-term securities available-for-sale because we intend to sell these securities for current and future cash flow needs and will not hold them until their maturity. Therefore, in FY 2003, we adjusted the value of these marketable securities at their fair market value and recorded all unrealized gains and losses as other comprehensive income on our balance sheet. The net carrying amount of the transferred securities amounted to 37.616 million and the related unrealized gain recorded in other comprehensive income amounted to 0.258 million. Prior to FY 2003, securities were classified as held to maturity and carried at cost unless a decline in fair market value was considered other-than-temporary in which case they would be written down to fair market value. All of the marketable securities held by us are classified as current assets.

In FY 2003 we sold our available-for-sale marketable securities in the form of equity investment funds and shifted all of our fund investments to fixed income equity and fixed income debt securities. In FY 2003, we also sold all of the fixed income equity securities that we held in FY 2003. As a result, we have limited our risks from these securities to issuer credit and liquidity risks and to general market interest rate changes. Proceeds from sales of available-for-sale securities in the first nine months of fiscal year 2003 totaled 94.378 million. The realized losses related to the sales of these securities amounted to 2.609 million. Our only equity investment remaining in marketable securities is our investment in Paradigm Genetics.

Restructuring Activities

We engaged in a number of restructuring activities in FY 2004 and FY 2003. The purpose of these restructuring activities was to reduce expenses and the complexity of our organization and to implement the changes in our strategy. For more information about our strategy, see Item 4: Information on the Company Strategy.

Effective December 31, 2002, we closed down our *i*D^3 activities. Accordingly, we reflected the revenue and expenses relating to our internal drug discovery activities as a separate item in our consolidated statement of operations under discontinued operations . We also reclassified revenue and expenses relating to our *i*D^3 activities for FY 2002 as discontinued operations to

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enable comparisons to the information set forth for FY 2003 and FY 2004 . Likewise, we show the assets relating to our *i*D^3 activities as a separate item under assets held for sale in our consolidated balance sheet as of March 31, 2003, and we reclassified the assets relating to our *i*D^3 activities on our consolidated balance sheet as of March 31, 2002 as assets held for sale to enable balance sheet comparisons.

Revenues from discontinued operations include revenues from drug discovery collaborations that we have discontinued. Expenses related to discontinued operations include R&D expenses and general and administrative expenses directly related to discontinued operations, including severance payments to former *i*D^3 employees, as well as depreciation and amortization expenses relating to assets used by our *i*D^3 activities. Expenses related to severance payments and lease termination payments of approximately 1.9 million and 0.9 million, respectively, were allocated to discontinued operations for FY 2003. A total of 83 employees were terminated in connection with the closure. In FY 2004, we reported income from discontinued operations mainly due to the release of accrued expenses and sale of some assets related to iD³. No costs or revenues were incurred or earned during FY 2001. Revenue and expenses related to our drug discovery activities that we have not discontinued are not allocated to discontinued operations. These revenues and expenses involve primarily our arrayTAG and Chem.Folio products that we licensed or sold to customers in FY 2004 as well as our Caco-2 cell line licensing activities.

In FY 2003, we also terminated a five-year lease agreement for approximately 30,345 square feet of office space in Heidelberg that our company had leased in August 2001 in anticipation of future staff growth. We made a one-time termination payment of 900,000 in consideration for this lease termination.

In FY 2003, we also adopted a number of further restructuring measures that concluded in FY 2004. These measures included the following:

- The termination of employees at our sites in the United States, Cambridge, United Kingdom and Heidelberg, Germany. We accrued severance payments to employees expected to be affected by these terminations.

- The consolidation of the operations of our site at Cleveland, Ohio into our site at Columbus, Ohio, including the relocation of a number of employees from Cleveland to Columbus.

- The termination of our lease for our laboratory facility in San Diego, California. For a description of our termination of this lease, see Item 4: Information on our Company Facilities above. We also agreed to terminate the sublease of a portion of the laboratory facility in San Diego to MediGene Inc. and a related services agreement in return for an early termination fee payment by MediGene to us. For more information about this sublease and its termination, see Item 4: Information on the Company Facilities .

We accrued the necessary restructuring obligations for these measures in a total amount of 5.598 million as of March 31, 2003, and included accruals for aggregate severance payments and net lease termination payments after deducting MediGene s sublease and termination payment obligations. These restructuring measures were adopted prior to December 31, 2002 and followed the guidance in EITF 94-3 Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity .

We allocated these accrued expenses among our general and administrative expenses, R&D expenses and discontinued operations.

In FY 2004, we also adopted a number of restructuring measures which include the following:

In the second quarter of FY 2004 we decided also to close down our Columbus site, resulting in the termination of 19 employees as of December 31, 2003. These restructuring activities were accounted for in accordance with SFAS No. 146, Accounting for Costs Associated With Exit or Disposal Activities . As of September 30, 2003, we accrued severance payments in the amount of 246,000 based on contractual agreements and rental obligations from non-cancelable contracts in the total amount of 266,000. As of March 31, 2004, 492,000 was paid out and recorded against the accrual.

In the third quarter of FY 2004, we announced plans of further restructuring activities. These included a further decrease in our workforce to approximately 190 employees as of March 31, 2004. We reduced our workforce at our sites in San Diego, Cambridge, US and Heidelberg and recorded expenses of approximately 300,000 for severance payments of which 199,000 were paid out by March 31, 2004. The remaining 101,000 was accrued as of March 31, 2004.

As a result of our workforce reduction, we accrued rental expenses for unused office space at our Heidelberg site in the amount of 580,000 as of December 31, 2003, as we could not terminate the long-term lease for this space early.

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As of March 31, 2004, we utilized 60,000 of this accrual. In accordance with SFAS No. 146 we are required to reduce the accrual by amounts that could reasonably be expected to be received under subleases. Due to the current market conditions for rental space in Heidelberg, we do not believe it is reasonable that this space will be subleased during the remaining term of our lease agreement, which expires on December 31, 2006. We therefore accrued the full, discounted amount of rent expenses to be incurred for the remainder of the lease term.

Due to the expiration of our i-biology® collaboration with Bayer as of June 30, 2004, and the corresponding closing of the operations of our subsidiary LION bioscience Research Inc. in Cambridge, Massachusetts and reduction of our workforce, we accrued severance and retention payments and other closing-related personnel expenses of $0.3 million in FY 2004 based on an amount due under contractual arrangements. We expected the total amount of severance and retention payments and other closing-related personnel expenses to be $0.7 million.

Critical Accounting Policies

We have identified the following as critical accounting policies to our company due to the estimation processes involved in each revenue recognition, accounting for goodwill, accounting for income taxes, and accounting for our marketable securities and other financial assets.

Revenue Recognition

We recognize the license revenue from annual and multi-year software licenses when the requirements of Statement of Position (or SOP) 97-2, Software Revenue Recognition, as amended by Statement of Position 98-9 Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions have been met, ratably over the contractual term of the undelivered elements of the arrangement.

We derive the principal portion of our revenue from licensing activities, which consists of license fees for our IT products and solutions, and fees for support and maintenance provided to customers related to these products and solutions, and milestone payments for professional services related to these products and solutions. Management judgment may be made in connection with the application of the accounting rules related to revenue recognition. Material differences in the amount and timing of our revenue for any period might result if our management made different judgments or utilized different estimates.

Our IT products are typically licensed under non-cancelable license agreements with license periods ranging from one year to multiple years or perpetual terms. For our one-year licenses, customers pay fees for use of the software at the beginning of the license term or following installation if installation is required by the customer. These licenses typically renew automatically for a further one-year period at our prevailing contractual license rates unless either party terminates. For our multiple-year licenses, our policy requires annual license payments in advance throughout the term of the license without contractual concessions. We also license various IT products under perpetual license agreements. Under our perpetual licenses, the customer pays a one-time license fee, that may be payable in installments over a maximum of one year. In addition, a customer pays, at the customer s option, an annual fee for support and maintenance of our IT products, including future software updates and upgrades. The support and maintenance term typically ranges from 12 to 36 months, with the majority of these arrangements having an initial support and maintenance term that is the same as the software license term. The license and support and maintenance fees are typically determined on the basis of the number of servers or installation sites where the program is installed and, except for our SRS software licensed during FY 2001 and prior financial years, on the number of workstations or users. We also charge fees for product training and installation and software customization and related professional services.

We apply the provisions of Statement of Position 97-2, Software Revenue Recognition, as amended by Statement of Position 98-9 Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions to all transactions involving the licensing of our IT products and solutions. We start recognizing revenues in the form of license fees from the sale of software licenses when evidence of an arrangement exists, delivery has occurred, the fee is fixed and determinable, collection of the fee is probable and, if required under the contract, customer acceptance has been obtained. Delivery generally occurs when the product is received by the customer or made available for downloading by the customer from our servers. Revenue from license fees under perpetual licenses is recognized upfront, provided these conditions to revenue recognition have been satisfied. Revenue from license fees under multi-year or short-term license agreements, *i.e.*, those that have a term of 12 months or less, is recognized on a straight-line basis over the term of any undelivered elements of the arrangement, starting when these conditions to revenue recognition have been satisfied. Revenue from support and maintenance fees from short-term, multiple-year and perpetual licenses is recognized ratably on a straight-line basis over the term of these services. If maintenance is offered for free or at a discount as part of a software license arrangement, the discount amounts are deferred from the software license fees and recognized ratably over the maintenance period based on the fair value as established by independent sale of maintenance to customers.

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At the time of the transaction, we assess whether the fee associated with our revenue transactions is fixed and determinable based on the payment terms associated with the transaction and whether or not collection is reasonably assured. We assess collection based on a number of factors, including past transaction history with the customer and the credit-worthiness of the customer. We do not request collateral from our customers. If we determine that collection of a fee is not reasonably assured, we defer the fee and recognize revenue at the time collection becomes reasonably assured, which is generally upon receipt of cash. For all sales, we use a signed license agreement as evidence of an arrangement. Sales through our distributors are evidenced by a master agreement governing the relationship together with binding purchase orders or license agreements on a transaction by transaction basis.

We typically ship our IT products on a data carrier such as CD, or make them available for downloading from our servers, promptly after the execution of a software license agreement. Accordingly, we do not generally have any significant software backlog, and believe that backlog at any particular time, or any fluctuation in backlog, is not indicative of sales of any succeeding period. We consider our IT products delivered when the customer has received the data carrier or has been provided with the password or other access information to download the IT product from our servers.

Our software license agreements typically include software licensing and providing post-contract customer support (or PCS), which includes post-contract technical support and unspecified product upgrades. We recognize our multi-year license arrangements depending on the PCS term. Certain of these arrangements have a PCS term that is the same as the software license term. SOP 97-2 requires the seller of software that includes PCS to establish vendor-specific objective evidence (or VSOE) of fair value of the undelivered element of the contract in order to account separately for the PCS revenue. We determine the VSOE of the fair value of PCS and PCS renewals as a percentage of the software license revenue and by reference to contractual renewals when the renewal term is substantive. However, in those cases where the initial PCS term is relatively long (i.e., greater than 50% of the original license term) or the PCS renewal rate is significantly below our normal pricing practices, the PCS renewal rate is not substantive and therefore a determination of VSOE of fair value cannot be achieved in accordance with AICPA Technical Practice Aid (or TPA) 5100.54, Fair Value of PCS in a Multi-Year Time-Based License and Software Revenue Recognition . In those cases, we recognize the license revenue pro-rata over the term of the related PCS. Due to the fact that the majority of the multi-year arrangements that we have entered into to date have a PCS term greater than 50% of the original license term, there is not sufficient history for the remaining multi-year contracts to establish VSOE of fair-value based on a percentage of the license revenue. Consequently, it is our current practice to recognize all revenue from multi-year customer arrangements pro-rata over the term of the related PCS.

For perpetual license arrangements with multiple elements (for example, license and maintenance and support), we allocate revenue to each component of the arrangement using the residual value method based on the fair value of the undelivered elements, which is specific to us. This means that we defer revenue from the arrangement fee equivalent to the fair value of the undelivered elements. Fair values for the ongoing maintenance and support obligations for both our multiple year licenses and perpetual licenses are initially based upon separate sales of renewals to other customers and thereafter upon renewal rates quoted in the contracts. Fair value of services, such as training, and installation services, is based upon our price lists for these services.

If an arrangement includes an acceptance provision, acceptance occurs upon the earlier of receipt of a written customer acceptance or expiration of the acceptance period.

Revenue from installation and training is recognized after these services have been rendered. We may enter into professional services arrangements related to our products, such as the development of customized solutions that require us to perform significant work either to alter our underlying software or to build additional complex interfaces or additional features so that the software performs as the customer requests based on our products.

Revenues from professional service arrangements sold separately are generally accounted for separately from new software license revenue because the arrangements qualify as services transactions as defined in SOP 97-2. The more significant factors considered in determining whether the revenue should be accounted for separately include the nature of services (i.e., consideration of whether the services are essential to the functionality of the licensed software product), degree of risk, availability of services from other vendors, timing of payments, and impact of milestones or acceptance criteria on the realizability of the software license fees. Revenues for professional services are generally recognized as the services are performed. If there is a significant uncertainty about project completion or receipt of payment for the professional services, revenue is deferred until the uncertainty is sufficiently resolved. We estimate the percentage of completion on contracts with fixed or not to exceed fees on a monthly basis utilizing hours incurred to date as a percentage of completion of total estimated hours to complete the project. If we do not have a sufficient basis to measure progress towards completion, revenue is recognized when we receive final acceptance from the customer of the corresponding project or project milestones. When total cost estimates exceed revenue, we accrue the estimated losses immediately based upon an average daily rate applicable to our professional services organization. The complexity of the estimation process and issues related to the assumptions, risks and uncertainties inherent with the application of the percentage of completion method of accounting affect the amount of revenue and related expenses reported in our consolidated financial statements. A number of internal and external factors can affect our estimates, including labor rates, utilization and efficiency variances and specification and testing or milestone acceptance changes.

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If an arrangement does not qualify for separate accounting of the software license and professional service transactions, then new software license revenue is generally recognized together with the consulting services based on percentage of completion accounting, which is applied to any arrangements that include milestone or customer specific acceptance criteria that may affect collection of the software license fees, where the services include significant modification or customization of our software, or where the software license payment is tied to the performance of professional services.

For further information on our revenue recognition policies, please see the description in note A.3 to our consolidated financial statements included in Item 18 below.

We believe that accounting estimates applicable to our revenue recognition policies are critical because:

- The determination that it is probable that the customer will pay for our products and services purchased is inherently judgmental;
- The allocation of proceeds to certain elements in multiple-element arrangements is complex;
- Establishing company-specific fair values of elements in multiple-element arrangements requires adjustments from time-to-time to reflect recent prices charged when each element is sold separately; and
- The determination of the stage of completion for certain professional service arrangements is complex.

Goodwill

In July 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets . This standard changes the accounting for goodwill and other intangible assets by, among other things, requiring companies to cease amortizing goodwill and certain intangible assets with an indefinite useful life created by business combinations accounted for using the purchase method of accounting. In lieu of amortization, we are required to perform an impairment review of our goodwill during each financial year and other times during the financial year when indicators of impairment exist.

In accordance with the provisions of SFAS No. 142, we have adopted the statement effective April 1, 2001 and did not amortize the goodwill created by our acquisitions of Trega and NetGenics. Under SFAS No. 142, the workforce we acquired as part of our acquisition of Trega may no longer be considered an intangible asset. Therefore, 2.5 million was subsumed into goodwill in FY 2002. As of March 31, 2002, we therefore recorded goodwill in the aggregate amount of 58.6 million on our consolidated balance sheet.

We assess the impairment of goodwill annually or whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors that we consider important and that could trigger an impairment review include the following:

- a significant decline in our share price for a sustained period;

our market capitalization relative to our net book value;

a significant underperformance by us relative to expected historical or projected operating results;

significant changes in our use of the acquired assets or the strategy for our overall business; and

significant negative industry or economic trends.

In assessing the fair value and a possible impairment of goodwill, we must make assumptions regarding the development of our share price, market capitalization, estimated future cash flows and other factors. The fair value of goodwill is determined by allocating the fair value of the reporting unit to all of the assets and liabilities of that unit as if the unit had just been acquired in a business combination and the fair value of the reporting unit was the price paid to acquire the reporting unit.

We performed an impairment review in connection with the preparation of our results of operations for the six months ended September 30, 2002. Based on this review, we determined that the goodwill created by the Trega Biosciences and NetGenics acquisitions was impaired and that this decline was other than temporary. Accordingly, we determined to write off the aggregate goodwill from both acquisitions and recorded a non-cash expense in the aggregate amount of 58.526 million.

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Income Taxes

As part of the process of preparing our consolidated financial statements we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves us estimating our actual current tax exposure together with assessing temporary differences resulting from differing treatment of assets and liabilities for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheet.

We account for income taxes under the asset and liability method. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the amounts carried on the balance sheet of our financial statements for existing assets and liabilities and their respective tax bases, and net operating losses and net operating losses carried forward under applicable tax laws. Deferred tax assets and liabilities are determined on the basis of the tax rates applicable to taxable profits in the year in which we expect the differences to be recovered or settled.

We must assess the likelihood that our deferred tax assets will be recovered from future taxable income and, to the extent we believe that recovery is not likely, we must establish a valuation allowance. To the extent we establish a valuation allowance or increase this allowance in a period, we record an expense within the tax provision in our statement of operations.

Significant management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities and any valuation allowance recorded against our net deferred tax assets. As of March 31, 2004, our aggregate net operating losses carried forward was 298 million. German losses accounted for roughly 189 million, and the losses from the operations of our U.S. subsidiaries for most of the remaining balance. While under applicable German law, these losses may be carried forward indefinitely, United States tax law as a general rule imposes a maximum period of 20 years. Under new German tax laws in effect starting January 1, 2004, the utilization of tax losses in Germany is limited to 60% of the taxable income exceeding 1 million. In view of the uncertainty regarding our company s future profitability and our ability to utilize these deferred tax assets before they expire, we have recorded a valuation allowance representing 118 million.

This valuation allowance is based on our estimates of taxable income by jurisdiction in which we operate and the period over which our deferred tax assets will be recoverable. In the event that actual results differ from these estimates or we adjust these estimates in future periods we may need to establish an additional valuation allowance which could materially impact our financial position and results of operations. Our net deferred tax asset and liability as of March 31, 2004 was 0.004 million after the adjustment for a valuation allowance of 118 million.

Marketable Securities and Other Financial Assets

We classify our investments in securities as marketable securities and other long-term investments .

Marketable Securities

We consider our securities to be marketable securities if they have a readily determinable fair market value and can be readily converted into cash. We classify our marketable securities as short-term available-for-sale .

Our available-for-sale securities consist of debt and equity securities that are publicly traded. During FY 2004 and FY 2003, our available-for-sale securities also included investments in diversified funds. We carry our available-for-sale investments at fair value, based on quoted market prices, and unrealized gains and losses, net of taxes, are included in accumulated other comprehensive income, which is reflected as a separate component of stockholders equity. Gains and losses are recognized when realized on our consolidated statement of operations.

Our marketable securities comprise debt securities with maturities between one year and an infinite maturity.

We have a policy in place to review our investments in available-for-sale marketable securities on a regular basis to evaluate whether or not these securities have experienced an other-than-temporary decline in fair value. In determining whether a decline is other-than-temporary, we consider the length of time and the extent to which such value has been less than our carrying value, if applicable, the financial condition and prospects for the underlying issuer of the securities, and our ability and intent to retain our investment for a period of time sufficient to allow for any anticipated recovery in value. If we believe that an other-than-temporary decline exists in our marketable securities, it is our policy to write down these investments to the market value and record the related write-down as an investment loss on our consolidated statement of operations. The determination whether a decline in value is deemed to be other-than-temporary involves significant judgment by our management. The amount and timing involved in recording these write-downs may have a material impact on our results of operations.

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Effective the beginning of FY 2003 we reclassified all of our marketable securities previously classified as held-to-maturity as available-for-sale marketable securities and report all of these securities as short-term securities available-for-sale because we do not intend to hold theses securities until their maturity. Therefore, in FY 2003, we adjusted the value of these marketable securities at their fair market value and recorded all unrealized gains and losses as other comprehensive income on our balance sheet. For more information about the effect of this reclassification, see Overview Investments above.

Other Long-Term Investments

Our other long-term investments comprise investments in privately-held companies, in particular investments in our strategic alliance partners, that we intend to hold as a long-term investment. We accounted for these investments using the cost method of accounting. Our other long-term investments are in companies whose shares are not publicly traded, and, therefore, there is no established market for their securities. Accordingly, we determined the fair value of these investments without reference to a trading market. It is our policy to review the fair value of these companies on a regular basis to evaluate the carrying value of our investments in these companies.

Our review policy includes, but is not limited to, reviewing each of the companies cash position, financing needs, earnings/revenue outlook, operational performance, management/ownership changes, and competition. The evaluation process is based on information that we receive or request from these privately-held companies. This information is not subject to the same disclosure regulations as U.S. public companies, and as such, our basis for these evaluations is subject to the timing and the accuracy of the data we receive from these companies. If we believe that the carrying value of our investment in a company is at an amount in excess of fair value, it is our policy to record a reserve and the related write-down is recorded as an investment loss on our consolidated statement of operations. Estimating the fair value of non-marketable equity investments in early-stage technology companies is inherently subjective, involves significant judgment by us, and may contribute to significant volatility in our reported results of operations.

We recognize realized gains and losses upon sale or maturity of these investments using the specific identification method.

Based on our review, we determined to write-down the value of our shareholdings and investments in GeneProt, ChemNavigator, Gesellschaft für Medizinische Datenverabeitung (GMD) and SimUtility, Inc. and to record realized losses in FY 2003 and FY 2002 corresponding to these write-downs. For a description of these write-downs and realized losses, see Overview Investments above.

Results of Operations

The table and graphics below sets forth information about our revenues from continuing operations by geographical regions, business categories as well as the licensing revenue per IT product for the periods indicated:

Distribution of revenues from continuing operations(1)	FY 2004	FY 2003	FY 2002
Germany	19%	17%	31%
United States	61%	62%	52%
Other	20%	21%	17%

Total	100.0%	100.0%	100.0%

(1) Allocated based on location of the customer.

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	2004	2003	2002
		(in million,)	
Drug Discovery	980	1.531	2.898
Licenses	8.174	12.450	9.503
Professional Services	7.518	12.681	18.307
Maintenance and Support	3.003	2.697	1.314
Total Revenue	19.675	29.359	32.022

Period: FY 2004 Period: FY 2004 Period: FY 2004

Item 5: Operating and Financial Review and Prospects

FY 2004 Compared with FY 2003

Revenues

Our revenues for FY 2004 decreased to 19.675 million compared to 29.359 million in FY 2003. The weakness of the life sciences industry during FY 2004 and the continuing reluctance by life sciences companies during FY 2004 to make investments in IT-driven R&D solutions, lower revenues from our collaborations with Bayer compared to the previous financial year, as well as the weakness of the U.S. dollar compared to the euro, our reporting currency, in FY 2004 compared with FY 2003 contributed to this overall decline in our revenue. Bayer s contribution to our revenues fell from 9,7 million in fiscal year 2003 to 7,6 million in fiscal year 2004. The weakness of the U.S. dollar accounted for an 8% drop in revenues from FY 2003 to FY 2004, as some 70% of sales were generated in U.S. dollars and then subsequently translated to euro. This had a positive impact on the cost side, however, as almost 50% of costs are incurred in U.S. dollars.

Revenue from licenses decreased to 8.174 million in FY 2004 compared to 12.450 million during FY 2003. This decrease in licensing revenue is mainly attributable to a number of new software license arrangements entered into at the end of FY 2002, resulting in a recognition of corresponding license revenues mainly in FY 2003. In addition, some of the major software license arrangements entered into in FY 2003 were perpetual licenses and we recognized the perpetual license fees as revenue upfront whereas in FY 2004 we entered mostly into one-year or multi-year licenses and we recognized the license fees as revenue on a pro-rata basis.

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Revenue from software maintenance and support increased to 3.003 million in FY 2004 compared to 2.697 million in FY 2003. This increase is primarily attributable to the increase in the number of software and support agreements entered into with customers in the second half of FY 2003, which also impacted the revenue in FY 2004 due to the ratable recognition of maintenance and support fees from these agreements. In addition, we entered into new maintenance and support agreements at the end of FY 2003.

Our revenue from professional services decreased to 7.518 million in FY 2004 compared to 12.681 million during FY 2003. This decrease in professional services revenue is primarily attributable to lower professional services fees from our two collaborations with Bayer. In addition, our professional services revenue was adversely impacted by the reluctance of life science customers to enter into new professional services projects during FY 2004.

Revenue from our remaining drug discovery activities decreased to 0.980 million in FY 2004 compared to 1.531 million in FY 2003. This decrease is mainly attributable to a shift in focus by us to our own internal drug discovery research and the closing of our internal drug discovery activities, called *i*D^3, effective December 31, 2002. Revenue from drug discovery activities which were not part of our *i*D^3 activities derived primarily from sales and licenses of chemical compounds from our Chem.Folio® compound libraries and from sales of our arrayTAG clone collections and related arrayBase databases as well as license fees from the Caco-2 cell line.

We experienced only minor changes in the geographic distribution of our revenue. The United States continued to be our most important market with about 61% of our revenue generated in the United States in FY 2004, compared to 62% in FY 2003. Germany accounted for about 19% of our revenue generated in FY 2004 compared to about 17% in FY 2003. Revenue contributions from other regions, including from Japan, where we sell our products through CTC, our Japanese distributor, decreased slightly to about 20% compared to about 21% in FY 2003.

Cost of Sales

Cost of sales decreased to 9.466 million in FY 2004 compared to 18.677 million in FY 2003. This decrease relates primarily to 6.943 million from our restructuring activities (workforce reductions of professional services employees, cost savings program, substitution and termination of suppliers), recorded loss accruals of 1.483 million for two professional services projects in FY 2003 and recorded expenses of 0.785 in connection with the issuance and cancellation of outstanding stock options granted to personnel in our professional services organizations in FY 2003.

Selling Costs

Selling expenses (without depreciation of property, plant and equipment or amortization of intangible assets) decreased to 8.276 million in FY 2004 compared to 11.229 million in FY 2003. This decrease is primarily attributable to 2.064 million from our restructuring activities (workforce reductions of sales and marketing employees, cost saving program, substitution and termination of suppliers). In addition, the issuance and cancellation of outstanding stock options, which increased the selling costs in FY 2003 by 0.889 million, contributed to the reduction in selling expenses.

General and Administrative Costs

Our general and administrative expenses (excluding depreciation of property, plant and equipment or amortization of intangible assets) decreased to 9.272 million in FY 2004 compared to 21.490 million in FY 2003. This decrease is mainly attributable to 10.932 million from our restructuring activities (workforce reductions of administration employees, site closings, cost saving program) and to 1.286 million resulting from the issuance and cancellation of outstanding stock options in FY 2003.

Research and Development Costs

Our R&D expenses (without depreciation of property, plant and equipment or amortization of intangible assets) decreased in FY 2004 to 12.507 million compared to 34.225 million in FY 2003. This decrease in R&D expenses is primarily attributable to 17.381 from our global restructuring activities (workforce reductions of research and development employees, site closings, cost saving program) and 4.337 million from the issuance and cancellation of outstanding stock options.

Expenses related to the discontinuation of *i*D^3, our internal drug discovery activities, such as severance payments to the *i*D^3 workforce, are not reflected in our R&D expenses. Instead, these expenses are included under discontinued operations.

Our actual R&D expenses in each of FY 2004 and FY 2003 were reduced by the receipt of subsidies and grants from third parties, including the German government. These payments totaled 0.212 million in FY 2004 and 0.631 million in FY 2003.

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Other Operating Income and Expenses

Other operating income and expenses net were 1.759 in FY 2004 and thus did not change significantly compared to net other operating income of 1.733 in FY 2003.

Depreciation of Property, Plant and Equipment and Amortization of Intangible Assets

Our depreciation and amortization expenses decreased to 4.625 million in FY 2004, compared to 14.021 million in FY 2003. This decrease is primarily attributable to a one-time impairment charge of 4.320 million we took in FY 2003 and significantly lower investments in property, plant and equipment and intangible assets in FY 2004 than in previous years resulting in lower depreciation and amortization charges in FY 2004 of 5.076 million. For a description of this impairment charge, see the discussion in Overview Investments above.

Impairment of Goodwill

In FY 2003, we wrote off the aggregate goodwill from our acquisitions of NetGenics and Trega Biosciences in the total amount of 58.526 million after we determined that the goodwill created by these acquisitions was impaired and that this decline was other than temporary. For a description of this write-off, see the discussion in Overview Our Acquisitions and Overview Critical Accounting Policies above. We had no write-offs of goodwill in FY 2004.

Interest Income

Our interest income (net) decreased to 1.355 million in FY 2004 compared to 3.654 million in FY 2003. This decrease primarily results from the decline in our cash, cash equivalents and marketable securities during FY 2004 compared to FY 2003, as well as from lower interest rates.

Results from Marketable Securities and Other Long-Term Investments

We recorded a gain from marketable securities and other long-term investments (net) of 0.227 million in FY 2004 compared to a loss of 13.594 million in FY 2003. This gain resulted from the sale of some fixed income securities. The loss in FY 2003 was attributable to the write-off of the value of our shareholdings in GeneProt, ChemNavigator, and Paradigm Genetics. In addition, we realized losses from the sale of available-for-sale marketable securities when we shifted our investments to fixed income equity and fixed income debt securities. We also took impairment charges from our investments in these fixed income securities in FY 2003. For a description of these write-offs, losses, and impairment charges related to our investments, see the discussion in Overview Investments and Overview Critical Accounting Policies above.

Net Loss from Continuing Operations

We incurred a net loss from continuing operations of 21.456 million in FY 2004 compared to a net loss of 137.329 million in FY 2003. This decrease is attributable to the significant decrease in our expenses as result of our restructuring activities and cost saving programs. Additionally, our expenses in FY 2003 included one-time, non-cash items in the total amount of 62.011 million with respect to the write-off of goodwill and intangible assets relating to our acquisitions of Trega Biosciences and NetGenics, losses, including non-recurring losses, from marketable securities and other long-term investments in the aggregate amount of 13.594 million, expenses and accruals, including non-recurring expenses and accruals, with respect to our activities under our restructuring program, and non-recurring expenses in the aggregate amount of 4.361 million related to our employee stock option plans and the cancellation of outstanding stock options and the termination of our stock option plans in FY 2003.

Income and Losses from Discontinued Operations

Income from *i*D^3, our internal drug discovery activities, which we discontinued effective December 31, 2002, was 0.698 million in FY 2004 compared to a loss of 15.465 million from discontinued operations in FY 2003. The result in FY 2003 includes the issuance and cancellation of the outstanding stock options in the amount of 0.960 million. The income in FY 2004 resulted mainly from the sale of assets and the release of an accrual. For a description of our discontinued operations, see the discussion in Overview Restructuring Activities above.

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FY 2003 Compared with FY 2002

Revenues

Our revenues for FY 2003 decreased to 29.359 million compared to 32.022 million in FY 2002. The weakness of the life sciences industry during FY 2003 and the continuing reluctance by life sciences companies during FY 2003 to make investments in IT-driven R&D solutions, as well as the weakness of the U.S. dollar compared to the euro, our reporting currency, in FY 2003 compared with FY 2002 contributed to this overall decline in our revenue.

Revenue from licenses increased to 12.450 million in FY 2003 compared to 9.503 million during FY 2002. This increase in licensing revenue is mainly attributable to a number of new software license arrangements entered into at the end of FY 2002, resulting in a recognition of corresponding license revenues mainly in FY 2003. In addition, we initiated a shift in our software licensing strategy practices from license agreements with multi-year terms to licenses with perpetual terms in FY 2003, which led to an increase in license revenue in FY 2003. This increase occurred despite the fact that the total number of new software licenses decreased to 42 in FY 2003 compared with 55 new software licenses in FY 2002. New global SRS license arrangements in FY 2003 included deals with three major pharmaceutical companies, AstraZeneca, Eli Lilly and Johnson & Johnson, as well as license agreements with Schering AG and GeneProt for our new LION DiscoveryCenter integration platform. In addition, in FY 2003 existing customers renewed their license agreements for software products that we did not discontinue.

Revenue from software maintenance and support increased to 2.697 million in FY 2003 compared to 1.314 million in FY 2002. This increase is primarily attributable to the increase in revenue from maintenance and support corresponding to the increase in license revenue from the major licensing transactions entered into at the end of FY 2002.

Our revenue from professional services decreased to 12.681 million in FY 2003 compared to 18.307 million during FY 2002. This decrease in professional services revenue is primarily attributable to delays in our pharmacophore informatics project under our development agreement with Bayer. Specifically, Bayer delayed a $2 million milestone payment to us due to delays in achieving corresponding milestones, extended the milestone schedule for the remaining deliverables under the development agreement into FY 2004 and FY 2005 and amended the development agreement by making milestone payments dependent upon us achieving the corresponding milestones and deliverables. As a result, we changed the revenue recognition method for the revenue under the amended development agreement with Bayer from percentage-of-completion based on costs-to-costs to milestone dependent, resulting in a decrease in revenue from professional services. Bayer also made a one-time payment in FY 2002 in the amount of 2.62 million ($2.310 million) pursuant to an amendment to our *i*-biology arrangement with Bayer. For a description of this amendment, see Item 10: Additional Information Material Contracts Our Agreements with Bayer AG Basic Agreement . In addition, our professional services revenue was adversely impacted by the reluctance of life science customers to enter into new professional services projects during FY 2003, as well as the lengthy sales cycle for our new IT solutions and products, such as our LION DiscoveryCenter integration platform, as our professional services are based on these IT solutions and products.

Revenue from our remaining drug discovery activities decreased to 1.531 million in FY 2003 compared to 2.898 million in FY 2002. This decrease is mainly attributable to a shift in focus by us to our own internal drug discovery research and the closing of our internal drug discovery activities, called *i*D^3, effective December 31, 2002. Revenue from drug discovery activities which were not part of our *i*D^3 activities derived primarily from sales and licenses of chemical compounds from our Chem.Folio® compound libraries and from sales of our arrayTAG clone collections and related arrayBase databases.

We experienced only minor changes in the geographic distribution of our revenue. The United States continued to be our most important market with about 62% of our revenue generated in the United States in FY 2003, compared to 52% in FY 2002. Germany accounted for about 17% of our revenue generated in FY 2003 compared to about 31% in FY 2002. This decrease is primarily attributable to the decline in revenue from Bayer under our pharmacophore informatics project resulting from delays in that project and the change in the revenue recognition method for the revenue under this project from percentage-of-completion to milestone dependent as well as a decline in revenue from new software license agreements with customers in Germany. Revenue contributions from other regions, including from Japan, where we sell our products through CTC, our Japanese distributor, increased to about 21% compared to about 17% in FY 2002. This increase is primarily attributable to our marketing and sales efforts to promote our products and services to customers in other countries, including in particular in other European countries.

Cost of Sales

Cost of sales increased to 18.677 million in FY 2003 compared with 11.395 million in FY 2002. This increase relates primarily to the pharmacophore informatics project for Bayer and other professional services engagements as well as costs for our LION Hosted Services (LHS) offering. Specifically, we made payments in FY 2003 to our subcontractor in connection with the performance of our amended development agreement with Bayer that we had held back due to delays in the performance of project milestones under that agreement. We also incurred one-time expenses in terminating our outsourcing agreement with a service provider for our LHS offering and switching these IT services to IBM as our new IT hosting service provider. In addition, we also continued to build-up our professional services organization in FY 2003 pursuant to our strategy shift. The costs in FY 2003 are also impacted by restructuring activities.

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Selling Costs

Selling expenses (without depreciation of property, plant and equipment or amortization of intangible assets) slightly decreased to 11.229 million in FY 2003 compared to 12.546 million in FY 2002. This decrease is primarily attributable to the implementation of our global sales force organization in FY 2003 and resulting cost synergies, including a shift in resources from the sales organization to our professional services organization, seasonal trade fair activities, and the impact of the strong euro compared to the U.S. dollar in FY 2003 compared to FY 2002. This decrease was offset by an increase in expenses incurred by us under our stock option plans and in obtaining stock option waivers from personnel in our sales and marketing organizations in FY 2003. The costs in FY 2003 are also impacted by restructuring activities. For a description of the termination of our stock option plans, see the discussion in Overview General .

General and Administrative Costs

Our general and administrative expenses (without depreciation of property, plant and equipment or amortization of intangible assets) increased to 21.490 million in FY 2003 compared to 18.369 million in FY 2002. This increase is mainly attributable to expenses related to the integration of NetGenics following our acquisition of NetGenics in January 2002, and expenses related to our activities under our global restructuring program, including in particular severance payments and accruals associated with administrative workforce reductions, the transfer of our U.S. headquarters from San Diego, California, to Cambridge, Massachusetts, and lease termination and restructuring payments and accruals in connection with the restructuring and termination of our lease obligations for office and laboratory space, as well as fees paid by us to Boston Consulting Group for various consulting projects in connection with the shift in our strategy. For a description of this restructuring program, see the discussion in Overview Restructuring Activities above. In addition, we incurred additional expenses under our stock option plans and in obtaining stock option waivers from personnel in our administrative organization in FY 2003.

Research and Development Costs

Our R&D expenses (without depreciation of property, plant and equipment or amortization of intangible assets) increased in FY 2003 to 34.225 million compared to 33.900 million in FY 2002. This slight increase in R&D expenses is primarily attributable to expenses related to our global IT development workforce and expenses related to our activities under our global restructuring program, including in particular severance payments and accruals associated with workforce reductions in our global IT development organization and the closing of our development site in Cleveland, Ohio, and increased IT development efforts in developing our new IT solutions. We incurred additional expenses under our stock option plans and in obtaining the stock option waivers of personnel in our administrative organization in FY 2003. The costs in FY 2002 include the expenses related to the integration of NetGenics.

Expenses related to the discontinuation of *i*D^3, our internal drug discovery activities, such as severance payments to the *i*D^3 workforce, are not reflected in our R&D expenses. Instead, these expenses are included under discontinued operations.

Our actual R&D expenses in each of FY 2003 and FY 2002 were reduced by the receipt of subsidies and grants from third parties, including the German government. These payments totaled 0.631 million in FY 2003 and 1.317 million in FY 2002.

Other Operating Income and Expenses

Other operating income and expenses net increased to 1.733 million in FY 2003 from 1.104 million in FY 2002. This slight increase is primarily attributable to gains and losses from translation of assets and liabilities in foreign currencies into euros, income from subleases and cash received from an account receivable previously written off.

Depreciation of Property, Plant and Equipment and Amortization of Intangible Assets

Our depreciation and amortization expenses increased to 14.021 million in FY 2003 compared to 11.885 million in FY 2002. This difference is primarily attributable to an increase in depreciation of property, plant and equipment, including in particular software, hardware, furniture and office equipment, and leasehold improvements, and an impairment charge of 3.485 million attributable to intangible assets, specifically, software and technology and customer relationships, from our acquisitions of Trega Biosciences and NetGenics as well as amortization of intangible assets resulting from our acquisition of NetGenics before we recorded this impairment charge effective September 30, 2002. For a description of this impairment charge, see the discussion in Overview Investments above.

Impairment of Goodwill

In FY 2003, we wrote off the aggregate goodwill from our acquisitions of NetGenics and Trega Biosciences in the total amount of 58.526 million after we determined that the goodwill created by these acquisitions was impaired and that this decline was other than temporary. For a description of this write-off, see the discussion in Overview Our Acquisitions and Overview Critical Accounting Policies above. We had no write-offs of goodwill in FY 2002.

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Interest Income

Our interest income (net) decreased to 3.654 million in FY 2003 compared to 6.302 million in FY 2002. This decrease primarily resulted from the decline in our cash, cash equivalents and marketable securities during FY 2003 compared to FY 2002, as well as from lower interest rates.

Results from Marketable Securities and Other Long-Term Investments

We incurred a loss from marketable securities and other long-term investments (net) of 13.594 million in FY 2003 compared to 3.493 million in FY 2002. This loss was attributable to the write-off of the value of our shareholdings in GeneProt, ChemNavigator, and Paradigm Genetics. In addition, we realized losses from the sale of available-for-sale marketable securities when we shifted our investments to fixed income equity and fixed income debt securities. We also took impairment charges from our investments in these fixed income securities. For a description of these write-offs, losses, and impairment charges related to our investments, see the discussion in Overview Investments and Overview Critical Accounting Policies above.

Net Loss from Continuing Operations

We incurred a net loss from continuing operations of 137.329 million in FY 2003 compared to a net loss of 52.422 million in FY 2002. This increase is attributable to the decrease in our revenue and the significant increase in our expenses. Our expenses in FY 2003 included one-time, non-cash items in the total amount of 62.011 million with respect to the write-off of goodwill and intangible assets relating to our acquisitions of Trega Biosciences and NetGenics, losses, including non-recurring losses, from marketable securities and other long-term investments in the aggregate amount of 13.594 million, expenses and accruals, including non-recurring expenses and accruals, with respect to our activities under our restructuring program, and non-recurring expenses in the aggregate amount of 4.361 million related to our employee stock option plans and the termination of these stock option plans in FY 2003.

Loss from Discontinued Operations

Loss from *i*D^3, our internal drug discovery activities, which we discontinued effective December 31, 2002, was 15.465 in FY 2003 compared to a loss of 9.549 million from discontinued operations in FY 2002. Revenues from discontinued operations decreased to 0.381 million in FY 2003 from 1.074 million in FY 2002. This decrease is mainly attributable to a shift in focus by us from drug discovery services activities to our own internal drug discovery research. Our total expenses from discontinued operations increased to 12.586 million in FY 2003 compared to 9.348 million in FY 2002. This increase is due primarily to the closing costs related to our R&D activities, such as severance payments for our *i*D^3 employees, expenses related to the sale and disposal of equipment and assets used in discontinued operations and the termination of lease and other contractual obligations related to our *i*D^3 activities. In addition, we recognized 1.8 million in losses from the sale of assets used in our discontinued operations in FY 2003. Depreciation and amortization expenses from discontinued operations increased to 3.260 million in FY 2003 compared with 1.275 million in FY 2002. This increase is due primarily to accelerated depreciation and amortization of assets used in our discontinued operations and the write-down of the estimated fair value of assets held-for-sale that were used in our discontinued operations. For a description of our discontinued operations, see the discussion in Overview Restructuring Activities above.

Liquidity and Capital Resources

We fund our operations through our operating cash flow and equity. Over the past four fiscal years, we have funded our operations principally from the August 2000 issuance of equity in our company, the proceeds of which have been used to fund operating deficits and to repay indebtedness. We anticipate that during the current fiscal year we will continue to generate operating deficits, which will be funded from existing cash, cash equivalents and investments in, or sale of, marketable securities.

We believe that our liquid assets will be sufficient to fund our current plans for our business during fiscal year 2005 and fiscal year 2006. Our belief is based on our current business plan and our refined strategy. However, our business plan and strategy could change in the future or new developments could occur, each of which may require additional funding sooner than anticipated. Even if we have sufficient liquidity for our current business strategy, we may seek to raise additional funding because of favorable market conditions or other strategic factors.

Our future cash requirements depend on numerous factors, including:

the development of IT solutions, research software applications and other software for the life sciences industry;

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our performance of complex or long-term customer projects;

the length of the sales cycle for our IT solutions, products and services;

our ability to attract subscribers and purchasers for our IT solutions, products and services;

our ability to establish, maintain and perform customer or R&D collaborations with others;

our reaction to technological developments of competitors and to market developments; and

the costs involved in enforcing or defending against patent and copyright claims and other intellectual property rights.

These factors may result in our need for significant additional funds in the future, which we may seek to raise through public or private offerings or debt financing. We cannot assure you that additional financing or payments from customers for our IT solutions, products or services will be available when needed or that, if available, such financing or funds will be obtained on favorable terms. If adequate funds are not available when needed, we may have to curtail our operations or attempt to raise funds on unattractive terms.

Cash Flow

During FY 2004 and FY 2003, we had net cash outflows of 29.476 million and net cash inflows of 42.080 million, respectively.

Operating Activities

The net cash used in our operating activities was 26.304 in FY 2004, 43.911 million in FY 2003 and 51.377 million in FY 2002.

The decrease in the amount of net cash used in our operating activities in FY 2004 compared to FY 2003 and also compared to FY 2002 was primarily attributable to the effect of our restructuring activities, including our cost-saving measures, the closing of several sites and the discontinuation of our iD^3 activities in FY 2003. For a description of our restructuring activities, see Item 5: Operating and Financial Review and Prospects Overview Restructuring Activities .

Investing Activities

We used 0.584 million net cash in our investing activities in FY 2004 while our investing activities provided 86.694 million in FY 2003 and 5.044 million in FY 2002.

We experienced lower cash outflows of 0.732 million in FY 2004 compared to 2.583 million in FY 2003 from investments in property, plant and equipment due to our restructuring program, which required fewer investments in computer hardware and software and office equipment. In FY 2004 we also sold office furniture and other equipment, which was no longer needed and which resulted in proceeds of 0.642 million. In FY 2003, we also sold laboratory equipment that had been used in our iD^3 activities, which we discontinued effective December 31, 2002. Proceeds from these sales totaled 0.748 million. In addition, we sold available-for-sale marketable securities in FY 2004 and FY 2003. Proceeds from these sales totaled 4.506 million and 94.378 million, respectively. The realized gains related to the sales of these securities amounted to 0.227 million in FY 2004 as compared to losses of 2.609 million in FY 2003.

Cash outflows from our investing activities in FY 2002 are attributable mainly to our investments in ownership interests in our collaboration partners GeneProt, SimUtility and BioSolveIT, for a total of 10.805 million. In addition, we made improvements to our facilities in Heidelberg and purchased hardware totaling 7.960 million. These cash outflows from our investing activities in FY 2002 were more than offset by cash inflows in the amount of 23.720 million from the sale of all of our shares in Tripos in FY 2002 and the payment by Tripos of an accrued dividend immediately prior to the sale and cash inflows in the amount of 5.863 million from interest payments received from our investments in fixed-income securities.

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Financing Activities

Net cash used in our financing activities was 2.588 million in FY 2004, 0.703 million in FY 2003 and 1.586 million in FY 2002.

The increase in net cash used in our financing activities in FY 2004 compared to FY 2003 is attributable to the pay off of the total outstanding principal loan amount and all accrued interest under our bank loan during FY 2004 in the total amount of 2.560 million.

The decrease in net cash used in our financing activities in FY 2003 compared to FY 2002 is attributable to fewer capital leases used by us to finance laboratory equipment and IT hardware, resulting in lower aggregate payments under these leases. The reduction in the number of ongoing capital leases results from the discontinuation of our iD^3 activities and the sale of laboratory equipment previously used in these activities and sold by us during FY 2003. We made payments under capital leases in a total amount of 0.134 million in FY 2003 compared with 0.863 million in aggregate capital lease payments in FY 2002. In addition, we made payments of principal under our bank loan in the amount of 0.569 million in each of FY 2003 and FY 2002.

Liquid Assets

Our cash, cash equivalents and marketable securities amounted to 43.106 million at March 31, 2004.

Loan Agreement

In December 1998, we entered into a loan agreement with Bayrische Hypo- und Vereinsbank to finance research and development activities. Under the loan agreement, we were entitled to borrow amounts up to 4.6 million until December 31, 2007. As of March 31, 2000, we had fully utilized this credit facility. The loan amount was repayable in 16 equal, semi-annual installments, beginning on March 31, 2000. Interest was payable quarterly at a rate of 4.75% per annum. In connection with this loan, we granted the lender a security interest in one position of our fixed income securities. We paid off the entire principal amount and outstanding and accrued interest under this facility during financial year 2004.

Capital Expenditures

We had no material capital commitments for capital expenditures at March 31, 2004. For a description of our capital expenditures in prior fiscal years, see Item 4: Information on the Company Capital Expenditures.

Impact of Inflation

Inflation has not had a material effect on our business.

Impact of Foreign Currency Fluctuation

For more information regarding the impact of foreign currency fluctuation on LION and its business, see Item 11: Quantitative and Qualitative Disclosure About Market Risk Foreign Currency Exchange Risk .

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Aggregate Contractual Obligations

The following table presents our aggregate contractual obligations as of March 31, 2004 with payments due in the periods indicated:

Contractual Obligations	Total Payments due	Payments due by no later than March 31, 2005	Payments due between April 1, 2005 and March 31, 2008	Payments due between April 1, 2008 and March 31, 2010	Payments due after April 1, 2010
Capital Lease Obligations	74,000	16,000	48,000	10,000	0
Operating Lease Obligations	2,120,000	1,161,000	959,000	0	0
Purchase Obligations	1,831,000	555,000	1,276,000	0	0
Other Long Terms Obligations	446,000	446,000	0	0	0
Total	4,471,000	2,178,000	2,283,000	10,000	0

Our capital lease obligations include payments resulting from capital lease arrangements for computer hardware and office equipment entered into between 1997 and 1999.

Operating lease obligations include payments under the lease agreements for our sites in Cambridge, Massachusetts, Cambridge, United Kingdom, and Heidelberg, Germany as well as several leases of office equipment.

Purchase obligations include payment of license fees and maintenance and support payments under long-term software and database in-licensing agreements entered into by us.

Other long-term obligations include our subcontracting arrangement with Tripos UK concerning the performance of the pharmacophore informatics project under one of our collaborations with Bayer, which was recently concluded, and our on-going collaboration agreements with Deltasoft and ChemCart.

Research and Development

For more information regarding the company s R&D activities, see Item 4: Information on the Company Research and Development .

Recent Accounting Announcements

In October 2003, the FASB issued FASB Staff Position FIN 46-6 (FSP FIN 46-6), Effective Date of FASB Interpretation No. 46, Consolidation of Variable Interest Entities . FSP FIN 46-6 deferred the effective date for applying the provisions of FIN 46 for interests held by public entities in variable interest entities or potential variable interest entities created before February 1, 2003. In December 2003, the FASB issued FIN 46 (revised December 2003), Consolidation of Variable Interest Entities (FIN 46R), which addresses how a business enterprise should evaluate whether it has a controlling financial interest in an entity through means other than voting rights and accordingly should consolidate the entity. FIN 46R replaces FASB Interpretation No. 46, Consolidation of Variable Interest Entities , which was issued in January 2003 as well as FSP FIN 46-6. We were required to apply FIN 46R on December 31, 2003 for all entities previously considered to be special purpose entities . We had no special purpose entities and therefore the adoption of this portion of FIN 46R had no impact on our consolidated financial statements. We are required to apply FIN 46R to all entities not considered to be special purpose entities as of March 31, 2004. We currently do not believe that we have any variable interests in any VIEs and therefore do not believe that the adoption of FIN 46R will have a material adverse effect on our net assets, financial position or results of operations.

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In November 2003, the Emerging Issues Task Force (EITF) reached a partial consensus on EITF 03-01, The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments . EITF 03-01 requires that additional information about unrealized losses pertaining to certain debt and equity securities and non-marketable cost method investments be disclosed. We have included all disclosures to marketable securities in note 7 to our consolidated financial statements. The requirements of EITF 03-01 did not impact our disclosures in the notes to our consolidated financial statements for FY 2004, as our marketable securities included only unrealized gains as of March 31, 2004.

Item 5E: Off-Balance Sheet Arrangements

We have not entered into any off-balance sheet arrangements, transactions or other relationships with unconsolidated entities.

Item 6: Directors, Senior Management and Employees

Directors and Senior Management

In contrast to corporations organized in the United States, our company, as a German stock corporation, is governed by three separate bodies: the supervisory board and the management board (so-called two tier board system) as well as the ordinary or extraordinary shareholders meeting. Their roles are defined by German law, by our company s articles of incorporation (Satzung), by the rules of procedure for the management board and the supervisory board and our company s service agreements with the members of the management board.

Our supervisory and management boards are separate, and no individual may simultaneously be a member of both boards. The management board is responsible for managing our company s business in accordance with applicable laws and our company s articles of association and the rules of procedure. It represents our company in its dealings with third parties. The supervisory board appoints and removes the members of the management board and oversees the management of our company but is not permitted to make management decisions.

Under German law, the supervisory board members and executive board members owe a duty of loyalty and care to our company. In carrying out their duties, members of both the management board and the supervisory board must exercise the standard of care of a prudent and diligent businessperson, and they are jointly and severally liable to our company for any resulting damages if they fail to do so. If their actions are validly approved by resolution at a shareholders meeting their liability to our company is excluded while any liability to third parties remains unaffected. Both boards are required to take into account a broad range of considerations in their decisions, including the interests of our company and its shareholders, employees, creditors and, to some extent, the common interest. The management board is generally required to respect shareholders rights to equal treatment and equal information.

As a general rule under German law, a shareholder has no direct recourse against the members of the management board or the supervisory board in the event that they are believed to have breached a duty to our company. Apart from insolvency or other special circumstances, only our company has the right to claim damages from members of either board. Our company may only waive these damages or settle these claims if at least three years have passed and if its shareholders approve the waiver or settlement at a shareholders meeting with a simple majority, provided that opposing shareholders do not hold, in the aggregate, one-tenth or more of the share capital of our company and do not have their opposition formally noted in the minutes of the shareholders meeting.

In February 2002, the German government published the German Code of Corporate Governance, which was issued by a government appointed commission. This Corporate Governance Code recommends specific governance practices. After an amendment to the German Stock Corporation Act, the supervisory board and the management board of a company whose shares are listed on a stock exchange are required to declare annually whether or not the company complies with the recommendations of the Corporate Governance Code. As required by German law, our company has publicly declared that it fully complies with all of the recommendations of the German Corporate Governance Code except that following the resignation of Dr. Friedrich von Bohlen und Halbach, our company s former chief executive officer, effective on December 31, 2003 our company has two co-CEOs whereas the German Corporate Governance Code recommends having one CEO.

The shareholders vote on the ratification of the actions of our company s management board and supervisory board at our company s annual general shareholders meeting. At the annual general shareholders meeting, our company s shareholders must approve the amount of the appropriation of retained earnings, the appointment of an independent auditor and certain significant corporate transactions, if any. The management board calls the annual general shareholders meeting. The annual general shareholders meeting must be held within the first eight months of each fiscal year.

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Supervisory Board

The principal task of the supervisory board is to supervise our board of management. To ensure that these functions are carried out properly, the management board must, among other things, regularly report to the supervisory board with regard to current business operations and future business planning. The supervisory board is also entitled to request special reports at any time.

The supervisory board appoints and removes the members of the management board and oversees the management of our company. German law prohibits the supervisory board from making management decisions. However, the supervisory board may resolve that certain transactions require the approval of the supervisory board. The supervisory board is also responsible for representing our company vis-à-vis the management board members.

Our company s supervisory board currently consists of three members. In the past, our company s supervisory board consisted of six members. However, at the annual general shareholders meeting on August 7, 2003, our company s shareholders approved our company s proposal to amend our company s articles of association to reduce the number of supervisory board seats from six to three. Our company s shareholders elect the members of the supervisory board at the annual general shareholders meeting. In the event of a vacancy on the supervisory board, the commercial register of the lower court in Heidelberg, Germany may appoint, upon application by the management board, a successor to fill this vacancy for the remainder of the departing member s term. Our company s shareholders may remove any member of the supervisory board by a majority of votes cast at an annual general shareholders meeting. Our company has not entered into contracts with any member of the supervisory board that provide for benefits upon a termination of the services of the member.

The members of the Supervisory Board are each elected for the same fixed term of approximately five years. Unless the shareholders specify a reduced term when electing individual members of the supervisory board or the entire supervisory board, the maximum term of office of each member of the supervisory board expires at the end of the annual general shareholders meeting for the fourth fiscal year following the fiscal year in which the member was elected. Reelection is possible. The term of a member of the supervisory board appointed by the commercial register to cure a deficiency in the composition of the supervisory board ends at the time when such deficiency is cured. The term of a member of the supervisory board elected by the shareholders to succeed a departing member ends at the time when the term of the original member would have ended. A substitute member of the supervisory board may be elected by the shareholders at the same time as a member to replace such member in case he or she departs. The term of a substitute member who replaces a departing member ends with the conclusion of the next annual general shareholders meeting where members of the supervisory board are elected or, at the latest, at the time when the term of the original member would have ended.

The supervisory board elects a chairman and one deputy chairman from among its members by majority vote of its members. The participation of all three members, which would include abstaining from voting, is required for the supervisory board to act. The supervisory board normally acts by simple majority vote of the votes cast, with the chairman having a deciding vote in the event of a deadlock in a second vote on the same matter. The supervisory board may set forth in its rules of procedure that any resolutions by the supervisory board and its committees may be passed in writing, by telegram, telephone, facsimile, telex, or similar means, including in particular by way of video conference.

Under our company s articles of association, the supervisory board should meet at least once during each quarter of the calendar year. The supervisory board is required to meet at least twice during each half of a calendar year. The remuneration of the members of the Supervisory Board is determined by the Articles of Incorporation.

Our company s supervisory board has adopted rules of procedure. According to these rules of procedure, no more than one member of our company s supervisory board may be a former member of our company s management board. In addition, no member of the supervisory board may be a member of more than five supervisory boards of other publicly traded companies. In general, supervisory board meetings are called upon 14 days prior notice. However, in urgent matters the chairman of the supervisory board may shorten the notice period and may even call ad hoc meetings. Notices of a supervisory board meeting must be submitted together with an agenda to the members of the supervisory board. As a general matter, resolutions may be passed only with regard to the agenda. Resolutions with regard to other topics may only be passed if no member of the supervisory board objects. Our company s supervisory board adopts resolutions with simple majority unless applicable law or our company s articles of association require another majority. Our company s articles of association do not require a unanimous vote of the supervisory board members on any matter.

Consistent with the requirements of the Sarbanes-Oxley Act, a U.S. law on corporate governance and financial reporting that came into effect on July 30, 2002, and applicable U.S. securities regulations, our supervisory board also acts as our company s audit committee.

Our company s supervisory board may appoint committees from among its members and may, to the extent permitted by law, entrusts committees with the authority to make decisions. Our supervisory board has, consistent with the recommendations of the German Corporate Governance Code, created an audit committee, consisting of all of the members of the supervisory board. The chairman of the audit committee is Professor Dr. Klaus Pohle, the former Chief Financial Officer of Schering AG. The responsibilities

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of the audit committee include selecting an independent auditor to be proposed to our company s general shareholders meeting for appointment as auditor. The audit committee is also charged with reviewing our company s independent auditor s work and reports and our consolidated financial statements and also determines special audit areas and directly discusses and reviews audit issues identified by our company s independent auditors. The audit committee supervises the independent auditor s performance. The audit committee s responsibilities also include monitoring and supervising our company s risk management and negotiating the fees for our auditors. The audit committee s meetings are to be called upon five business days prior notice. Notices of an audit committee meeting must be submitted together with an agenda to the committee members. The Chief Financial Officer of our company is to be invited to attend all meetings of the company s audit committee. The audit committee may only pass resolutions if all committee members vote on the proposed resolution.

Our company s audit committee has adopted its own rules of procedure. The audit committee s rules of procedure provide that the auditor is to notify the audit committee promptly of any matters of significance to the supervisory board that result from any audits as well as matters that would contradict our company s stated compliance with the German corporate governance code. The rules of procedure also provide for a process with respect to the prior approval of all non-audit services to be performed by the independent auditors for our company. The audit committee s rules of procedure generally prohibit our company from retaining our company s auditors for services, including certain specified services, such as bookkeeping, financial information systems design and implementation, appraisal and valuation, actuarial, human resources, investment, and legal services, that would compromise the independence of our company s auditors.

The audit committee may authorize our company s chief financial officer to retain the auditors without the prior approval of the audit committee if services to be rendered by the auditors are in the ordinary course, are not likely to compromise the auditor s independence and the fees for such services do not exceed 15,000 per project and 120,000 per year in the aggregate. The supervisory board also reviews the internal control, disclosure and audit processes of the company.

The present members of our company s supervisory board, their ages, the date when they were first elected or appointed to the supervisory board, the date when their terms expire, and their current principal occupations and memberships on the boards of other companies are as follows:

Supervisory Board Members

Name	Age	Date First Elected/Appointed	Term expires	Principal Occupation
Jürgen Dormann Chairman	64	July 19, 2002(1)	August 7, 2008	President & Chief Executive Officer and Chairman of the Board of ABB, Ltd.; Supervisory Board Vice-Chairman of Sanofi-Aventis (since August 2004)(1)
Prof. Dr. Klaus Pohle Deputy Chairman	66	August 7, 2003(2)	August 7, 2008	President of the German Standardization Council; member of the board of DWS Investment GmbH; member of the board of directors of Coty Inc., New York City, USA; member of the supervisory board of Hypo Real Estate Holding AG; Supervisory Board Member of Sanofi-Aventis (since August 2004) (2)
Richard Roy	49	May 16, 2003(3)	August 7, 2008	Business Consultant; Member of the Board of Directors of Swisscom AG;

	Deputy Chairman of the Supervisory Board of Realtech AG (3)

(1) Mr. Dorman was elected by the annual general shareholders meeting on July 19, 2002 to fill the vacancy left by the resignation of Lorenzo Giulini. Mr. Giulini resigned from our company s supervisory board effective July 19, 2002 for personal reasons. Mr. Dormann was reelected at our company s annual general shareholders meeting on August 7, 2003 to serve for a five-year term. Mr. Dormann was also a member of the board of directors of International Business Machines Corporation (IBM) until April 2003.

(2) Professor Dr. Pohle served as Chief Financial Officer and a member of the management board of Schering AG until April 2003.

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(3) Mr. Roy was appointed to our company s supervisory board effective May 16, 2003 by the lower court of the commercial register in Heidelberg, Germany to fill the vacancy left by the resignation of Klaus Tschira. Dr. h.c. Tschira resigned from our company s supervisory board effective December 31, 2002 for personal reasons. Mr. Roy was reelected at our company s annual general shareholders meeting on August 7, 2003 to serve for a five-year term. Mr. Roy served as Vice President Corporate Strategy EMEA (Europe, Middle East, Africa) at Microsoft Inc. until June 2002.

Management Board

Our company s management board manages our company s business and represents it in dealings with third parties. The management board is also required to ensure appropriate risk management within our company and to establish an internal monitoring system. The management board regularly reports to the supervisory board about our operations and business strategies, and prepares special reports upon request.

Under our company s articles of association, the supervisory board determines the size of the management board. Our company s management board currently consists of two members following the resignation of our company s former chief executive officer and chairman of our company s management board, Dr. Friedrich von Bohlen und Halbach, who resigned effective December 31, 2003.

Resolutions of the management board may be taken either in meetings, by circulating written consents or verbally in a telephone conference among the board members in lieu of a meeting. Our company s articles of association provide that if the management board consists of two members, the attendance of both members is required for a quorum. If the management board consists of more than two members, a quorum requires the attendance of two thirds of the members of the management board. The management board acts by simple majority vote of the members present unless another majority is required by applicable law. If the management board consists of more than two members, the chairman of the management board has a casting vote in the event of a tie. Our company currently does not have a chairman of the management board.

In addition to matters requiring the consent of the supervisory board under German law, the supervisory board adopted the management board s rules of procedure, which require that the management board may only engage in certain transactions with approval of the supervisory board. These transactions include investments exceeding 1 million, mergers and acquisitions, establishment and termination of business divisions, certain financial transactions, such as borrowings exceeding 2 million, the issuance of debt securities, the granting of security interests, the granting of pensions to key employees, and other specified transactions exceeding specified threshold amounts, such as lease agreements, service agreements, consulting agreements, and the appointment of holders of a general power of attorney (*Prokurist*). The management board s rules of procedure further provide that the entire management board must vote on matters of significance to our company or its subsidiaries, our annual report, matters to be submitted to the supervisory board, and matters relating to any meeting of our company s shareholders.

The supervisory board appoints the members of the management board for a maximum term of five years. The initial term of office for a member of management is one year. At the end of this initial one-year, the term automatically extends for four more years, unless our company s supervisory board gives notice of termination within three month prior to expiration of the initial one-year term. Members of the management board may be reappointed or have their term extended for one or more terms of up to five years each. The supervisory board may remove a member of the management board prior to expiration of his term for good cause, for example in the case of a serious breach of duty or a good faith vote of no confidence at an ordinary or extraordinary shareholders meeting. A member of the management board may not vote on matters relating to certain contractual agreements between that member and our company and may be liable to our company if he has a material interest in any contractual agreement between our company and a third party, which was not disclosed to, and approved by, the supervisory board.

Our company has not entered into contracts with any current member of the management board that provide for benefits upon a termination of employment of the member. Our company entered into a severance agreement with the former chairman of our management board, Dr. Friedrich von Bohlen und Halbach, in FY 2004 and severance agreements in the form of consulting agreements with : Dr. Jan Mous and Dr. Reinhard Schneider, two former members of our company s management board in FY 2003. For a description of these agreements, see Item 7: Major Shareholders and Related Party Transactions Related Party Transactions below.

Our company may be represented by two members of the management board or by a member of the management board together with a holder of a general power of attorney (Prokura). According to our company s articles of association, the supervisory board may grant sole power of representation to the members of the management board. Our company s supervisory board has not granted this power to any current member of the management board.

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The present members of our company s management board, their ages, date when they were first appointed to the management board, the date when their terms expire and their positions are as follows:

Management Board Members

Name	Age	Date First Appointed	Term Expires	Position
Martin Hollenhorst	44	April 1, 2002	March 31, 2007	Co-Chief Executive Officer and Chief Financial Officer
Dr. Daniel Keesman	41	July 1, 2002	June 30, 2007	Co-Chief Executive Officer and Chief Operating Officer

Martin Hollenhorst joined our company as Chief Financial Officer and a member of our management board in April 2002. Following the resignation of Dr. von Bohlen und Halbach as our company s CEO, Mr. Hollenhorst also became Co-CEO of our company. Mr. Hollenhorst has accumulated extensive finance, controlling and management experience working for a variety of companies operating on an international scale. Prior to joining our company, he worked as an independent management consultant in Washington, D.C., specializing in advising German-American companies on strategic and acquisition matters. Prior to that, he was Chief Executive Officer of A.N.N. Systems ASA, a German-American software company, and prior to that, he worked for seven years for the Vossloh group, a publicly traded finance and management holding company with an international portfolio of industrial subsidiaries, where he was responsible for finances and controlling. In addition, he was General Manager of Hegenscheidt MFD GmbH, based in Erkelenz, Germany, and Detroit, Michigan. Martin Hollenhorst also worked for six years at the accounting firm Deloitte & Touche, eighteen months of which he spent in the US working as a consultant for mergers and acquisitions.

Effective June 27, 2002, our company s supervisory board appointed Dr. Daniel Keesman as Chief Business Officer and a member of our company s management board. Following the resignation of Dr. von Bohlen und Halbach as our company s CEO, Dr. Keesman also became Co-CEO of our company. In February 2004 we announced that Dr. Keesman became our Chief Operating Officer. Dr. Keesman joined our company in March 2001 as Vice President of Global Sales and Marketing and was subsequently promoted to Executive Vice President, Global Business. Prior to joining us, he served as Vice President for MDL Information Systems Europe and Managing Director of MDL Information Systems GmbH, Frankfurt. He had also held various other positions within MDL, one of which was Director, Professional Services Europe. He received his Ph.D. in chemistry from the University of Stuttgart, Germany.

Members of our senior management include the following:

Effective June 3, 2004, Joseph Donahue was appointed Chief Business Officer of our U.S. subsidiary, LION bioscience Inc. He also leads our North American operations as President of our subsidiary LION bioscience Inc. He joined us in May 2003 from Spotfire, where he most recently served as Vice President of Global Life Sciences and Chemicals Markets. Prior to joining Spotfire, Mr. Donahue was Vice President of North American Sales at MDL Information Systems. During a fifteen-year tenure at MDL, Mr. Donahue held numerous positions of increasing responsibility in sales and marketing. He received degrees in Chemistry and Computer Science from Villanova University.

Dr. Thure Etzold joined our company in July 1998 and currently serves as Managing Director of our subsidiary LION bioscience Ltd. in Cambridge, U.K. He also serves as Senior Vice President Product Development Biology at LION. He is also a group leader in the research program at the EBI (European Bioinformatics Institute) in Hinxton, U.K. Prior to joining our company, he was a staff scientist at the EMBL (European Molecular Biology Laboratory) in Heidelberg, Germany. Dr. Etzold holds a PhD from the Max-Planck-Institut für Zuechtungsforschung in Cologne, Germany and joined the Ph.D. program at the EMBL in Heidelberg, Germany.

Günter Dielmann joined our company in December 2002 as Vice President Investor Relations. From 1983 to December 2002 Mr. Dielmann worked in the investment banking industry focusing primarily on equity research and portfolio management. Mr. Dielmann received a degree in engineering with an emphasis in business science from the University of Karlsruhe, Germany in 1983.

Dr. Werner Eberhardt serves as Vice President Global Marketing. He joined our company in July 2001 and was initially responsible for support services. Prior to joining our company, Dr. Eberhardt worked for five years each in product marketing and management positions for Merck KGaA and Hewlett-Packard/Agilent. Dr. Eberhardt received his Ph.D. at the Max Planck Institute for Biochemistry in Martinsried, Germany and received his Diploma in Analytical Chemistry from the University of Saarbruecken in Germany.

Dr. Franz-Werner Haas serves as General Corporate Counsel and Head of Patent-department. Before he joined our company s legal department in July 2002, Dr. Haas was assistant to the executive board of an international commercial and service enterprise. Key responsibilities of his activity were issues under corporate law, the coordination of national and international associated companies as well as the worldwide sales and distribution of goods. Dr. Haas holds a Doctor of Laws from the university of Saarbruecken, from the Katholike Universiteit Leuven/Belgium and a Master of Laws (LL.M.) from the University of Edinburgh/UK.

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Dr. Rupert Lück joined our company in March 1998. He currently serves as Senior Director Strategic Projects. Dr. Lück held several IT lead positions with our company, where he was responsible for building LION s IT systems infrastructure including the high performance computing center at its headquarters in Heidelberg and the integration of our sites in the United Kingdom and in the United States. Prior to joining our company, he worked as an IT consultant for several companies, such as Lufthansa Systems. Dr. Lück received a degree in biophysics and biochemistry and holds a Ph.D. in bioinformatics, both from the University of Duesseldorf, Germany.

Peter Willinger joined our company in November 1998 as Director Controlling and has served as Vice President Global Finance & Operations since October 2001. After studying business economics at the Mannheim University where he received his BA, Mr. Willinger worked as a controller for Rudolf Wild GmbH & Co KG in Heidelberg for eight years before he joined our company.

Compensation

The aggregate compensation of our company s supervisory board was 148,000 for FY 2004. Under our company s articles of association, the compensation for each member of the supervisory board is currently 25,000 per fiscal year. The chairman of the supervisory board currently receives three times this amount. In addition, the members of the supervisory board will receive variable compensation in the amount of 10% of the fixed compensation for the first fiscal year during which we have achieved a positive return on equity. Thereafter, the variable compensation will be a proportionate share of the fixed compensation that is equal to the proportionate return on equity (percentage) based upon our annual financial statements. Each supervisory board member acting as chairman of a supervisory board committee that meets at least twice a year also receives additional annual compensation in the amount of 10,000.00. The shareholders of our company may increase the amount of compensation of the supervisory board by vote at the annual general shareholders meeting. Our company also reimburses the costs incurred by the members of the supervisory board in connection with performing their duties as supervisory board members and any value-added tax (VAT). Members of our company s supervisory board have received no compensation from any of our company s subsidiaries. None of the members of our supervisory board hold any options to purchase shares in our company. For more information regarding the compensation of our supervisory board, please refer to note 27 to our consolidated financial statements.

The aggregate compensation of our company s entire management board during FY 2003 was 734,000, including discretionary bonuses in the aggregate amount of 80,000. The members of the management board have received no compensation from any of our company s subsidiaries. For more information regarding the compensation of our management board, please refer to note 27 to our consolidated financial statements.

Effective March 31, 2003, our company entered into revised employment agreements with the current members of our management board. Pursuant to these employment agreements, our Co-Chief Executive Officer and Chief Financial Officer, Martin Hollenhorst, and our Co-Chief Executive Officer and Chief Operating Officer, Dr. Daniel Keesman, each receives a fixed annual salary of 204,000. In addition, each of them is also entitled to receive variable compensation of up to 50% of the amount of their fixed annual salary. The actual amount of the variable compensation to be paid to each member of the management board will be determined by our company s supervisory board and will be based upon each member s individual performance of his respective responsibilities in his area of responsibility, the performance of the management board as a whole as well as our success, taking into account specific business areas.

In addition to salaried remuneration and any discretionary bonus, the members of our company s management board receive benefits in the form of automobile allowance, allowance for life or accident insurance, allowance for housing expenses, as well as continued payment of salary in the event of illness for up to three months and payment of relocation expenses. The members of our management board may also elect to have our company contribute up to 10% of their fixed salary to a pension fund or equivalent entity.

The members of our supervisory and management board are also entitled to receive liability insurance coverage, including insurance against liabilities under U.S. securities laws. We currently provide such coverage at no cost to the members of our company s supervisory and management boards.

We did not provide any loans, warranties or guaranties to members of our company s supervisory or management boards during FY 2004, FY 2003 or FY 2002.

Our company entered into a severance agreement with Dr. Friedrich von Bohlen und Halbach, the former Chairman of our company s management board, in FY 2004 as well as severance agreements in the form of consulting agreements with Dr. Reinhard Schneider and Dr. Jan Mous, two former members of our management board in connection with their resignation as board members and their departure from our Company in FY 2003. For more information concerning these arrangements with Dr. Schneider and Dr. Mous, see Item 7: Major Shareholders and Related Party Transactions .

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We have not paid any consideration to Dr. Schneider or Dr. Mous for their waiver of options held by them to purchase ordinary shares of our company. In FY 2003, we paid 8,350 to Dr. Keesman in consideration for his waiver of 30,000 options held by him to purchase ordinary shares of our company.

In May 2003, we hired Joseph Donahue as President of LION bioscience Inc. Mr. Donahue serves as Chief Business Officer of LION bioscience Inc. and as a member of our executive management team. Mr. Donahue receives an annual fixed salary of $167,200. Mr. Donahue also received a $35,000 signing bonus. He is also eligible to receive a quarterly bonus of up to $25,000 provided he meets certain quarterly performance milestones to be determined by the board of directors of LION bioscience Inc. In addition, our company entered into a consulting agreement with Mr. Donahue in May 2003. In FY 2004, we paid aggregate compensation of $231,188 to Mr. Donahue, including bonuses and fees for advisory and consulting services. In addition to salaried remuneration and any discretionary bonus, Mr. Donahue receives benefits in the form of automobile allowance, allowance for life insurance, participation in LION bioscience s 401k plan and health insurance plan. In addition, our company entered into a consulting agreement with Mr. Donahue in May 2003. Under the terms of this agreement Mr. Donahue receives fees of $4,400 per month for advisory and training services to our company s German management board members in the field of U.S.-related sales, professional services and marketing and treatment of U.S. professionals.

Thure Etzold joined LION in April 1998. He currently acts as Managing Director to our subsidiary in the United Kingdom, LION bioscience Limited. Dr. Etzold also serves as a member of the executive team of our company in his capacity of Senior Vice President of Bioinformatics Product Development. Dr. Etzold receives an annual fixed salary of £80,000 and an annual car allowance of £10,000, both of which are paid monthly. He is also eligible to receive an annual bonus of up to 40% of his current salary, provided he meets certain annual performance milestones to be determined by the board of directors of our U.S. subsidiary LION bioscience Inc. This bonus is paid annually. In FY 2004, we paid aggregate compensation of £129,545 to Dr. Etzold, including bonuses. In addition to salaried remuneration and any discretionary bonus, Dr. Etzold receives further benefits in the form of personal life insurance, business and personal travel insurance and benefits for personal pension.

We did not provide any loans, warranties or guaranties to any member of our management board or any head executive of any of our subsidiaries during FY 2004, FY 2003, FY 2002 or FY 2001 except for a loan to Dr. Rudolph Potenzone, the former President of our U.S. subsidiary LION bioscience Inc. For a description of this loan, see Item 7: Major Shareholders and Related Party Transactions Related Party Transactions Relationship with Dr. Rudolph Potenzone .

Employees

The following table sets forth the number of our full-time equivalent employees by job category at the end of each of the last three financial years.

Worldwide Employees

	March 31, 2002	March 31, 2003	March 31, 2004
IT Development	278	177	53
Internal Drug Development (iD^3)	127	0	0
Marketing and Sales	91	30	32

Professional services	0	77	62
Administration	94	53	30
Total	590	337	177

Of our full-time equivalent employees at March 31, 2004, 88 were based in Germany or elsewhere in continental Europe, 38 were based in the United Kingdom and 51 were based in the United States of America. See Item 5: Operating and Financial Review and Prospects Overview Restructuring Activities for more information about our restructuring activities that have affected the number of our employees.

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We do not have a workers council. None of our employees are subject to a collective bargaining agreement. We have not experienced any major labor disputes resulting in work stoppages since our formation. For information concerning our relationship with an improvement committee created by the employees of our company, we refer to Item 3: Key Information on the Company - Risk Factors Risks Related to Our Business - We may be restricted in our ability to implement reductions of our company s workforce because a committee formed by our employees may object to termination of employees of our company, requiring us to enter into binding mediation before an independent third party with respect to any such work force reductions. above.

Share Ownership

According to the notices we have received, each member of our supervisory board and our management beneficially owns less than one percent of our shares. The share ownership of Dr. von Bohlen und Halbach, our company s former Chief Executive Officer and Chairman of our company s management board, is disclosed in Item 7: Major Shareholders and Related Party Transactions .

Stock-Based Compensation Plans

Our company does not maintain any employee stock option plans. Prior to our company s annual shareholders meeting on August 7, 2003, our company maintained a 2000 Stock Option Plan, a 2001 Stock Option Plan and a 2002 Stock Option Plan for the benefit of our company s executives and employees and those of our company s subsidiaries as well as the members of our management board.

No options had been issued under the 2002 Stock Option Plan. In March 2003, all holders of options issued under our 2000 and 2001 Stock Option Plans irrevocably waived all of their options and rights to purchase our company s ordinary shares under these plans. We paid these option holders consideration for this irrevocable waiver, subject to shareholder approval at the annual general shareholders meeting on August 7, 2003, in the aggregate amount of approximately 188,000. The shareholders approved payment of this consideration and voted to terminate all of our company s stock option plans and the entire contingent capital reserved for issuances of shares under these stock option plans at the annual shareholders meeting on August 7, 2003. See Item 5: Operating and Financial Review and Prospects Overview for more information concerning this option waiver program.

Item 7: Major Shareholders and Related Party Transactions

The share capital of our company consists of ordinary shares, which are issued in bearer form. Accordingly, we generally have no way of determining who our company s shareholders are or how many shares a particular shareholder owns. However, under Section 21 of the German Securities Trading Act (*Wertpapierhandelsgesetz*), holders of voting securities of a German company admitted to official trading on a stock exchange within the European Union or the European Economic Area are obligated to notify a company of the level of their holdings whenever such holdings reach, exceed or fall below certain thresholds, which have been set at 5%, 10%, 25%, 50% and 75% of a company s outstanding voting rights.

The following table shows the current beneficial ownership of our company s share capital as of September 24, 2004 based on the notifications under the German Securities Trading Act. Our company is not directly or indirectly owned or controlled by any foreign government, any other corporation or by any other natural or legal person(s). None of the listed major shareholders has any special voting rights as a result of their holdings.

Name and address of beneficial owner	Shares beneficially owned: Amount of beneficial ownership	Shares beneficially owned: Percent of shares
Dr. Friedrich von Bohlen und Halbach	2,103,706(1)	10.59
Bayer AG	1,400,000(2)	7.05

(1) Represents the beneficial ownership of our Company s shares by Dr. von Bohlen und Halbach as last notified to us in April 2004. Since the reporting obligations under the German Securities Trading Act concerning beneficial ownership are different from the reporting requirements under U.S. securities laws, and since our company s ordinary shares are in bearer form only, we are unable to determine the current amount of ordinary shares beneficially owned by Dr. von Bohlen und Halbach under the definition of beneficial ownership for U.S. securities laws purposes. For example, the number of shares listed in the above table does not include any shares held by the wife of Dr. von Bohlen und Halbach, Dr. Anna Caterina von Bohlen und Halbach. On February 20, 2004 Dr. Anna Caterina von Bohlen und Halbach gave notice pursuant to the German Securities Trading Act that she had sold 161,918 shares in our Company, thereby reducing the amount of her ownership in our company s share capital to below 5% of our company s outstanding voting rights. Since as a result of this

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transaction, the number of shares owned by Dr. Anna Caterina von Bohlen und Halbach fell below the 5% reporting threshold, we are unable to determine whether Dr. Anna Caterina von Bohlen und Halbach has reduced or increased the amount of her ownership further but below the 5% reporting threshold.

As of September 9, 2003, the aggregate number of shares beneficially owned by the children of Dr. Friedrich von Bohlen und Halbach was 240,000. We have included these 240,000 shares in Dr. Friedrich von Bohlen und Halbach s beneficial ownership interest of 10.59%.

(2) Represents the beneficial ownership of Bayer AG as notified to us in August 2004 in connection with our company s annual shareholders meeting on that date.

Related Party Transactions

Relationship with Dr. Friedrich von Bohlen und Halbach

In December 2003, our company entered into a severance agreement with Dr. Friedrich von Bohlen und Halbach, the former Chief Executive Officer and a former member of our company s management board. Under the term of this severance agreement, we paid a total of 317,000 to Dr. von Bohlen in return for a general release of claims by Dr. von Bohlen in FY 2004.

Relationship with Dr. Reinhard Schneider

Our company has entered into a severance agreement in the form of a consulting agreement with Dr. Reinhard Schneider, the former Chief Information Officer and a former member of our company s management board, for consulting services starting in March 2003. The agreement is designed to ensure knowledge transfer from Dr. Schneider to our company. We have agreed to pay Dr. Schneider a total of about 15,500 per month under this agreement until September 30, 2005, provided however that if Dr. Schneider provides services to a third party or becomes employed by a third party, this agreement terminates automatically at the end of the calendar year in which such engagement commences and our company will be required to make reduced monthly payments to Dr. Schneider until the effective termination date. The agreement was terminated on May 1, 2004. Under the agreement, we paid Dr. Schneider a total of 15,400 during FY 2003 and 175,320 during FY 2004. In addition, we paid Dr. Schneider 10,460 in April and May 2004 and will make a final payment to Dr. Schneider under this agreement in the current financial year of up to 60.000.

Dr. Schneider, a former member of our management board, held options to purchase 37,100 shares under our company s 2000 stock option plan. These options were granted in August 2000. In March 2003, Dr. Schneider irrevocably waived these options. We did not pay any consideration to Dr. Schneider for this irrevocable waiver. See Item 6: Directors, Senior Management and Employees Share Ownership and Item 5: Operating and Financial Review and Prospects Overview Restructuring Activities for more information about this waiver program.

Relationship with Dr. Jan Mous

Our company entered into a severance agreement in the form of a limited consulting agreement with Dr. Jan Mous, the former Chief Science Officer and a former member of our company s management board, for consulting services starting on January 1, 2003. The agreement was designed to ensure knowledge transfer from Dr. Mous to our company. During FY 2003, we paid Dr. Mous a total of 46,500 under this severance agreement. We paid Dr. Mous an additional 176,500 in FY 2004. We have no further payment obligations to Dr. Mous under this agreement, as he took on new employment with a third party in July 2003. Dr. Mous, a former member of our management board, held options to purchase 105,000 shares under our company s 2000 stock option plan. These options were granted in August 2000. In March 2003, Dr. Mous irrevocably waived these options. We did not pay any consideration to Dr. Mous for this irrevocable waiver.

Relationship with Reiner Doelle

Our company has entered into a severance agreement in the form of a consulting agreement with Reiner Doelle, our former Executive Vice President for Global Software Development, for consulting services starting on October 1, 2003 and running until September 30, 2005. The agreement is designed to ensure knowledge transfer from Reiner Doelle to our company. We have agreed to pay Reiner Doelle a total of up to 158,188 per year under this agreement for services actually rendered to us. Under the agreement, we paid Reiner Doelle a total of 65,611 during FY 2004 and 82,757 during the period from April 1 until August 30, 2004.

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Relationship with Dr. Rudolph Potenzone

In connection with our restructuring activities and the termination of employment of Rudolph Potenzone, Ph.D., as Chief Executive Officer of our company s U.S. subsidiary LION bioscience Inc., we entered into a severance agreement with Dr. Potenzone in March 2003. Pursuant to that agreement, we paid Dr. Potenzone $50,000 in April 2003 in return for a general release of claims by Dr. Potenzone. In addition, we agreed to waive Dr. Potenzone s repayment obligations under a loan agreement made by us to Dr. Potenzone in March 2001, pursuant to which we had loaned Dr. Potenzone approximately $151,000 at an interest rate of 6.5% per year. Under the terms of the severance agreement, we also paid to Dr. Potenzone a performance based bonus in an aggregate amount of approximately $32,000 in April 2003. Dr. Potenzone also held options to purchase a total of 40,000 shares under our company s stock option plans. These options were granted in March and December 2001. In March 2003, Dr. Potenzone irrevocably waived these options. We paid 11,280 to Dr. Potenzone for this waiver.

Relationship with ChemNavigator

In July 2004, we entered into license and reseller agreements with ChemNavigator, Inc. In addition, we entered into an agreement with ChemNavigator, effective December 1, 2003 for the use of office space at ChemNavigator s premises in San Diego, California. For further information on these agreements with ChemNavigator, see Item 4: Information on the Company Research and Development Alliances - ChemNavigator and Item 4: Information on the Company Facilities . We hold 1,176,666 shares of preferred stock series B in ChemNavigator, representing an ownership interest equal to approximately 15% of ChemNavigator s outstanding voting shares. We are also entitled to appoint a director to ChemNavigator s board of directors. We paid a total of approximately 0.2 million from April until August 2004.

Item 8: Financial Information

Consolidated Financial Statements

See Item 18. Financial Statements and pages F-1 through F-43.

Other Financial Information

Legal Proceedings

We are not a party to any material litigation or administrative proceedings, nor are we currently aware of any pending or threatened litigation or arbitration proceedings that could have a material adverse effect upon our business, results of operations or financial condition except as follows: In FY 2004, we commenced legal action in the Delaware Court of Chancery against GeneProt, Inc. We had acquired 681,818 preferred shares issued by GeneProt in March 2002. Under GeneProt s articles of incorporation, we were entitled to require Geneprot to repurchase our preferred shares by paying us the original purchase price for these shares plus interest in the event GeneProt carried out any of a specified list of corporation transactions, including a sale of all or substantially all of its assets if we did not consent to the transaction. In December 2003, GeneProt entered into a number of transactions with Novartis AG that we considered a sale of substantially all of GeneProt s assets. We accordingly notified GeneProt of our election to have our shares repurchased and demanded that GeneProt repay to us the price we paid for these preferred shares plus interest. GeneProt refused to do so, prompting us to commence the lawsuit to enforce our redemption rights. The action is

currently in the discovery phase. We cannot give you any assurances that, we will prevail with our claim or that if we prevail, we will be able to collect from GeneProt all or a portion of the redemption payment and other damages awared to us by the court.

We may become subject to other legal proceedings and claims, either asserted or unasserted, in the future. Any litigation involves potential risk and potentially significant litigation costs, and therefore there can be no assurance that any litigation which may arise in the future would not have such a material adverse effect on our business, financial position, results of operations or cash flows.

Dividend Policy

Payment of dividends, if any, are approved at our company s annual general shareholders meeting and are paid once a year, although we currently cannot pay any dividends. We can only pay dividends when our company is profitable. Upon proposal by our management board and supervisory board, our company s annual general shareholders meeting approves the allocation of our company s net profits, which our company determines on the basis of our company s unconsolidated financial statements prepared in accordance with the accounting principles generally accepted in Germany. The management board and the supervisory board are authorized to allocate, in their discretion, up to one half of our company s net profit in any fiscal year to other retained earnings (andere Gewinnrücklagen). Shareholders participate in dividends in proportion to the number of shares held by each shareholder.

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We have never declared or paid any dividends. We expect to retain our future earnings, if any, for use in the operation and expansion of our business and do not anticipate paying any dividends in the foreseeable future.

Dividends approved at the annual general shareholders meeting are payable on the first stock exchange trading day after that meeting, unless decided otherwise at the meeting. When shareholders hold shares that are entitled to dividends in a clearing system, the dividends are paid according to that clearing system s rules. We will publish notice of dividends paid and the paying agent or agents appointed in the Internet version of the Federal Gazette (www.ebundesanzeiger.de).

We will not pay any dividends directly to holders of our company s American Depositary Shares (ADSs). Instead, we will pay dividends and make other distributions to the depositary s nominee who acts as the registered owner of the shares underlying our company s ADSs. JPMorgan Chase Bank currently acts as the depositary for our company s ADSs. Our company s management board may determine to terminate our ADS program and all outstanding ADSs. For more information concerning this possible termination, see Item 4: Information on the Company Risk Factors Risks Related to Holding Our Company s Shares or ADSs .

The depositary has agreed to pay ADS holders cash dividends or other distributions it receives on our company s ordinary shares or other deposited securities, after deducting expenses. Such distributions, if any, will be made in proportion to the number of underlying shares represented by a holder s ADSs.

We may make various types of distributions with respect to our securities. Except as stated below, to the extent the depositary is legally permitted, it will deliver such distributions to ADS holders in proportion to their interests in the following manner:

Cash. The depositary will convert cash distributions from foreign currency to US dollars as promptly as practicable if this is permissible and can be done on a reasonable basis. The depositary will endeavor to distribute such cash in a practicable manner, and may deduct any taxes required to be withheld, any expenses of converting foreign currency and transferring funds to the United States, and certain other expenses and adjustments. In addition, before making a distribution, the depositary will deduct any taxes withheld. ADS holders bear the risk if the exchange rates fluctuate during a time when the depositary cannot convert the currency.

Shares. In the case of a distribution in shares, the depositary will issue additional ADSs to evidence the number of ADSs representing such shares. Only whole ADSs will be issued. Any shares which would result in fractional ADSs will be sold and the net proceeds will be distributed to the ADS holders entitled thereto.

Rights to Receive Additional Shares. In the case of a distribution of rights to subscribe for additional shares or other rights, if we provide satisfactory evidence that the depositary may lawfully distribute such rights, the depositary may arrange for ADS holders to instruct the depositary as to the exercise of such rights. However, if we do not furnish such evidence, the depositary may:

Sell such rights on the German stock exchange on which they are traded, if practicable, and distribute the net proceeds as cash; or

Allow such rights to lapse, whereupon ADS holders will receive nothing.

We have no obligation to file a registration statement under the Securities Act in order to make any rights available to ADS holders. If we do not choose to file a registration statement, the Securities Act will restrict the sale, deposit, cancellation and transfer of ADSs issued upon the exercise of rights.

Other Distributions. In the case of a distribution of securities other than those described above, the depositary may either

Distribute such securities in any manner it deems fair and equitable; or

Sell such securities and distribute any net proceeds in the same way it distributes cash.

Fractional cents will be withheld without liability for interest and added to future cash distributions.

To the extent the depositary determines, after consultation with us, that any distribution is not lawful or practicable with respect to any holder, the depositary may make the distribution in a method that it deems lawful and practicable, including the distribution of foreign currency or securities. The depositary may also retain such items, without paying interest on or investing them, on behalf of the ADS holder as deposited securities.

There can be no assurances that the depositary will be able to convert any currency at a specific exchange rate or sell any property, rights, or shares or other securities at a specified price, or that any such transactions can be completed within a specified time period.

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Significant Changes

No significant change has occurred since the dates of the annual financial statements included in this annual report.

Item 9: The Offer and Listing

Nature of Trading Market

General

The principal trading market for our company s ordinary shares is the Frankfurt Stock Exchange. American depositary shares (ADSs), each representing one ordinary share, are traded on the Nasdaq National Market and trade under the symbol LEON. The depositary for our company s ADSs is JPMorgan Chase Bank. As of March 31, 2004, there were a total of 1,116,525 ADSs outstanding, held by approximately 3,000 holders. As of August 31, 2004 there were a total of 1,337,364 ADSs outstanding, held by approximately 3,500 holders.

In June 2004, our company announced that it is considering whether to delist its ADSs from the Nasdaq National Market and terminate its ADS agreement. If our company determines to proceed with these measures and to delist our company s ADSs, our company s ADSs would no longer be traded on the Nasdaq National Market. For more information on these measures, see Item 4: Information on the Company Risk Factors Risks Related to Holding Our Company s Shares or ADSs .

Trading on the Nasdaq National Market

ADSs representing our company s shares have been traded on the Nasdaq National Market since August 11, 2000. The table below sets forth, for the periods indicated, the high and low closing prices for the ADSs on the Nasdaq National Market.

	LION ADSs Nasdaq National Market	
	High	Low
	$	$
Most Recent Fiscal Years		
Fiscal Year Ended March 31, 2002	37.80	7.20

Fiscal Year Ended March 31, 2003	10.35	2.25

Fiscal Year End