

# Consolidated Financial Statements for 2003



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## GROUP MANAGEMENT REPORT

### Industry Overview

#### Macroeconomic Development

Europe's economic growth remained modest in the first half of 2003. However, global economic expansionary forces, which had gained the upper hand in the early part of the year, accelerated in the second half of the year. The most powerful expansive impetus was provided by the U.S. economy, which in the third quarter posted the highest quarterly growth since 1984. The Japanese economy benefited from strong demand for imports from its neighbors in Asia and from the U.S.A. as well as from brisk domestic demand. Although the euro zone could not keep up with the faster economic pace in the U.S.A. and the strong growth in Japan, there are many factors that indicate a gradual cyclical revival may have taken root in Europe.

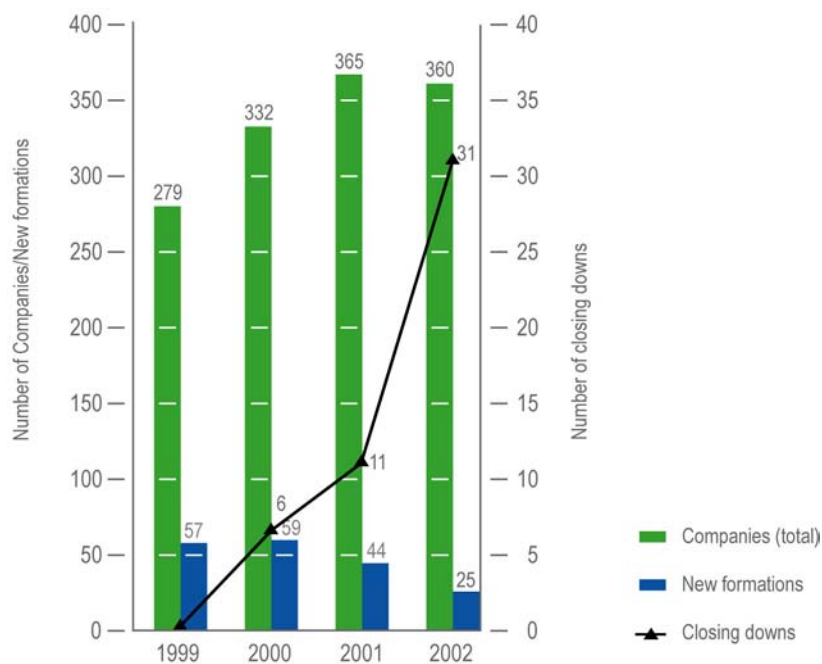
The underlying economic conditions for a continuation of the recovery process developed favorably, in part because of low interest rate levels. Short-term interest rates in the euro zone have dropped from 2.9% to 2.1% during 2003, while short-term U.S. interest rates remained at 1.0% at year-end – interest rate levels whose depths have not been seen since 1958. Mirroring this development in reverse, equity prices on the leading stock exchanges for the most part displayed an upward trend, which was mainly associated with solid quarterly results in the corporate sector. For example, during 2003, the Dow Jones index increased by 25%, the Nikkei by 24% and the DAX by 37%.

The U.S. dollar exchange rate came under considerable pressure in the fourth quarter of 2003. At the end of December 2003, the euro/U.S. dollar exchange rate rose to 1.26 U.S. dollar per euro, thus reaching an all-time high since the introduction of the euro. Two reasons have been given for the euro's record-breaking run; first and foremost - the continuing high budget deficit in the U.S.A. weighs in on the mind of investors, and second - the possibility looms that Asian central banks' purchases of U.S. dollars may decline in the future.

#### Development within the Biotech Sector

The situation and sentiment within the biotech sector have changed rather substantially over the past two years. In 2003, the total number of companies in Germany in the biotech sector decreased for the first time since the mid-1990s. In 2002 and 2003, the number of newly founded companies did not offset the number of new insolvencies, liquidations and acquisitions/mergers. The most telling statistics of the industry – total headcount, the level of spending on research and development, and revenues - have all also declined.

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Source: Ernst&Young, Biotechnology Report 2003

In contrast to the U.S.A., where seven biotech IPOs have taken place during the fourth quarter of 2003, no IPOs were successfully executed in Germany in 2003. Moreover, during the year only a few companies in Europe, such as the Austrian company Intercell and U3 Pharma in Germany, reported the successful conclusion of equity financing. The inflow of capital in Europe to biotech companies amounted to U.S.\$ 2.5 billion compared to U.S.\$ 1.1 billion in the previous year. This compares to a total of U.S.\$ 15.1 billion invested in the U.S.A., a year-on-year increase of 65%. Positive news generated through strong revenue growth for the larger established biotech companies such as Amgen and Gilead and by a series of new approvals for companies such as FluMist (MedImmune) and Raptiva (Genentech/XOMA) also contributed substantially to the upturn in fortunes in the U.S. biotech sector. Also a catalyst was news from Genentech in the form of Avastin, at the ASCO (American Society for Clinical Oncology) meeting in May 2003. The contrast between Europe and the U.S.A. in the biotech sector development was also reflected in the development of equity prices: the NASDAQ Biotech index rose by 46% in 2003, while the German Prime Pharma & Healthcare index increased by only 20%.

Nonetheless, pharmaceutical companies, irrespective of their geography, continue to remain under pressure to launch new products. Research spending of pharmaceutical companies has risen considerably since the 1980s. Nevertheless, productivity has decreased steadily in terms of the number of market approvals. Major pharmaceutical companies are investing increasingly in pre-clinical development products from the biotech sector, and no longer exclusively in product candidates in advanced stages of development. Wide-ranging research cooperation agreements signed in 2003, such as those between Aventis/Immunogen and Amgen/Biovitrum, are a clear sign of this development. Such alliances offer pharmaceutical companies the opportunity to outsource a part of their research and thus to spread the risks more efficiently. Many pharmaceutical companies now invest more than a fifth of their research budgets in such alliances.

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In 2003, there was also uplifting news related to therapeutic antibodies. The number of approved therapeutic antibodies on the market increased from 12 to 16 by the end of the year. Two antibodies on the market, Rituxan and Remicade, are blockbuster drugs, meaning that they generated annual revenues of more than U.S.\$ 1 billion each. In total, global revenues of therapeutic antibodies grew to more than U.S.\$ 5 billion, a year-on-year growth of approximately 25%.

Although there were a few clinical development failures in 2003, such as Genmab's antibody Humax-CD4 for the treatment of psoriasis, Genentech presented positive findings for Avastin from a phase III study with colorectal cancer patients at the annual meeting of the American Society for Clinical Oncology (ASCO). The German company Merck also presented promising data at this meeting relating to their therapeutic antibody cancer drug Erbitux. Despite stumbling blocks encountered in the U.S., Erbitux was approved during the year in Switzerland.

## Financial Analysis

### Operating Revenues

Compared to the same period of the previous year, revenues for the full year 2003 decreased by 9% to EUR 15.3 million (2002: EUR 16.8 million). Reasons behind the decline included later than anticipated timing for deal signing and milestones achievements, as well as foreign exchange effects. Using constant exchange rates (2002), MorphoSys 2003 revenues would have been EUR 0.6 million, or 4% higher.

A substantial majority of revenues recorded in 2003 relate to annual licensing fees received from existing partners. In this regard, milestones revenues amounted to EUR 0.5 million or 3% for the full year 2003 compared to 10% in the prior year. The Company also recorded grant revenues, arising from the German Federal Ministry of Education and Research ("Bundesministerium für Bildung und Forschung"), amounting to EUR 0.1 million during the reporting period, and remained essentially unchanged to the same period in the previous year.

Of total revenues, approximately 82% related to therapeutic antibody collaborations, 17% to antibody research collaborations, and 0.2% to the "Antibodies by Design" initiative. For purposes of classification, the following partners were considered to be therapeutic antibody collaborations: Bayer, Centocor, GPC Biotech, ImmunoGen, ProChon, Roche, Schering and Pfizer. Target research collaborations consisted of: Biogen, Bristol-Myers Squibb (formerly DuPont), ImmunoGen (expansion) and Oridis Biomed. Approximately 81% (2002: 77%) of total Company revenues arose from MorphoSys' three largest alliances with Centocor, Bayer and Schering.

Geographically, 81% of MorphoSys' commercial (non-grant) revenues in the amount of EUR 12.4 million were generated with biotechnology and pharmaceutical companies located in the United States and 19% in Europe, compared to 76% and 24%, respectively, for the prior year.

## **Operating Expenses**

For the full year 2003, total operating expenses, including stock-based compensation expenses, substantially decreased by 56% to EUR 18.8 million (2002: EUR 42.3 million), a reduction of EUR 23.5 million, and was appreciably better than expected. A significant reduction in expense resulted from lower patent and licensing expenses arising from the settlement agreement with Cambridge Antibody Technology ("CAT") and license agreement with XOMA. In addition, the Company's restructuring plan implemented during the year 2003 also led to lower personnel-related costs and reduced product development-related costs.

### ***Research and Development Expenses***

Costs for research and development fell by EUR 10.6 million to EUR 9.0 million (2002: EUR 19.6 million). This decrease resulted chiefly from lower licensing costs as a result of the licensing and settlement agreements with CAT and XOMA in the prior year, as well as the Company's decision to refocus efforts in proprietary product development. Under the Company's restructuring plan, proprietary products will be out-licensed at the pre-clinical stage, thereby resulting in notably lower product development costs.

### ***Sales, General and Administrative Expenses***

Sales, general and administrative expenses amounted to EUR 7.6 million compared to EUR 18.7 million in the previous year. The decrease in general and administrative expenses was largely due to lower patent litigation costs with the amount of EUR 0.3 million (2002: EUR 7.0 million), arising as a result of the settlement with CAT in December 2002. Also substantially contributing to cost savings was the closing of MorphoSys U.S.A. Inc., with net savings to MorphoSys of approximately EUR 1.8 million for the year 2003.

### ***Stock-Based Compensation***

Stock-based compensation in the amount of EUR 2.2 million for the year 2003 was recorded as a non-cash charge (2002: EUR 3.9 million), resulting from application of SFAS No. 123 "Accounting for Stock Based Compensation" under U.S. GAAP accounting. MorphoSys has been expensing stock options since fiscal year 1999. The decrease in stock-based compensation was mainly due to declining expenses from options and convertible bonds granted in prior periods. Stock-based compensation for new grants was also lower through the reduced stock price of MorphoSys shares underlying the programs at the time of grant, as well as forfeitures and reduced numbers of new grants.

## **Cost by Expenditure Type**

Personnel costs (excluding expenses arising from stock-based compensation) amounted to EUR 7.5 million (2002: EUR 10.1 million) or 40% of total costs were the largest cost block within operating expenses in 2003. The reduced levels in 2003 compared to the prior year resulted from leaner staff structures arising from the Company's restructuring plan implemented in 2003. External services, which includes external lab funding and various outsourced administrative services, amounted to EUR 3.8 million (2002: EUR 8.1 million), or 20% of total costs, was primarily reduced by lower levels of external lab funding expense and legal expenses. Intangible costs, which include patent litigation costs and amortization of licenses and patents, amounted to EUR 0.9 million (2002: EUR 15.1 million), or 5% of the total in 2003. Intangibles costs were sharply lower in 2003 mainly due to savings arising from patent and licensing settlements

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entered into from the prior year. Infrastructure costs, which mainly include rent, utilities and equipment depreciation costs, amounted to EUR 2.3 million (2002: EUR 2.6 million), or 12% of total costs, and remained largely unchanged compared to the prior year.

### **Non-Operating Items**

Non-operating income decreased by EUR 1.8 million to a non-operating loss of EUR 0.7 million (non-operating income 2002: EUR 1.1 million), and was mainly due to interest expense. EUR 0.7 million resulted from the election to issue shares associated with the XOMA agreement and is a non-cash charge relating to the accounting of such conversion under U.S. GAAP accounting. Additionally, EUR 0.2 million interest expense was recorded during the period and arose in connection with interest expense on liabilities associated with the CAT settlement. Additionally, the Company recorded an impairment charge related to unrealized losses on available-for-sale securities in the amount of EUR 0.8 million in the year of 2003. MorphoSys considers all reductions in market value of its marketable securities (available for sale securities), which are longer than six months in duration, to be deemed other than temporary decline in value unless facts and circumstance indicate otherwise. Since the date of the write-off, the securities have regained their value by EUR 0.6 million, 75% of the original loss, at year-end 2003.

In December 2003, the Company recorded an unrealized gain of EUR 0.3 million as part of its hedging program to protect against foreign exchange exposure from the U.S. dollar reflected as non-operating income.

### **Net Loss**

The Company posted a loss from operations in 2003 of EUR 3.5 million (2002: EUR 25.5 million), with sharply lower operating expenses responsible for the reduced loss levels. EBITDA (Earnings before Interest, Taxes, Depreciation Amortization and Stock-Based Compensation) amounted to EUR 1.2 million; the first time MorphoSys has achieved a positive EBITDA result (2002: EUR (18.7) million). Mirroring this trend, the net loss of EUR 4.1 million in 2003 (2002: 24.4 million), was markedly lower due to lower operating expenses. The resulting loss per share for the full year 2003 amounted to EUR 0.96 (2002: EUR 6.35), a reduction of 85%.

### **Liquidity / Cash Flows**

On December 31, 2003, the Company had EUR 23.2 million in cash, cash equivalents and marketable securities compared to a EUR 19.1 million balance at December 31, 2002 - an increase of more than 20% over the prior year - and the first year in the Company's history that such an increase in cash and short term investments from operating activities took place. In 2003, cash provided by operating activities was also positive for the first year ever. For the full year 2003, cash provided by operations amounted to EUR 5.8 million in comparison to cash used in operating activities of EUR 15.2 million in the year 2002. During the year 2003, the Company's current assets decreased by EUR 3.3 million to EUR 26.2 million compared to EUR 29.5 million at December 31, 2002, primarily as a result of lower receivables levels at year end 2003.

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### **Assets**

Total assets increased by EUR 3.4 million to EUR 45.8 million in the year 2003, compared to EUR 42.4 million at December 31, 2002. The difference was attributable to the increase in intangible assets of EUR 8.3 million arising from the acquisition of the CAT license and was partly offset by a decrease in current assets of EUR 3.3 million.

### **Liabilities**

During the year 2003, total current liabilities fell by EUR 8.0 million principally due to the settlement in licenses payable of EUR 4.9 million (of which EUR 3.8 million was non-cash) as well as a drop of other accounts payable by EUR 2.0 million. The decrease in licenses payable resulted from the payment of certain obligations under the settlement agreement with CAT and the payment of the XOMA license agreement with equity.

Deferred revenue increased by EUR 2.3 million to EUR 10.4 million, largely as a result of the collaborations entered into in the fourth quarter of 2003. The long-term portion of EUR 6.1 million for the year ended December 31, 2003 (2002: EUR 3.7 million) million was reclassified into non-current liabilities.

### **Equity**

At year-end 2003, the total number of shares issued was 4,901,332 of which 4,841,570 were outstanding, compared to 3,949,706 and 3,889,944 in the prior year.

As part of the MorphoSys-XOMA licensing agreement signed in 2002, in October 2002 MorphoSys elected to issue 363,466 shares to XOMA as partial consideration for the XOMA license received. The capital increase was registered and the shares were issued to XOMA in the first half of the year 2003. In coordination with MorphoSys, XOMA successfully sold all their MorphoSys shares of stock by the third quarter of 2003.

In December 2002, MorphoSys signed a settlement with CAT to resolve long-standing patent litigation issues. As part of the agreement, MorphoSys agreed to issue 588,160 shares to CAT as partial consideration for the CAT license. The license and subscription agreements were executed in July 2003 and the capital increase was registered in August 2003. The shares issued to CAT were subject to a lockup and CAT remained a shareholder at year-end.

Both aforementioned share issuances excluded stockholders' pre-emptive rights as allowed under the Company's Articles of Association and respective shareholder resolutions.

In May 2003, the annual stockholders assembly authorized the Company to increase its Conditional Capital II, IV and V up to 1,275,000, 450,269 and 111,447 shares respectively.

## **Capital Expenditure**

During 2003, total investment in intangibles amounted to EUR 8.4 million (2002: EUR 3.7 million). A large majority of the increase related to the acquisition of the CAT license in 2003 acquired with MorphoSys equity. Amortization of capitalized intangibles for the year 2003 was EUR 1.6 million compared to EUR 1.2 million in the previous year.

Investment in Property and Equipment amounted to EUR 0.7 million in the year 2003 compared to EUR 0.9 million in the previous year. Depreciation for 2003 of EUR 0.9 million remained unchanged to the same period last year.

## **Subsidiaries / Segments / Organizational Structure**

MorphoSys' global headquarters is located in Martinsried/Munich, Germany. The Company's R&D center and all administrative departments are currently located at its headquarters. The Company currently possesses two wholly-owned subsidiaries:

### **MorphoSys U.S.A., Inc.**

MorphoSys U.S.A., Inc., was formed in the year 2000 for the purpose of assisting MorphoSys AG in marketing and commercializing its technologies. The U.S. subsidiary, with its office in Charlotte, North Carolina, was responsible for all marketing and corporate development activities of MorphoSys. In November 2002, the Company announced restructuring measures with the aim of reducing expenditures related to the development of proprietary drug candidates and refocusing its commercial strategy. In line with these measures the activities of MorphoSys U.S.A., Inc. were transferred to MorphoSys AG in Germany and the operations in Charlotte, NC, were substantially closed by year-end 2002. Termination of all leased office space was finalized in August 2003, and represented the last significant expenditure associated with the subsidiary.

All costs, actual and estimated, which are associated with MorphoSys U.S.A., Inc. have been included in the financial statements and notes thereof.

### **MorphoSys IP GmbH**

In November 2002, MorphoSys formed MorphoSys IP GmbH, whose purpose is to administer the internally-generated intellectual property of MorphoSys AG. To this end MorphoSys AG sold at fair market value the rights to certain internally-generated intellectual property in 2002. MorphoSys IP GmbH is a wholly-owned subsidiary of MorphoSys AG, and a profit-pooling agreement exists between those two companies. In order to fulfill its operational needs, MorphoSys IP GmbH has contracted administrative services from MorphoSys AG and entered into a sublicensing agreement with MorphoSys AG, in order to enable MorphoSys AG to commercialize said patents/technologies.

## **Commercial Partnerships and Alliance Development**

MorphoSys possesses one of the leading technologies in the field of human antibodies. The Company makes use of its technology not only in development of its own products but also in collaborations with internationally re-known pharmaceutical and biotech companies.

In 2003, the Company was able to report progress in its existing partnerships. In addition, existing collaborations were expanded and new collaborations signed. The following partnerships were either established or expanded in the 2003 fiscal year (in alphabetical order):

### **Boehringer Ingelheim GmbH**

MorphoSys AG and Boehringer Ingelheim GmbH ("Boehringer Ingelheim") signed a cross-licensing agreement in February 2003. Under the agreement, MorphoSys obtained the exclusive worldwide license for patents which are in possession or control of Boehringer Ingelheim, in order to develop, manufacture and sell therapeutic and diagnostic antibodies against ICAM-1 (intercellular adhesion molecule-1). For the sale of therapeutic or diagnostic antibodies against ICAM-1, MorphoSys will pay milestone payments and royalties to Boehringer Ingelheim. In return, Boehringer Ingelheim will receive exclusive licenses for therapeutic antibodies against two undisclosed target molecules that MorphoSys will develop with its HuCAL<sup>®</sup> GOLD antibody technology. Should antibodies be further developed by Boehringer Ingelheim, MorphoSys will receive milestone payments and royalties from Boehringer Ingelheim for the development and sale of these HuCAL<sup>®</sup> GOLD antibodies.

### **Lonza Biologics**

In January 2003, MorphoSys AG signed an agreement with Lonza Biologics ("Lonza") for the production of clinical-grade HuCAL<sup>®</sup> antibodies. The term of the contract is five years and provisions in the contract guarantee MorphoSys access to Lonza's antibody manufacturing capacities. The agreement comprises future development projects both for MorphoSys' own antibody projects and for antibodies from collaborations. Under the scope of the collaboration, MorphoSys can offer its partners manufacturing capacities at Lonza and thereby substantially increase the value of its antibody projects.

### **Pfizer Inc.**

In December 2003 MorphoSys AG and Pfizer Inc. ("Pfizer") announced a collaboration for the development of therapeutic antibodies. Under the collaboration, MorphoSys will use its HuCAL<sup>®</sup> GOLD library to generate therapeutic antibodies against multiple targets from Pfizer. Pfizer is to carry out the pre-clinical and clinical development and the subsequent marketing of resultant products. MorphoSys received an upfront payment, and, for each antibody developed in the collaboration, research support and milestone payments. MorphoSys also stands to receive royalty payments on any antibody products coming out of the collaboration. The potential value to MorphoSys in committed funding and potential developmental milestone payments on future products is estimated to be in excess of U.S.\$ 50 million, not including royalties.

## **Antibodies by Design**

The Company launched a new business initiative, "Antibodies by Design" in 2003. This new initiative was created to leverage MorphoSys' core technological capabilities in the design and manufacture of antibodies for research purposes; it will commercialize the HuCAL<sup>®</sup> technology focusing on the custom generation of research antibodies for partners on an individual basis. The Company expects that it will partner Antibodies by Design's "sequence-to-antibody" services with established catalog antibody providers and, subsequently, with protein array providers. Antibodies by Design's "sequence-to-antibody" services are expected to allow for the development of custom antibodies from only the antigen sequence information with a lead-time of approximately ten to twelve weeks, in comparison to the current market benchmark of six months.

## **Manufacturing**

As a result of its partnership with Lonza Biologics, MorphoSys has gained a competent partner in the production of antibody material. Lonza has many years of experience in the field of process optimization and production of biological agents. The production of clinical antibody material is a time-consuming and expensive procedure, which is strictly controlled by the relevant authorities.

For its own pre-clinical investigations, MorphoSys produces antibodies in milligrams. The new business initiative "Antibodies by Design" also produces antibodies for its customers in this quantity. The current MorphoSys capacity is fully capable of producing antibodies in these amounts, and these materials are used exclusively for research and are therefore not subject to any particular production guidelines. MorphoSys currently has no plans to build its own production facilities for the manufacture of clinical antibody material due to the investment and expense involved with such production sites.

## **Human Resources**

### **People at MorphoSys**

At MorphoSys, there is a very high focus on Company personnel, as the Company's future success is in large part due to the commitment and performance of the people working there. In order to achieve maximum corporate success, it is of central significance for the Company to hire the most highly qualified and motivated employees and to be able to retain them for the long term.

Various measures currently in place at the Company serve to create optimum working conditions for all employees. As an example, employees with personnel management responsibilities attend leadership and management skill seminars. In addition, technical or specialist training form an important part of each employee's experience at MorphoSys. As part of the Company's international orientation, MorphoSys offers English courses to all its employees.

As in previous years, stock options and convertible bonds were offered to all employees as part of a long-term incentive scheme. The aim of this program is to give employees a long-term

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stake in the success of the Company. In addition, all employees take part in a Company-wide management-by-objectives program. The programs targets include both Company and personal goals. The achievement of each employee's goal is linked to the annual bonus program. Such measures guarantee a goal-orientated culture across the Company.

In 2003, MorphoSys employees also produced a Company "Credo". This credo is the model for interaction and communication within the Company as well as for cooperation with partners and customers. Intensive and open dialog across all levels of the hierarchy is promoted to ensure that all employees understand, promote and implement the Company's essential values.

### **Significant Appointments**

#### ***Supervisory Board of MorphoSys AG***

At the ordinary stockholders' assembly of May 16, 2003, the two members of the Supervisory Board Prof. Jürgen Drews and Prof. Andreas Plückthun were re-elected. Prof. Jürgen Drews, Managing Director of the Bear Stearns Health Innoventure Fund, is the Deputy Chairman of the Supervisory Board and has been on the MorphoSys AG Supervisory Board since 1997. Prof. Andreas Plückthun, Professor of Biochemistry at the University of Zurich, Switzerland, is a co-founder of MorphoSys AG.

#### ***Antibodies by Design***

In order to establish the new business initiative, MorphoSys was able to recruit two new employees, experienced in the area of marketing and sales of research reagents during the year.

Dieter Lingelbach joined MorphoSys on April 1, 2003 from Roche Diagnostics, where he was responsible for global marketing and sales of biochemicals. He heads the new business initiative "Antibodies by Design" and serves as Senior Vice President. Mr. Lingelbach has almost 20 years of professional experience in management consulting at Booz, Allen & Hamilton and in diagnostics, health care and biotechnology at Roche Diagnostics (formerly Boehringer Mannheim), mostly in the areas of strategy development, marketing and sales.

Joanne Crowe joined MorphoSys in May 2003 from Qiagen, where she was International Marketing Director responsible for the management of global marketing activities and planning and administration of Qiagen's marketing budget. At MorphoSys, she was appointed as Senior Director Marketing & Sales responsible for all marketing & sales activities of "Antibodies by Design". Ms. Crowe has more than 12 years experience in marketing and marketing communications to the life science research industry.

## Number and Qualification of Employees

On December 31, 2003 the MorphoSys Group employed 95 employees (December 31, 2002: 110). The MorphoSys Group employed an average of 93 employees for the full year 2003 (2002: 116): For Q4 2003, the average was 95 employees (Q4 2002: 116).

Of the 95 employees, 71 worked in research and development and 24 in administration and sales. At the end of 2003, 35 of MorphoSys' employees had a Ph.D. degree (December 31, 2002: 45).

On December 31, 2003, MorphoSys employed 2 trainees as "technical information processors in the area of information technology" (December 31, 2002: 2 trainees).

## Environment and Health Protection

MorphoSys carries out its research in safety level "Bio I" and "Bio II" laboratories and under observance of all relevant legal guidelines. Internal standards are more stringent than those guidelines which are legally required. One designated full-time employee for work safety is part of the competent team of employees specifically responsible for work safety, biological safety and fire prevention. Employees are given regular training to inform them of the latest guidelines. To date, no official inspections have resulted in any requirement to change procedures. Due to regular maintenance by internal employees, all laboratory equipment adheres to the highest possible standard of safety.

A detailed waste management concept which has been extensively documented, ensures that disposal of laboratory waste is always in line with valid limits and guidelines.

Regular medical checks are carried out for all MorphoSys employees. An initial medical check is carried out for all new employees in the research department. Such checks are repeated yearly. Furthermore, employees are routinely vaccinated against hepatitis A and B.

## Research and Development

MorphoSys uses its own HuCAL<sup>®</sup> technology for development of therapeutic antibodies and research reagents. This technology has been thoroughly tried and tested in numerous partnerships.

In the course of its therapeutic antibody collaborations, MorphoSys generates human antibodies for its partners which are then optimized according to their requirements. In the context of these partnerships, MorphoSys is responsible for the manufacture and optimization of the antibodies whereas the partner is responsible for pre-clinical and clinical development.

More recently, MorphoSys has been developing its own proprietary therapeutic antibodies as candidates for out-licensing to potential partners, prior to their entry into clinical development.

## Collaborations

In the course of the 2003 fiscal year, MorphoSys made significant progress in various existing collaborations.

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### ***Bayer AG***

In January 2003, Bayer AG ("Bayer") purchased an exclusive license to further develop a HuCAL<sup>®</sup> antibody. This antibody targets an undisclosed solid tumor target molecule. The antibody was selected from the HuCAL<sup>®</sup> library by Bayer Biotechnology, Berkeley, California, U.S.A and characterized in detail. Furthermore, the antibody demonstrated to be significantly effective in various cancer-animal models. Bayer is currently planning to further characterize the most promising candidate in further pre-clinical studies and then to proceed to clinical development in the indication of solid tumors.

In December 1999, MorphoSys and Bayer signed an extensive partnership agreement for the development of antibodies. In July 2001, the collaboration was extended for a further four years. The collaboration focuses on the manufacture of human antibodies for therapeutics, diagnostics, and genome research. Bayer is focusing on the development of therapeutic antibodies derived from HuCAL<sup>®</sup> and currently has several antibody programs in various indications. The acquisition of this exclusive license is Bayer's second such license from MorphoSys. Moreover Bayer retains further options for exclusive licenses for the development of therapeutic HuCAL<sup>®</sup> antibodies.

MorphoSys AG announced an agreement with Bayer HealthCare for the cross-licensing of certain technologies. Under the agreement, MorphoSys received the human cell line HKB 11 for production of HuCAL<sup>®</sup> antibodies. MorphoSys also received the right to use the cell line for its own research and an option for the commercial production of antibodies using the HKB 11 cell line. In exchange, Bayer will switch its in-house R&D programs to the MorphoSys HuCAL<sup>®</sup> GOLD antibody technology. Additionally, MorphoSys received an installation fee from Bayer HealthCare.

### ***Boehringer Ingelheim GmbH***

In the context of the partnership agreement signed in February 2003, Boehringer Ingelheim selected its first option for development of a therapeutic antibody in November 2003. MorphoSys will develop a therapeutic antibody against an undisclosed target molecule in the field of inflammatory diseases and select this antibody from the HuCAL<sup>®</sup> GOLD library. Boehringer Ingelheim will be responsible for the further pre-clinical and clinical development as well as for the subsequent marketing of any resulting products.

### ***Centocor Inc.***

In July 2003, MorphoSys achieved the third milestone in the collaboration with Centocor Inc. ("Centocor"), a subsidiary of the US company Johnson & Johnson. MorphoSys generated several antibodies against a Centocor target molecule in the inflammatory diseases indication. The antibodies, which were systematically optimized by MorphoSys, met all eight predefined success criteria, and thus triggered the milestone.

In December 2000, MorphoSys and Centocor undertook to collaborate on the development of human antibodies in various indications. In the context of the collaboration, Centocor was granted the option of developing therapeutic antibodies against up to 30 different target molecules. In March 2002, Centocor AutoCAL<sup>™</sup> ordered the system developed by MorphoSys for the automated screening of the HuCAL<sup>®</sup> antibody library.

### ***F. Hoffmann-La Roche***

MorphoSys and F. Hoffmann-La Roche ("Roche") presented successful and promising animal data from their collaboration on Alzheimer's disease at the "33rd Annual Meeting of the Society for Neuroscience" in New Orleans, Louisiana, U.S.A. Within the collaboration, MorphoSys, using its HuCAL<sup>®</sup> library, generated antibodies against Roche's Alzheimer target molecule amyloid  $\beta$ -peptide (A $\beta$ ). The antibodies bound very specifically to human amyloid plaques (protein deposits). In the Alzheimer animal model performed by Roche, the systemically administered antibodies demonstrated highly specific binding to the amyloid plaques in the brains of transgenic mice. Massive accumulations of amyloid plaques in the brain are symptomatic of Alzheimer patients. The use of antibodies against such amyloid plaques could therefore be a possible method of treatment for Alzheimer patients.

MorphoSys and Roche have been collaborating since September 2000 on developing antibodies for the treatment of Alzheimer's disease. Using its proprietary HuCAL<sup>®</sup> library, MorphoSys generated various antibodies against the target molecule of Roche. Between December 2000 and March 2001 a total of four milestones were reached in the collaboration. MorphoSys provided a series of HuCAL<sup>®</sup> antibodies which bound selectively to human cerebral tissue affected by Alzheimer's disease. Both in *in vitro* studies and in the Alzheimer animal model, the HuCAL<sup>®</sup> antibodies generated by MorphoSys showed a high affinity for the target molecule. Looking ahead, MorphoSys has the potential to receive milestone payments and royalties for end products derived from the collaboration.

### ***Schering AG***

In July 2003, MorphoSys and Schering AG ("Schering") announced successful results from their collaboration. Working under the collaboration, MorphoSys selected and optimized antibodies against a Schering oncological target molecule. These antibodies had previously showed effectiveness in an *in vitro* test system. Moreover, the antibody showed specific accumulation in tumor tissue in tumor localization studies with mice.

MorphoSys and Schering signed a strategic collaboration agreement in December 2001. As part of the collaboration, the companies are developing therapeutic antibodies and *in vivo* diagnostic agents, particularly in the oncology indication. The MorphoSys HuCAL<sup>®</sup> GOLD technology is used in Schering's plants in Berlin and also at Berlex Biosciences in Richmond, California, U.S.A.

### **Proprietary Antibody Development**

MorphoSys is developing human therapeutic antibodies in the indications of inflammatory diseases, cancer and infectious diseases. The Company intends to out-license these candidates prior to the start of their clinical development. The pipeline with proprietary antibody products currently includes the following candidates:

#### ***MOR101 and MOR102 (ICAM-1)***

MOR101 and MOR102 are human HuCAL<sup>®</sup> antibodies against the target molecule ICAM-1 (intercellular adhesion molecule-1), also known as CD54.

MOR101, a Fab fragment, is being developed for the indication of dermal burns. There is a significant medical need for this drug as there are currently no drugs on the market which treat dermal burns.

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MOR102, a HuCAL<sup>®</sup> IgG antibody, is being currently developed for the indication of psoriasis. Further development potential may arise from additional inflammation indications such as rheumatoid arthritis.

Due to their strong anti-inflammatory properties without related immune suppressive side effects, both anti-ICAM-1-antibodies have the potential to replace existing standard therapies.

In October 2003, MorphoSys published the first promising results from pre-clinical studies for MOR101 and MOR102.

In a preliminary animal model for MOR 101, a chimeric Fab fragment derived from the murine BIRR-1 antibody was tested. The study demonstrated that this fragment displays the same effectiveness as the complete murine antibody BIRR-1. This study was performed in collaboration with Prof. Pallua and Dr. Fuchs, Plastic Surgery, University of Aachen.

In an animal model for psoriasis, it was shown that administration of MOR102 reduces epidermal swelling by 40%. The studies were performed in collaboration with Prof. Boehncke, Department of Dermatology, University of Frankfurt.

On the basis of these results, MorphoSys is planning to further develop the two antibody programs, MOR101 and MOR102, and is currently looking for a partner to take over further pre-clinical and clinical development.

### ***Further Development Programs***

MorphoSys currently has two further antibody programs. Both programs are still in the research phase:

- MOR202 is a human HuCAL<sup>®</sup> antibody against an undisclosed target molecule in the indication of oncology.
- Another program is currently in progress. No further information on this has been disclosed to date.

MorphoSys intends to out-license its current therapeutic antibody programs to partners prior to clinical development.

### **Intellectual Property**

For biotech companies such as MorphoSys, it is of critical importance to establish an extensive international patent portfolio to protect its proprietary technologies. The centerpiece of this portfolio are the proprietary technologies pertaining to the HuCAL<sup>®</sup> antibody library. Moreover, all additional patents, which are necessary for the use of our proprietary technology, have been in-licensed.

At present, MorphoSys has six granted patents and more than 40 patent applications are pending throughout the world.

### ***IP Highlights of 2003 include:***

A positive recommendation in the patent dispute with Applied Molecular Evolution (AME): The Magistrate Judge recommended that the district judge of the district court in Boston, Massachusetts, U.S.A. allow MorphoSys' petition for non-violation of AME's patents and overrule AME's petition for patent violation by MorphoSys. If the district judge accepts the Magistrate Judge's recommendation, all counts of AME's charge will be decided in favor of MorphoSys.

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The granting of the HuCAL<sup>®</sup> EST patent in the U.S.A.: The U.S. patent (US 6,653,068) with the title of "Generation of Specific Binding Partners to (Poly)Peptides Encoded by Genomic DNA Fragments or ESTs" covers methods for expressing large quantities of EST-coded protein fragments as fusion proteins and the subsequent selection of HuCAL<sup>®</sup> antibodies against these proteins. The technology is currently employed in several of MorphoSys' collaborations with partners.

### ***Idea Database***

In 2003, MorphoSys set up software to assemble a database of ideas. A reason for using this software tool, is to systematically record and evaluate employees' ideas, notifications of inventions, and proposals for improvement. Through such a system, the creative potential of each employee can be noted, while at the same time a systematic workflow is ensured in order that interesting ideas are neither missed nor ignored.

### **Risk Report**

MorphoSys AG operates on a global basis. Its business activities comprise different risks, which are relevant to many business functions. The business, financial condition and results of operation of MorphoSys may be materially adversely affected by each of these risks. The Company has established a risk management system that is used regularly to identify, measure and control such risks as an integrated part of normal business activities.

### **Product Development**

MorphoSys is committed to generating therapeutic antibodies for its commercial partners and, more recently, its own account. Thus, the Company's product pipeline comprises both partnered and proprietary therapeutic antibody development programs. These programs are subject to a number of risks of failure inherent in the development of medical therapies. Product candidates require pre-clinical studies and clinical trials in humans as well as regulatory approval prior to commercialization. To date, none of the Company's licensees or partners has commercialized a product based on MorphoSys' HuCAL<sup>®</sup> technology and HuCAL<sup>®</sup>-derived therapeutics are not expected to be commercially available for a number of years. In addition, none of the HuCAL<sup>®</sup>-derived product candidates has reached clinical development and thus has not yet proven that it may be able to successfully complete all stages of clinical testing and regulatory approval procedures. Pre-clinical studies may not predict and do not ensure safety or efficacy in humans and are not necessarily indicative of the results that may be achieved in pivotal clinical trials with humans.

### **Competition and Technological Change**

MorphoSys' business environment is characterized by rapid change and intense competition. Its competitors include major pharmaceutical, chemical and biotech companies possessing greater financial, technical and marketing resources than those available to MorphoSys. In addition, certain biotech companies have formed collaborations with large established companies to support research, development and commercialization of products that may be competitive with those of MorphoSys. Moreover, certain research and academic institutions are also active in areas similar to MorphoSys'. Some of MorphoSys' competitors currently focus their business

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efforts on gaining a share of the market and offer their technology at little or no cost to collaboration partners. The first pharmaceutical product to reach the market is often at a significant advantage to later entrants, particularly since subsequent potential entrants must prove an advantage of their product over products already in the market. There is a risk that MorphoSys' competitors could succeed in developing technologies and products that are safer, less costly and more effective than its technologies or products. In addition, there is a risk that these technologies could produce products that reach the market earlier and could be more successful than those developed by MorphoSys.

### **Dependence on Health Care and Pharmaceutical Spending**

MorphoSys is, directly and indirectly, dependent on various sources of income, including, in particular, fees, milestone payments and royalties from licensees and partners, the financial condition of public treasuries and the financial markets, the government and governmental health authorities, research institutions, private health insurers and other organizations.

Part of MorphoSys' revenue is derived from entering into collaborations with partners, including pharmaceutical companies. Many collaborative and/or out-licensing agreements provide for milestone payments and fees to be paid subject to the satisfaction of specific criteria. MorphoSys has no control over whether its partners or licensees will be able to meet such milestones, nor will MorphoSys be able to control whether products derived from its technology are being developed at all by its partners. Moreover, certain pharmaceutical companies may be more likely to seek to in-license products which have already reached a relatively advanced stage of development, such as Phase II compounds, as opposed to less advanced product candidates still in pre-clinical stages. Consequently, the products in MorphoSys' pipeline may not reach a sufficiently advanced stage of development to be of interest to these pharmaceutical companies for some time. Therefore the Company can offer no assurance that there will be a guaranteed revenue stream from current or future collaborations.

### **IP Risks**

MorphoSys is or has been involved in legal proceedings in Germany and certain foreign jurisdictions, including the United States, including claims brought by and against it for license or patent infringement, which arise in the ordinary course of business. While the Company cannot predict the ultimate outcome of the still pending proceedings, management does not currently believe them to have a material adverse affect on the business, financial condition and results of operations of MorphoSys. However, the field of recombinant antibody libraries and phage display, in which the Company is active, is relatively new and the intellectual property position of the various parties involved is becoming increasingly complex and litigious. Therefore, MorphoSys can offer no assurance that further patent suits will not be brought by companies possessing existing patents or patents which have not yet been granted, or which the Company is currently not aware of. Any such proceedings, if brought and subsequently decided against MorphoSys, could have a material adverse effect on the business, financial condition and results of operations of MorphoSys.

## **Additional Funding Requirements**

MorphoSys' future capital requirements will continue to be substantial and will be dependent on many factors, including its ability to find licensees and to enter into satisfactory collaboration agreements as well as the success of such collaborations in generating revenues (e.g., licensing fees, milestone payments and royalties). The costs of pre-clinical testing of MorphoSys' products and technologies as well as the costs associated with filing, defending and enforcing patent rights may exceed the returns from these products. MorphoSys may also need to raise additional funds in future years. The Company can offer no assurance that adequate funds will be available to MorphoSys when needed on satisfactory terms or at all. If adequate funds are not available, or are not available on acceptable terms, MorphoSys may have to further reduce its expenditures for research and development, production or marketing. Any such development could have a material adverse effect on MorphoSys' business, financial condition and results of operations. If additional funds are raised by issuing shares, stockholders are likely to experience a dilution of their interests.

## **Currency Risk**

The group accounts are administered in euro. While the expenses of MorphoSys are predominantly paid in euro, a significant part of the sales depend on the current exchange rate of US dollar and euro. Though the Company examines the necessity of hedging transaction to minimize those currency risks once a year and closes them if necessary to prevent the annual results from negative effects. Therefore, the gains and losses resulting from hedging transactions are offset from the revenue transactions, which are hedged. In addition it is not secure, that hedging transactions will be sufficient to adjust extreme fluctuations in exchange rates.

## **Outlook for 2004**

### **Outlook for the Biotech sector**

Looking ahead into 2004, approximately 30 drugs will be launched onto the market, including products such as Avastin (Genetech), Erbitux (Imclone Systems) and Cinacalcet (Amgen). In addition to the product launches, 45 FDA approvals are expected – a number which could re-invigorate the outlook for the entire industry. Other positive news from the sector, including regulatory approvals and clinical milestones, could also provide an impetus to attract further money flow into the sector.

### **Strategy**

MorphoSys will continue to execute its strategy of partnered and proprietary therapeutic antibody development in 2004. This strategy has served the Company well in 2003, providing a positive cash flow for the year while an ever-stronger pipeline of therapeutic antibodies is being created. Management will continue to focus on securing new partnerships within which the Company's proprietary HuCAL<sup>®</sup> technology can be applied to generating future product candidates as a means of increasing the Company's long-term value. An important aspect of these activities in 2004 will be in securing a development partner for the Company's most

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advanced proprietary drug candidate MOR101 and MOR102. Additional proprietary product candidates, currently in the research phase, represent the next opportunities for out-licensing. The "Antibodies by Design" initiative, started in 2003, will continue to be pursued. The management of MorphoSys believes the Company is well positioned to execute its strategy and looks forward to a successful 2004.

### Revenues

As communicated in the previous year, 2003 was a year of consolidation after the restructuring at year-end 2002. Based on its market research, MorphoSys foresees an increase in demand for its technologies and products in 2004 as the pharma industry ramps its investment in external research and development. Company revenues are expected to increase in 2004 and achieve a double-digit percentage increase over the previous year. As such, these revenue projections are consistent with expectations for a growth Company. Revenue sources, as in previous years, will consist of committed annual licensing fees arising from the Company's multiyear partnerships and success milestones achieved within these partnerships. Within the scope of these partnerships, it is anticipated that at least one HuCAL<sup>®</sup>-derived antibody will be taken by one of MorphoSys' partners into clinical development. Also expected is the acquisition of new business partners, in the context of therapeutic antibody collaborations.

New sources of revenue are expected in 2004 which include the out-licensing of MorphoSys pre-clinical programs, in particular, MOR101 and MOR102. Also newly contributing to revenue, will be the "Antibodies by Design" initiative, formed in the year 2003, which focuses on the non-therapeutic antibody business, and in particular, on the generation of custom antibodies for research purposes.

### Expenses

Expenses are expected to rise slightly over 2003 levels. Above all, intangibles expense is likely to rise over 2003 levels due to higher amortization charges on licenses acquired in 2003. The higher charges are related to changes in accounting estimates in 2003 on the size of the license payments, and as well, due to the fact that full-year amortization charges will be charged against income, as opposed to partial-year charges in 2003 on CAT and XOMA licenses acquired. The difference in magnitude of these charges relates to the timing of the license acquisitions during the year 2003. Revenue generation and milestone achievement in certain collaborations will also trigger higher payments to third party licensors. Finally, expenses related to continuation of the AME litigation case are also expected to edge intangibles costs higher in 2004.

### Capital Investment

Capital Expenditures on Property and Equipment are expected to remain essentially constant, as compared to the previous year. The acquisition of substantial intangibles licenses, as was the case in the prior year, is currently not anticipated.

## **Human Resources**

Headcount is currently anticipated to increase only modestly. All increases are contingent on new business/collaborations to support the same.

## **R&D Activities**

In line with the previous year, MorphoSys' R&D team will focus on generating results and milestones within existing collaborations, and continue developing the existing portfolio of research/pre-clinical candidates for out-licensing. It is also planned that two new proprietary research/pre-clinical programs are to be started during the year, for eventual out-licensing.

## **Marketing/Commercial**

The Company will continue to intensify its efforts to attract new therapeutic antibody partners. In addition, the out-licensing of MorphoSys proprietary antibody candidates shall also be a priority going forward. Furthermore, the Company will continue to expand its marketing efforts relating to the "Antibodies by Design" initiative, in order to further develop the market for custom-generated non-therapeutic antibodies.

## **Dividends**

Although MorphoSys expects to continue the trend of reducing its losses, the Company believes that the payment of dividends should be deferred until such time, as its financial and liquidity position supports the same. As such, any profits generated by the business shall be reinvested into the operation of its business in order to create further growth opportunities for the future.

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**CONSOLIDATED BALANCE SHEETS (U.S. GAAP)**

	<b>December 31,</b>	
	<b>2003</b>	<b>2002</b>
	<b>EURO</b>	<b>EURO</b>
<b>ASSETS</b>		
Current Assets		
Cash and Cash Equivalents	6,652,456	842,082
Marketable Securities	16,508,575	18,274,338
Accounts Receivable	2,111,710	8,732,790
Prepaid Expenses and Other Current Assets	948,575	1,684,729
Total Current Assets	<u>26,221,316</u>	<u>29,533,939</u>
Property and Equipment, Net	1,907,895	2,097,796
Patents, Net	6,103,675	6,898,990
License Fees, Net	10,898,904	3,352,604
Other Assets	627,130	509,984
<b>Total Assets</b>	<b><u>45,758,920</u></b>	<b><u>42,393,313</u></b>
 <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current Liabilities		
Accounts Payable	258,732	2,273,539
Current Portion of License Payable	677,060	5,569,291
Current Portion of Deferred Revenue	4,272,249	4,378,995
Accrued Employees Benefits	949,122	1,468,907
Other Accrued Expenses and Liabilities	1,524,439	2,029,608
Total Current Liabilities	<u>7,681,602</u>	<u>15,720,340</u>
Non Current Liabilities		
License Payable, Net of Current Portion	1,651,360	2,275,347
Deferred Revenue, Net of Current Portion	6,086,205	3,707,360
Convertible Bonds Due to Related Parties	157,200	74,800
Total Non Current Liabilities	<u>7,894,765</u>	<u>6,057,507</u>
Stockholders' Equity		
Common Stock, € 3.00 Par Value;	14,703,996	11,849,118
Ordinary Shares Authorized (8,626,344 and 7,345,582 for 2003 and 2002, respectively) ;		
Ordinary Shares Issued (4,901,332 and 3,949,706 for 2003 and 2002, respectively)		
Ordinary Shares Outstanding (4,841,570 and 3,889,944 for 2003 and 2002, respectively)		
Treasury Stock (59,762 and 59,762 shares for 2003 and 2002, respectively), at cost	(21,934)	(21,934)
Additional Paid-in Capital	68,623,807	59,193,912
Accumulated Other Comprehensive Income/(Loss)	912,755	(517,591)
Accumulated Deficit	(54,036,071)	(49,888,039)
Total Stockholders' Equity	<u>30,182,553</u>	<u>20,615,466</u>
<b>Total Liabilities and Stockholders' Equity</b>	<b><u>45,758,920</u></b>	<b><u>42,393,313</u></b>

See Accompanying Notes

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**CONSOLIDATED STATEMENTS OF OPERATIONS (U.S. GAAP)**

	For the Years ended December 31,	
	2003	2002
	EURO	EURO
	<u>                    </u>	<u>                    </u>
<b>Revenues</b>	<b>15,308,464</b>	<b>16,757,097</b>
Operating Expenses		
Research and Development	8,998,012	19,591,834
Sales, General and Administrative	7,601,078	18,742,819
Stock Based Compensation	2,175,430	3,940,412
<b>Total Operating Expenses</b>	<b>18,774,520</b>	<b>42,275,065</b>
Loss from Operations	<b>(3,466,056)</b>	<b>(25,517,968)</b>
Interest Income	212,461	445,859
Interest Expense	874,415	687
Impairment of Marketable Securities	753,768	-
Other Income, Net	733,767	713,586
<b>Loss before Taxes</b>	<b>(4,148,011)</b>	<b>(24,359,210)</b>
Foreign Income Tax Expense	21	18,084
<b>NET LOSS</b>	<b>(4,148,032)</b>	<b>(24,377,294)</b>
Basic and Diluted Net Loss per Share	(0.96)	(6.35)
Shares Used in Computing Basic and Diluted Net Loss per Share	4,332,438	3,838,670

See Accompanying Notes

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**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (U.S. GAAP)**

	Common Stock		Treasury Stock		Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit	Total Stockholders Equity
	Shares	EURO	Shares	EURO				
<b>Balance at Jan. 1, 2002</b>	<b>3,591,331</b>	<b>10,773,275</b>	<b>59,762</b>	<b>(21,934)</b>	<b>32,452,966</b>	<b>37,047</b>	<b>(25,510,745)</b>	<b>17,730,609</b>
Exercise of stock options	495	1,485			7,177			8,662
Compensation Related to the Grant of Stock Options					3,940,412			3,940,412
Capital Increase for Euro Conversion		718			(718)			0
Capital Increase against Cash, Net of Issuance Cost of EUR 25,249	357,880	1,073,640			22,794,075			23,867,715
Other Comprehensive Loss: Change in Unrealized Losses on Available for Sales Securities						(557,178)		(557,178)
Foreign Currency Gain from Consolidation						2,540		2,540
Net Loss							(24,377,294)	(24,377,294)
Comprehensive Loss								(24,931,932)
<b>Balance at Dec. 31, 2002</b>	<b>3,949,706</b>	<b>11,849,118</b>	<b>59,762</b>	<b>(21,934)</b>	<b>59,193,912</b>	<b>(517,591)</b>	<b>(49,888,039)</b>	<b>20,615,466</b>
Compensation Related to the Grant of Stock Options					2,175,430			2,175,430
Capital Increase against contribution in kind (XOMA), Net of Issuance cost of EUR 23,314	363,466	1,090,398			3,110,896			4,201,294
Capital Increase against contribution in kind (CAT), Net of Issuance cost of EUR 150,000	588,160	1,764,480			4,143,569			5,908,049
Other Comprehensive Loss: Change in Unrealized Gain on Available for Sales Securities						1,418,156		1,418,156
Foreign Currency Gain from Consolidation						12,190		12,190
Net Loss							(4,148,032)	(4,148,032)
Comprehensive Loss								(2,717,686)
<b>Balance at December 31, 2003</b>	<b>4,901,332</b>	<b>14,703,996</b>	<b>59,762</b>	<b>(21,934)</b>	<b>68,623,807</b>	<b>912,755</b>	<b>(54,036,071)</b>	<b>30,182,553</b>

See accompanying notes

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**CONSOLIDATED STATEMENTS OF CASH FLOWS (U.S. GAAP)**

	<b>For the Years ended December 31,</b>	
	<b>2003</b>	<b>2002</b>
	<b>EURO</b>	<b>EURO</b>
<b>Operating Activities</b>		
Net Loss	(4,148,032)	(24,377,294)
<b>Adjustments to Reconcile Net Loss to Net Cash Used for Operating Activities:</b>		
Depreciation	851,743	890,034
Amortization of Intangible Assets	1,637,863	1,236,457
Net Gain on Sales of Marketable Securities	(326,270)	(276,872)
Unrealized Net Gain on Derivative Financial Instruments	(315,929)	-
Impairment of Marketable Securities	753,768	-
Gain on Sale of Property and Equipment	(2,652)	(3,940)
Net Gain from Accounting Estimate Change	(2,272,053)	-
Net Expense from Share Issuance (XOMA)	417,608	-
Recognition of Deferred Revenue	(7,930,121)	(6,416,412)
Stock-Based Compensation	2,175,430	3,940,412
<b>Changes in Operating Assets and Liabilities:</b>		
Accounts Receivable	6,621,080	(4,168,422)
Prepaid Expenses and Other Assets	1,098,937	(654,141)
Accounts Payable	(2,014,807)	2,020,599
Licenses Payable	89,612	3,847,910
Deferred Revenue	10,202,220	7,570,741
Accrued Employee Benefits	(519,785)	286,364
Other Accrued Expenses and Liabilities	(505,169)	858,768
<b>Net Cash Provided by (Used in) Operating Activities</b>	<b>5,813,443</b>	<b>(15,245,796)</b>
<b>Investing Activities:</b>		
Purchases of Marketable Securities	(12,075,587)	(39,552,408)
Proceeds from Sales of Marketable Securities	14,832,008	29,054,127
Purchases of Property and Equipment	(682,077)	(921,770)
Proceeds from Disposals of Property and Equipment	22,887	25,508
Additions to Patents	(58,746)	(496,630)
<b>Net Cash Provided by (Used in) Investing Activities</b>	<b>2,038,485</b>	<b>(11,891,173)</b>
<b>Financing Activities:</b>		
Proceeds from the Issuance of Common Stock, net	-	23,876,377
Proceeds from the Issuance of Convertible Bonds to Related Parties	82,400	74,800
Purchases of Derivative Financial Instruments	(164,000)	-
Payment of Financed License Payable	(1,798,830)	-
Cost of Share Issuance	(173,314)	-
<b>Net Cash Provided by (Used in) Financing Activities</b>	<b>(2,053,744)</b>	<b>23,951,177</b>
Effect of Exchange Rate Differences on Cash	12,190	2,540
Increase (Decrease) in Cash and Cash Equivalents	5,810,374	(3,183,252)
<b>Cash and Cash Equivalents at the Beginning of the Period</b>	<b>842,082</b>	<b>4,025,334</b>
<b>Cash and Cash Equivalents at the End of the Period</b>	<b>6,652,456</b>	<b>842,082</b>
<b>Supplemental Disclosures of Cash Flow Information:</b>		
Cash Received During the Year for Foreign Income Taxes	-	38,472
Unrealized Gain (Loss) on Marketable Securities	1,418,156	(557,178)
Interest Paid	201,170	-
Non-Cash Settlement of License Payable (XOMA)	4,224,608	-
License to be Settled in Equity	-	3,160,386
Non-Cash Settlement of License Payable (CAT)	8,330,102	-
Capital Increase for Euro Conversion	-	718

See Accompanying Notes

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2003 AND 2002

### 1. Organization and Summary of Significant Accounting Policies

#### Business and Organization

MorphoSys AG ("the Company") is a biotechnology company using combinatorial biology in drug discovery with the principal objective of developing and commercially exploiting new enabling technologies across a broad scientific spectrum. The Company was founded in July 1992 as a German limited liability company. In June 1998, MorphoSys AG was transformed into a German stock corporation. In March 1999, the Company went public on Germany's Neuer Markt, the stock exchange designated for high-growth enterprises. On January 15, 2003, MorphoSys AG was admitted to the Prime Standard segment of the Frankfurt Stock Exchange.

Substantially all operations are located in Germany. The Company has two wholly owned subsidiaries:

MorphoSys U.S.A., Inc., which was incorporated in the United States on February 16, 2000. The subsidiary's purpose was to assist the Company in the sale and licensing of MorphoSys AG products. MorphoSys U.S.A., Inc. substantially ceased its operations in November 2002.

MorphoSys IP GmbH, which was incorporated in Munich, Germany, on November 6, 2002. The subsidiary's purpose is to purchase, maintain and administer certain intangible assets of the MorphoSys Group. The Company's operations are physically located at the premises of MorphoSys AG, and the operations of MorphoSys IP GmbH commenced on December 31, 2002.

The accompanying consolidated financial statements reflect the application of certain significant accounting policies as described in this note and elsewhere in the accompanying consolidated financial statements and notes.

#### Basis of Financial Statement Presentation

The accompanying financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP). In accordance with German law, the Company is required to publish its financial statements in accordance with the German Commercial Code, which represents generally accepted accounting principles in Germany ("German GAAP"). German GAAP varies in certain significant respects from U.S. GAAP. Accordingly, the Company has recorded certain adjustments, principally relating to revenue recognition and the recording of certain costs, in order to present the accompanying financial statements in accordance with U.S. GAAP.

#### Use of Estimates

The preparation of the consolidated financial statements in conformity with accounting standards generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

## **Cash and Cash Equivalents**

The Company considers all highly liquid investments with an original maturity of three months or less to be cash equivalents. The Company invests its cash in deposits with two major German financial institutions.

## **Consolidation**

The accompanying financial statements consolidate the financial position, results of operations, and cash flows of MorphoSys AG and its subsidiaries. All intercompany transactions and balances have been eliminated.

## **Marketable Securities**

The Company accounts for its marketable securities using Statement of Financial Accounting Standards ("SFAS") No. 115, "Accounting for Certain Investments in Debt and Equity Securities." Management determines the proper classifications of securities at the time of purchase and re-evaluates such designations as of each balance sheet date. At December 31, 2003 and at December 31, 2002, such securities that are classified as available-for-sale are carried at market value with unrealized gains and losses reported in accumulated other comprehensive income, which is a separate component of stockholders' equity. Realized gains and losses on sales of investments, as determined on a specific identification basis, are included in the statements of operations when the investment is sold or matures. On a regular basis, the Company tests for impairment. If a decline in the fair value of available-for-sale securities is judged to be other than temporary, the cost basis for the security is written down to fair value as new cost basis. The written down amount is included in earnings as an impairment charge. The Company considers a decline in the market value of a marketable security, which is longer than six months in duration, to be deemed other than temporary unless specific facts and circumstances indicate otherwise.

## **Derivative Financial Instruments**

The Company accounts for its derivative instruments using SFAS No. 133 "Accounting for Derivative Instruments and Hedging Activities" and its corresponding amendments under SFAS No. 138. SFAS No. 133 requires the Company to measure every derivative instrument at fair value and record them as either an asset or liability. Changes in fair value are recorded in other income (see note 5).

## **Property and Equipment**

Property and equipment is stated at cost, less accumulated depreciation and amortization. Major replacements and improvements are capitalized while general repairs and maintenance are charged to expense as incurred. Assets are depreciated over three to ten years using the straight-line method. Leasehold improvements are amortized over the estimated useful lives of the assets or the related lease term, whichever is shorter.

## **Revenue Recognition**

The Company's revenues include technology access fees; fees earned from research and development collaboration agreements predominately with companies based in the United States.

Revenue related to non-refundable technology access fees, subscription fees and license fees are deferred and recognized on a straight-line basis over the relevant periods of the agreement, generally the research term or the estimated useful life of the collaboration for those contracts without a stipulated term unless a more accurate means of recognizing revenue is available. Research and development collaboration service fees are recognized in the period that the services are provided. Milestone revenues are recognized upon achievement of certain criteria.

Investment grants from governmental agencies for the support of specific research and development projects are recorded as revenue to the extent the related expenses have been incurred: Under the terms of the investment grants, the governmental agencies generally have the right to audit the use of the payments received by the Company.

For revenue arrangements with multiple deliverables the Company tests for separate units of accounting based on the criteria stated in EITF 00-21. If certain criteria are met, the consideration will be allocated among the separate units based on their respective fair values, and the applicable revenue recognition criteria will be considered separately for each of the separate units.

Deferred revenue represents revenues received but not yet earned per the terms of the contracts. At December 31, 2002 deferred revenue included EUR 2.8 million, for which cash was not received until January 2003. At December 31, 2003, cash was received for all deferred revenue recorded.

## **Segment Reporting**

The Company operates primarily in one business segment related to the development of antibody therapeutics within the Biotech-Industries. Accordingly, the Company does not disclose significant additional segment information under the definition of segment reporting, defined by the standards of SFAS No. 131, "Disclosure About Segments of an Enterprise and Related Information."

## **Research and Development**

Research and development costs are expensed as incurred.

## **Stock-Based Compensation**

The Company applies the provisions of SFAS No.123 "Accounting for Stock-Based Compensation," which requires the Company to record the estimated fair value of stock options and other awards at the grant date as compensation expense over the period in which the employees render the services associated with the award.

### **Foreign Currency Translation**

The financial statements of foreign subsidiaries have been translated into Euro in accordance with SFAS No. 52, "Foreign Currency Translation." All balance sheet accounts have been translated using the exchange rates in effect at the balance sheet date. The statement of operations amounts have been translated using the average exchange rate for the year. The gains and losses resulting from the changes in exchange rates from year-to-year have been reported in accumulated other comprehensive income.

### **Net Loss Per Share**

Basic and diluted loss per share is calculated in accordance with SFAS No. 128, "Earnings per Share". Basic loss per share is based upon the number of weighted-average shares of common stock outstanding for the respective years.

The Company's outstanding stock options and convertible bonds were excluded from the above calculations of dilutive net loss per share, as the effect of their inclusion would have been anti-dilutive.

### **Impairment of Long-Lived and Identifiable Intangible Assets**

The Company evaluates the carrying value of long-lived assets and identifiable intangible assets for potential impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Recoverability is determined by comparing projected undiscounted cash flows associated with such assets to the related carrying value. An impairment loss is recognized when the estimated undiscounted future cash flows are less than the carrying amount of the asset. An impairment loss would be measured as the amount by which the carrying value of the assets exceeds the fair value of the asset.

### **Patent Costs**

The Company capitalizes costs related to obtaining patents and protecting granted patents from infringement. Capitalized costs principally relate to the costs of legal counsel. Patent costs are amortized on a straight-line basis over the lesser of their estimated economic life or remaining patent term (10 years). Amortization commences at the time the patent is issued. The Company's patents covering its proprietary HuCAL<sup>®</sup> technology were granted in Australia in October 2000, in the United States of America in October 2001 and in Europe in June 2002. Further patent applications are pending in Canada and Japan.

### **Accounting for Acquired License Rights**

The Company acquired license rights by making upfront licensing payments, annual maintenance fees and sublicensing payments to third parties. The Company amortizes up-front licensing payments on a straight-line basis over the estimated useful life of the acquired license (10 years). Annual maintenance fees are amortized over the term of each annual agreement. Sublicensing payments are amortized on a straight-line basis over the life of the contract or the estimated useful life of the collaboration for those contracts without a stipulated term.

**Concentration of Credit Risk**

Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of cash, cash equivalents, marketable securities and accounts receivable. The Company's cash and cash equivalents are principally denominated in Euro and U.S. dollars. Marketable securities are placed in high-quality securities. Cash, cash equivalents and marketable securities are maintained principally with two high-quality financial institutions in Germany. The Company continually monitors its positions with, and the credit quality of, the financial institutions, which are counter parties to its financial instruments, and does not anticipate non-performance. The Company's revenues and accounts receivable are subject to credit risk as a result of customer concentrations. One customer individually accounted for approximately 88% of the Company's 2003 accounts receivable balance. In addition, three customers individually accounted for 40%, 27% and 15% of the Company's total revenues in the year 2003. On December 31, 2002, two customers accounted 50% and 46% for prior year's accounts receivable balance and three customers individually accounted for 39%, 25% and 13% of the Company's revenues in 2002.

**Accounts Receivable**

For accounts receivable, the allowance for doubtful accounts is based on the management's assessment of the collectibility of specific customer accounts and the aging of the accounts receivable. If there is a deterioration of a major customer's credit worthiness or actual defaults are higher than the historical experience, management's estimates of the recoverability of amounts due the Company could be adversely affected. Based on management assessment, no allowance was necessary on December 31, 2003 and 2002. The company does not require collateral from customers for accounts receivable. On December 31, 2003 and 2002, accounts receivable included unbilled amounts of approximately EUR 119,360 and EUR 265,000 respectively.

**Income Taxes**

The Company accounts for income taxes under SFAS No. 109, "Accounting for Income Taxes" using the liability method. Income taxes and credits are provided at statutory rates for taxable items included in the statements of operations regardless of the period in which such items are reported for income tax purposes. Deferred income taxes are recognized for temporary differences between financial statement and income tax bases of assets and liabilities for which income tax benefits will be realized in future years. Deferred tax assets are reduced by a valuation allowance if, based upon the weight of available evidence, it is more likely than not that some portion or all of the related tax asset will not be realized.

**Fair Value of Financial Instruments**

The carrying value of financial instruments such as cash and cash equivalents, accounts receivable and accounts payable approximate their fair value based upon the short-term maturities of these instruments. The fair value of marketable securities is based upon quoted market prices (see note 3). The fair value of license payables are determined by the effective interest method. Convertible Bonds are recorded at their accreted values, which approximate the cash outlay that is due upon the note settlements.

## **Reclassifications**

Certain amounts in prior year's consolidated financial statements have been reclassified to conform to the current year's presentation.

## **Effects of New Accounting Standards and Regulations**

In November 2002, the Emerging Issues Task Force (EITF) of the FASB issued EITF 00-21, "Revenue Arrangements with Multiple Deliverables," which addresses certain aspects of the accounting for arrangements that involve the delivery or performance of multiple products, services and/or rights to use assets. Under EITF 00-21, revenue arrangements with multiple deliverables should be divided into separate units of accounting if certain criteria are met, including whether there is objective and reliable evidence of the fair value of the undelivered items. In addition, the consideration should be allocated among the separate units based on their respective fair values, and the applicable revenue recognition criteria should be considered separately for each of the separate units. EITF 00-21 is effective for the Company's revenue arrangements entered into beginning July 1, 2003. Our adoption of EITF 00-21 did not have a material impact on our results of operations or financial position.

In July 2003, the FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities" ("FIN 46"), an interpretation of Accounting Research Bulletin No. 51, "Consolidated Financial Statements." FIN 46 prescribes how to identify variable interest entities and how an enterprise assesses its interests in a variable interest entity to decide whether to consolidate that entity. In October 2003, the implementation date of FIN 46 was deferred until the end of the first interim or annual period ending after December 15, 2003. On December 24, 2003 the FASB issued a revision to Interpretation 46 ("46R") to clarify some of the provisions of FASB Interpretation No. 46, Consolidation of Variable Interest Entities, and to exempt some entities from its requirements.

Under the new guidance special effective date provisions apply to enterprises that have fully or partially applied Interpretation 46 prior to issuance of this revised Interpretation. Our adoption of FIN 46 did not have a significant effect on our results of operations or financial position.

In April 2003, the FASB issued SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities," which amends and clarifies accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and hedging activities under FAS No. 133. The amendments set forth in SFAS No. 149 improve financial reporting by requiring that contracts with comparable characteristics be accounted for similarly. The provisions of SFAS No. 149 are effective for contracts entered into or modified after June 30, 2003. Our adoption of SFAS No. 149 did not have a significant effect on our results of operations or financial position.

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity". This statements establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. The provisions of SFAS No. 150, which also include a number of new disclosure requirements, are effective for instruments entered into or modified after May 15, 2003 and pre-existing instruments as of the beginning of the first interim period that commences after June 15, 2003. The adoption of the SFAS No. 150 did not have a significant effect on our results of operations or financial position.

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On December 17, 2003 the Securities and Exchange Commission ("SEC") published Staff Accounting Bulletin (SAB) No. 104, "Revenue Recognition". SAB No. 104 updates portions of the SEC Staff's interpretive guidance provided in SAB No. 101 and included in Topic 13 of the Codification of Staff Accounting Bulletins. SAB No. 104 deletes interpretive material no longer necessary, and conforms the interpretive material retained, because the pronouncements issued by the FASB's EITF on various revenue recognition topics, including EITF 00-21. SAB No. 104 also incorporates the codification of certain sections SAB No. 101's frequently asked questions and answers. The adoption of SAB No. 104 did not have a significant effect on our results of operations or financial position.

## 2. Restructuring

In November 2002, MorphoSys announced restructuring measures. These measures included the discontinuation of clinical drug development and the refocusing of the Company's commercial strategy. These measures were implemented in 2003 in the aim of strengthening the Company's financial position by significantly reducing its cost base.

In November 2002, the Company took actions to reduce its headcount by 24% from 120 to 91 employees, thereof 26 in Germany and 3 in the U.S.A. The total amount of expenses relating to the restructuring plan amounted to EUR 731,837. Of this total amount, EUR 387,415 were part of the Sales, General and Administrative costs (of which EUR 268,610 are related to MorphoSys U.S.A., Inc.), and EUR 344,421 were allocated to Research & Development expenses. The EUR 268,610 include leasehold improvements, cancellation fees, and severance payments. At December 31, 2002, EUR 47,449 of the total termination benefits had been paid and EUR 684,388 were included in accrued expenses of which EUR 415,778 were included in accrued employee benefits. Payments made in 2003 related to restructuring activities from 2002, approximated the estimated accrual at December 31, 2002. In August 2003, the last remaining liability related to the early termination of leased office space in the U.S. was settled. No significant further expenditures are currently anticipated. Therefore, the restructuring accrual at December 31, 2003 was zero.

### 3. Marketable Securities

Marketable securities consist of the following as of December 31, 2003 and 2002 (in thousands EUR):

	<b>Maturity</b>	<b>Cost</b>	<b>Gross Unrealized Holding</b>		<b>Market Value</b>
			<b>Gains</b>	<b>Losses</b>	
December 31, 2003					
HVB Euro Bond	June 7, 2011	3,268	456	-	3,724
HVB Debentures	December 6, 2009	2,562	161	-	2,723
DB Money Market Funds	daily	10,181	245	-	10,426
		<u>16,011</u>	<u>862</u>	<u>-</u>	<u>16,873</u>
Restricted Cash					<u>364</u>
					<u>16,509</u>
December 31, 2002					
HVB Euro Bond	June 7, 2011	3,794	-	(526)	3,268
HVB Debentures	December 6, 2009	2,789	-	(269)	2,520
DB Money Market Funds	daily	12,611	239	-	12,850
		<u>19,194</u>	<u>239</u>	<u>(795)</u>	<u>18,638</u>
Restricted Cash					<u>364</u>
					<u>18,274</u>

The net unrealized holding gains of EUR 861,929 for the year ended December 31, 2003 and net unrealized holding losses of EUR 556,228 for the year ended December 31, 2002 were recorded as a separate component of stockholders' equity. The unrealized losses in 2002 were due to a decline in the market value of marketable securities placed with HypoVereinsbank, as a result of a down- grading of the bank.

The Company invested for an aggregate amount of EUR 3.8 million in a silent partnership of HypoVereinsbank Luxembourg and EUR 2.8 million in securities of the HypoVereinbank AG. Under SFAS No. 115 "Accounting for Certain Investments in Debt and Equity Securities", both investments are designated as available-for-sale and are reported at fair value on the Company's balance sheet. Under the Company's accounting policy, marketable securities are presumed to be impaired, if their fair value is less than their cost basis for more than six months, unless specific facts and circumstances indicate otherwise. If the Company deems these investments further impaired at the end of any other period, an additional impairment may occur. During 2002/2003 MorphoSys' HypoVereinsbank investments had traded below their original cost basis for more than six months and therefore the Company deemed that an impairment of these investments had occurred. Accordingly impairment charges from January 2003 to June 2003 of EUR 753,768 were recognized in June 2003. Since June 30, 2003, the two impaired investments

have recovered and at December 31, 2003 the two investments had regained EUR 617,000 in market value.

For further details of restricted cash items see Note 4.

#### **4. Restricted Assets**

The Company has classified as restricted cash certain cash and cash equivalents and marketable securities in other assets that are not available for use in its operations. At December 31, 2003 and 2002, the Company had commitments of EUR 364,000 for guarantees issued and EUR 157,200 and EUR 74,800, respectively, for convertible bonds issued to employees.

#### **5. Derivative Financial Instruments**

In May 2003, MorphoSys entered into foreign currency options contracts to hedge foreign exchange exposure related to US Dollar accounts receivable. At December 31, 2003, options contracts in the notional amount of EUR 4,690,583 million or USD 5,250,000 million were outstanding and will mature between January 2004 and February 2004. The fair market value at December 31, 2003 was EUR 479,929 and recorded in other current assets on the balance sheet. The Company did not have any derivative financial instruments at December 31, 2002.

At December 31, 2003, the remaining contract premium for derivatives amounted to EUR 164,000.

For the period ending at December 31, 2003, unrealized gains amounted to EUR 315,929, of which EUR 193,500 were realized in January 2004 and included in total foreign exchange gains of EUR 389,196 (2002: EUR 483,042).

## 6. Accumulated Other Comprehensive Income (Loss)

Accumulated other comprehensive income/(loss) consists of unrealized gains or losses on marketable securities and translation adjustments from consolidation. For the period ended December 31, 2003 and 2002, the components of accumulated other comprehensive income/(loss) were as follows (in thousands EUR):

	<b>December 31,</b>	
	<b>2003</b>	<b>2002</b>
	<u>          </u>	<u>          </u>
Net Unrealized Gain (Loss) on Available-for-Sale Securities	862	(556)
Foreign Currency Translation Adjustment	51	38
Accumulated Other Comprehensive Income (Loss)	<u>913</u>	<u>(518)</u>

The impairment charge on the HypoVereinsbank investments of EUR 753,768 was recognized as an unrealized loss in the statement of operations and removed from accumulated other comprehensive income (loss).

## 7. Intangible Assets

The following sets forth the intangible asset classes as of December 31, 2003 and 2002 (in thousands EUR):

	December 31,	
	2003	2002
<b>Amortized Intangibles</b>		
Patents	8,569	8,531
License Rights	12,140	3,810
Accumulated Amortization Patents	(2,571)	(1,717)
Accumulated Amortization Licenses	(1,241)	(457)
<b>Unamortized Intangible Assets</b>		
Patents	106	85
<b>Net Intangible Assets</b>	<b>17,003</b>	<b>10,252</b>

The changes in the carrying amount of unamortized patents for the period ending December 31, 2003 is as follows (in thousands EUR):

	December 31,
	2003
<b>Unamortized Intangibles</b>	
Balance on December 31, 2002	85
Additions for the Full Year 2003	21
<b>Balance on December 31, 2003</b>	<b>106</b>

Amortization is expected to commence on unamortized patents once the related patents are issued. Amortization expense on intangible assets totaled EUR 1,637,863 for the twelve months period ended December 31, 2003 (December 31, 2002: 1,236,457 EUR). Patents are amortized over 10 years starting from the date of the first patent grant. Licenses are amortized over 10 years from the date of the acquisition.

Future amortization for the years 2004 to 2008 and thereafter are as follows (in thousands EUR):

<b>Year Ended December, 31</b>	
2004	2,071
2005	2,071
2006	2,071
2007	2,071
2008	2,071
Thereafter	6,542
	<u>16,897</u>

## 8. Property and Equipment

Property and equipment consist of the following at December 31, 2003 and 2002 (in thousands EUR):

	<b>December 31,</b>	
	<b>2003</b>	<b>2002</b>
Office and Laboratory Equipment	3,605	3,145
Furniture and Fixtures	1,267	1,260
Purchased Software	<u>1,186</u>	<u>1,044</u>
Total	6,058	5,449
Less Accumulated Depreciation	<u>(4,150)</u>	<u>(3,351)</u>
Net Property and Equipment	<u><u>1,908</u></u>	<u><u>2,098</u></u>

## 9. Commitments

The Company leases facilities and equipment under long-term operating leases. Total rent expense amounted to EUR 899,676 and EUR 983,908 for the years ended December 31, 2003 and 2002, respectively. In January 2004, MorphoSys amended the existing lease agreement of its facilities. The new lease agreement expires in September 2009. Future minimum payments under non-cancelable operating leases with initial terms of one year or more are as follows (in thousands Euro):

### Year Ended December, 31

2004	1,191
2005	968
2006	933
2007	897
2008	893
Thereafter	<u>893</u>
	<u><u>5,775</u></u>

The Company's total expenses under operating leases in the years ended December 31, 2003 and 2002 totaled approximately EUR 1,058,111 and EUR 1,280,221, respectively.

## **10. Contingent Liabilities**

In June 2001, a lawsuit was filed against the Company by Applied Molecular Evolution, Inc., ("AME") San Diego, U.S.A. at the United States District Court of Massachusetts in Boston/U.S.A., alleging that the Company infringes the Kauffman-Ballivet patent family. These patents cover the stochastic production of proteins and were granted in the late 1990's. A trial date has not yet been set, although in January 2003, MorphoSys confirmed that it had received a positive "Report and Recommendation" from the Magistrate Judge to the District Judge for the District Court in Boston, Massachusetts, U.S.A., in the legal action filed by Applied Molecular Evolution. The Magistrate Judge recommended that MorphoSys' motion for summary judgment of non-infringement is allowed and that AME's motion for partial summary judgment of infringement be denied. As a result no provisions for contingent liabilities have been made in the Company's financial statements.

In December 2002, the Company and Cambridge Antibody Technology ("CAT") entered into a settlement agreement pursuant to which they agreed to settle all patent disputes between the two companies. Pursuant to the settlement agreement, the Company agreed to make annual payments of EUR 1.0 million over the next five years as well as issue 588,160 new shares of common stock and make certain ongoing royalty and milestone payments, and in return will receive a license under certain CAT patents with respect to the previous and future development of HuCAL<sup>®</sup> libraries. The Company has the option to buy out its cash obligations to CAT for a predefined fixed amount at any time during the duration of the agreement. The Company recorded an accrual for the settlement with CAT in the year 2002. In addition, the Company recorded a net present value discount of approximately EUR 1.2 million on the annual payments to record the liability at its estimated fair value of EUR 3.8 million. The discount of 13% on the cash payments is being amortized to interest expense over the period of the payments. For the full year 2003 EUR 0.2 million was charged to interest expense. The settlement agreement was finalized in July 2003 and the Company engaged an external valuation expert to complete a valuation, whose basis provided the necessary information to finalize the accounting.

Based on the valuation analysis, the Company determined the fair value of the different components of the agreement and allocated the total consideration paid for each component based on the fair values of the consideration received. The completion of the analysis resulted in an accounting estimate change which reduced Research and Development expense by EUR 2.3 million. Accordingly a total of EUR 1.9 million was expensed for the release. The remaining EUR 8.3 million of consideration represents the value of the license received and has been capitalized as an intangible asset and will be amortized over its expected useful life of 10 years.

Management is not aware of any other matters that could give rise to any material liability to the Company that would have a material adverse effect on the Company's financial condition or results of operations.

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The change in accounting estimate had the following effect on net loss and net loss per share for the years ended December 31, 2003 and 2002 (in thousands EUR, except for per share data):

	<b>December 31,</b>	
	<b>2003</b>	<b>2002</b>
Net Loss	(4,148)	(24,377)
Effect from Change in Accounting Estimate	(2,272)	2,272
Pro-Forma Loss	<u>(6,420)</u>	<u>(22,105)</u>
Basic and Diluted Net Loss per Share	(0.96)	(6.35)
Effect from Change in Accounting Estimate	(0.52)	0.59
Pro-Forma Net Loss per Share	<u>(1.48)</u>	<u>(5.76)</u>

## 11. Stockholders' Equity

### Common Stock

On December 31, 2003, the common stock of the Company was EUR 14,703,996. This represented an increase of EUR 2,854,878 compared to December 31, 2002 balance of EUR 11,849,118. The increase arose as a result of the issuance of 363,466 shares to XOMA for a capital increase against contribution in kind, which was registered on May 6, 2003 in the commercial register and the issuance of 588,160 shares to CAT for a capital increase against contribution in kind, which was registered on August 26, 2003 in the commercial register.

On March 28, 2002, the Company's common stock increased by EUR 1,073,640 from EUR 10,773,275 to EUR 11,846,915 with new share arising from Authorized Capital II, in conjunction with the Schering collaboration signed in December 2001. In addition, the Company's common stock increased by EUR 718 from EUR 11,846,915 to EUR 11,847,633 to avoid fractional common stock as calculated by its imputed nominal value per share. During the year 2002, 495 shares were raised from conditional capital through exercise of the same number of employee stock options, thereby increasing the amount of subscribed capital by EUR 1,485, to a total of EUR 11,849,118, or 3,949,706 shares.

### Authorized Capital

On May 6, 2003, 363,466 shares of Authorized Capital I were issued to XOMA for a capital increase against contribution in kind.

On May 16, 2003, shareholder assembly authorized the Company to create a maximum of 431,317 new shares of Authorized Capital II and a maximum of 1,725,269 new shares of Authorized Capital I.

In August 2003, 588,160 shares of Authorized Capital I were issued to CAT for a capital increase against contribution in kind. Unused Authorized Capital I equaled 1,137,109 and 1,431,529 shares at December 31, 2003 and 2002, respectively. Unused Authorized Capital II equaled to 431,317 and 394,921 shares at December 31, 2003 and 2002, respectively.

### Conditional Capital

No stock options or convertible bonds were exercised in the year 2003. During the year 2002, 495 shares were raised from conditional capital through exercise of the same number of employee stock options, thereby increasing the amount of subscribed capital by EUR 1,485.

On May 16, 2003, the shareholder assembly authorized the Company to create additional shares for Conditional Capital III, IV and V in the maximum amount of 1,275,000, 450,269 and 111,447 shares, respectively.

In 2002, previously authorized Conditional Capital I and II, consisting of EUR 97,875 and EUR 900,750, respectively, and arising from prior year resolutions, were retained. Conditional Capital III, to allow issuance of convertible bonds and consisting of EUR 2,625,000 (875,000 shares) was also retained. Conditional Capital IV, an authorization to issue convertible bonds to management and employees as part of an equity incentive scheme, was retained and consisted

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of EUR 900,000 (300,000 shares). The shareholder assembly authorized the creation of Conditional Capital V consisting of EUR 223,668 (74,556 shares), which authorizes the Company to issue additional share options to employees.

### **Dividends**

Dividends may only be declared and paid from the accumulated retained earnings (after deduction of certain reserves) shown in the Company's annual German statutory accounts. Such amounts differ from the total of additional paid-in capital and accumulated deficit as shown in the accompanying consolidated financial statements as a result of the adjustments made to present the consolidated financial statements in accordance with U.S. GAAP. As of December 31, 2003 and 2002, the Company's German statutory accounts reflected no accumulated earnings available for distribution and accordingly, the Company's ability to pay dividends would depend upon the future earnings of the Company.

### **Additional Paid-In Capital**

On December 31, 2003, Additional Paid-in Capital amounted to EUR 68,623,807 (December 31, 2002 EUR 59,193,912). The increase of EUR 9.4 million is due to stock based compensation provisions in the amount of EUR 2,175,430, EUR 3,110,896 as a result of the XOMA share issuance, and EUR 4,143,569 as a result of the CAT share issuance.

In 2002 the Additional Paid-In Capital was increased by EUR 3,940,412 resulting from stock based compensation provisions, premiums associated with the Capital increase against cash from the agreement with Schering, and the exercise of employee stock options.

### **Treasury Stock**

Treasury Shares totaling EUR 21,934 (59,762 shares) at December 31, 2003, remained unchanged compared to December 31, 2002.

## **12. Stock Options**

### **1998 Employee Stock Option Program**

Effective June 15, 1998, the Company introduced an Incentive Stock Option Plan ("1998 Plan") which provides for the grant of options to purchase shares of the Company's common stock to key employees and members of the Company's Management Board. The 1998 Plan authorized the grant of options to personnel for 96,075 shares of the Company's common stock in the form of 45,450 registered warrants each equal to one share of common stock and 50,625 shares deliverable upon exercise of non-warrant option rights. The Company reserved 55,350 common shares plus 68,650 shares of treasury stock for stock options. All option rights granted under this 1998 Plan have a 10-year term.

Each warrant entitles the holder to receive one share. Upon exercise of a warrant, the exercise price, which equals the fair value of the shares on the date of grant, is due and payable. The holder of warrants can exercise up to the full amount of warrants 6 months after the date of grant. The holder of warrants also has the right to sell them. The warrants or shares obtained upon exercise vest annually on a graded basis over three years.

The non-warrant option rights are granted by way of an option agreement by the Company to the employee. For all grants commencing after June 1998, a two year holding period is required after the date of grant, after which the holder of non-warrant option rights can exercise up to the amount of vested option rights.

### **1999 Employee Stock Option Program**

Effective July 21, 1999, the Company amended the Incentive Stock Option Plan ("1999 Plan") authorizing the additional grant of options to employees for up to 300,250 shares, arising from conditional capital, and deliverable upon exercise of non-warrant option rights. On October 31, 1999, a grant of 98,100 shares was made to Company employees, management and the Supervisory Board. The options rights are non-transferable, and have a maximum life of 5 years. Additionally, a two-year holding period is required after the date of grant, after which the holder of the option rights can exercise up to the amount of vested option rights, under the condition that the value of the underlying stock has appreciated 10% per annum, cumulatively, in the year of exercise.

In the year 2002, additional grants to employee were made under the 1999 Plan, with terms identical to the 1999 stock options grants. 5,500 options were granted on January 15, 2002, to employees of MorphoSys AG.

In the year 2003, additional grants to executive board members were made under the 1999 Plan, with terms identical to the 1999 stock options grants. 36,000 options were granted on July 7, 2003 to executive board members of MorphoSys AG.

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### 2002 Employee Stock Option Program

Effective June 6, 2002 the Company amended the Incentive Stock Option Plan ("2002 Plan") authorizing the additional grant of options to employees for up to 74,556 shares, arising from conditional capital, and deliverable upon exercise of non-warrant option rights. On July 9, 2002, a grant of 7,500 shares was made to Company employees. The terms are very similar to those of "1999 Employee Stock Option Program". On May 16, 2003, the stockholders' assembly authorized the Company to grant additional 36,891 shares under the "2002 Employee Stock Option Program" with identical terms.

In the year 2003, grants to employees were made under the 2002 Plan, with terms identical to the 1999 and 2002 stock options grants. 2,500 options and 15,000 options were granted on January 15, 2003 and July 1, 2003 respectively to employees of MorphoSys AG.

On January 15, 2004, 35,000 options were granted to employees with terms identical to the 1999, 2002 and 2003 stock option grants.

A summary of the activity under the Company's Employee Incentive Stock Option Plans for the years ended December 31, 2003 and 2002, is represented as follows:

	<b>Weighted Average Price</b>	
	<b>Shares</b>	<b>EURO</b>
Outstanding at January 1, 2002	285,465	30.12
Granted	13,000	41.07
Exercised	(495)	17.50
Forfeited	<u>(32,500)</u>	<u>31.71</u>
Outstanding at December 31, 2002	<u>265,470</u>	<u>30.48</u>
Outstanding at January 1, 2003	265,470	30.48
Granted	53,500	10.89
Exercised	-	0.00
Forfeited	<u>(47,225)</u>	<u>31.65</u>
Outstanding at December 31, 2003	<u>271,745</u>	<u>26.40</u>

Stock options exercisable at December 31, 2003 and 2002 amounted to 179,295 and 133,720 shares, respectively. The weighted-average exercise prices of stock options exercisable were EUR 27.91 and EUR 25.40 at December 31, 2003 and 2002, respectively. Furthermore, the weighted average fair value of options granted during 2003 and 2002 is estimated to be EUR 7.57 and EUR 17.98, respectively.

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The following table presents weighted-average price and information about contractual life for significant option groups outstanding at December 31, 2003:

Range of Exercise Prices	Number Outstanding	Remaining Contractual Life (in Years)	Weighted-Average Exercise Price	Number of Exercisable	Weighted-Average Exercise Price
€ 10.88 - € 20.00	101,470	4.55	14.02	47,970	€ 17.50
€ 20.01 - € 58.00	161,150	1.68	25.46	126,075	€ 23.98
€ 58.01 - € 217.00	9,125	1.86	180.78	5,250	€ 217.60
	<u>271,745</u>			<u>179,295</u>	

The Company accounts for stock-based compensation in accordance with the provisions of SFAS No. 123. Compensation expense recorded in 2003 and 2002 in connection with stock options was EUR 1,864,722 and EUR 2,458,368 respectively. The fair value of the options issued in 2003 was calculated using the Black-Scholes option pricing model using the following assumptions: risk free interest rates ranging from 2.96% to 3.61%, dividend yield of 0%, 115% expected volatility and an expected option life of 3.0 years. For option grants in 2002, following assumptions were used: risk free interest rates ranging from 4.50% to 5.14%, dividend yield of 0%, 60% expected volatility and identical option life as of 2003.

Option valuation models require the input of highly subjective assumptions. Because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

### Stock Option Repricing

On September 1, 2001, the Company re-issued 94,100 options to employees, which were cancelled on July 5, 2001. The re-issued options have similar characteristics and vesting provisions as the original options granted. In accordance with SFAS No. 123, the re-issued options were revalued at the date of re-issuance using the Black-Scholes option-pricing model. A fair market value of approximately EUR 5,950,000 was assigned to the re-issued options, which will be recognized over the vesting period of the re-issued options. During the year ended December 31, 2003 and 2002, the Company recognized approximately EUR 1,650,000 and EUR 2,226,000, respectively, of stock-based compensation expense relating to these re-issued stock options.

### **13. Convertible Bonds**

At the Company's shareholder assembly in July 2002, the Company was authorized until June 30, 2006 to issue up to 300,000 non-interest bearing convertible bonds with a par/nominal value of EUR 1.00 each to employees and members of the Board of Management of the Company and its affiliates. The pre-emptive rights of the stockholders' were excluded. On May 16, 2003, the stockholders' assembly authorized the Company to grant additional 150,269 shares.

On January 15, 2002, pursuant to a Management Board decision, the Company issued 91,500 convertible bonds to the Management Board and employees of the Company.

The convertible bonds cannot be transferred or encumbered, other than through inheritance / death, or in the event of disability to work the Board of Management can allow the transfer with good cause.

The conversion rights may only be exercised if a declaration of termination of the employment agreement with the owner of the convertible bonds has not been declared at the time of exercise and a mutual termination agreement has not been entered into. In the event of non-exercise of the conversion rights, beneficiaries are refunded amounts paid to acquire the convertible bonds (i.e., EUR 1.00 per bond/share).

The beneficiaries may exercise the conversion rights only after the expiration of a waiting period of one year of grant date. Each convertible bond with a nominal value of EUR 1.00 allows the exchange into one share of ordinary no-par value common stock of the Company against payment of the exchange price. The convertible bonds cannot be exercised beyond December 31, 2004.

The exchange price for the convertible bonds issued on January 15, 2002 was EUR 57.56, representing the average closing price of a share of the Company in the final XETRA-auction at the Frankfurt stock market during the last five trading days preceding the resolution of the Board of Management on the issuance of the convertible bonds.

The exercise of the conversion rights is only possible if the stock exchange price on at least one day during the lifetime of the convertible bonds has amounted to EUR 63.31, or 110% of the average stock exchange price in the final XETRA-auction in the Frankfurt stock market during the five trading days prior to the resolution of the Board of Management on the issuance of the convertible bonds.

Shares, which are issued by virtue of the conversion rights, may participate in the profits of the Company at the first time in the business year for which no stockholders' resolution on the distribution of profits has been passed at the time of the issuance.

In the year 2003, additional grants to employees were made under the 2002 Plan, with terms identical to the 2002 stock convertible bonds grants. 70,700, 8,500 and 14,000 convertible bonds were granted on April 1, 2003, May 17, 2003 and July 1, 2003, respectively to board members, executive board members and employees of MorphoSys AG. The exercises price for the convertible bonds were EUR 11.69, EUR 10.00 and EUR 10.88, respectively.

The nominal value of EUR 5,400 relating to convertible bonds forfeited on December 31, 2003 was paid back to the respective people in January 2004.

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	<b>Convertible Bonds</b>	<b>Weighted Average Price EURO</b>
Outstanding at January 1, 2002	-	0.00
Granted	91,500	57.56
Forfeited	(16,700)	57.56
Outstanding at December 31, 2002	74,800	57.56
Outstanding at January 1, 2003	74,800	57.56
Granted	93,200	11.41
Forfeited	(16,200)	43.97
Outstanding at December 31, 2003	151,800	30.68

None of the Convertible Bonds granted in 2002 and exercisable in 2003 were exercised as of December 31, 2003.

Range of Exercise Prices	Number Outstanding	Remaining Contractual Life (in Years)	Weighted- Average Exercise Price	Number of Exercisable	Weighted- Average Exercise Price
€ 10.00 - € 20.00	88,400	2.00	11.40	0	€ 11.40
€ 57.56	63,400	1.00	57.56	63,400	€ 57.56
	151,800			63,400	

The Company accounts for stock-based compensation in accordance with the provisions of SFAS No. 123, compensation expense recorded in 2003 and 2002 in connection with convertible bonds was EUR 310,708 and EUR 1,482,044 respectively. The fair value of the convertible bonds issued was calculated using the Black-Scholes pricing model using the following assumptions: risk free interest rates ranging from 2.96% to 3.31%; dividend yield of 0%; 115% expected volatility; and an expected life of 2.0 years. For convertible bond issuance in 2002, following assumptions were used: risk free interest of 4.50%, dividend yield of 0%, 60% expected volatility and an option life of 2 years.

Option valuation models require the input of highly subjective assumptions. Because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

## 14. Taxes

As a result of the net losses incurred by the Company in each year since inception, no provision for income taxes has been recorded. At December 31, 2003, the Company has net operating loss carry forwards of approximately EUR 31 million to offset future taxable income. Under current German tax laws, these loss carry forwards have an indefinite life and may be used to offset the Company's future taxable income. Net operating loss carry forwards are subject to review and

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possible adjustment by the German taxing authorities. Furthermore, under current German tax laws, certain substantial changes in the Company's ownership may limit the amount of net operating loss carry forwards, which could be utilized annually to offset future taxable income. Subsequent significant ownership changes could further effect the limitation in future years.

Significant components of the Company's deferred tax liabilities and assets are as follows (in thousands Euro):

	<b>December 31,</b>	
	<b>2003</b>	<b>2002</b>
Deferred tax liabilities:		
Intangibles	3,302	2,553
Other	373	(7)
Total deferred tax liabilities	<u>3,675</u>	<u>2,546</u>
Deferred tax assets:		
Net operating loss carry forwards	11,628	9,303
Deferred revenue	230	360
Total deferred tax assets	<u>11,858</u>	<u>9,663</u>
Valuation allowance for deferred tax assets	<u>(8,183)</u>	<u>(7,117)</u>
Net deferred tax assets	<u>3,675</u>	<u>2,546</u>
Net deferred tax liabilities / (assets)	<u>—</u>	<u>—</u>

The Company has incurred losses since inception and has provided a full valuation allowance on its deferred tax assets at December 31, 2003 and 2002 since realization of these future benefits is uncertain. Income tax expense for the year ended December 31, 2003 amounted to EUR 21 compared to of EUR 18,000 in 2002, which related to current foreign taxes.

Under German corporate tax law, taxes on income are composed of corporate taxes, trade taxes and an additional surtax. The Company's combined German statutory tax rate is 37%. A reconciliation between the income tax expense computed at the corporate statutory tax rate of 37% and the Company's effective tax rate for the years ended December 31, 2003 and 2002 is as follows (in thousands Euro):

	<b>Years ended December 31,</b>	
	<b>2003</b>	<b>2002</b>
Tax provision at German statutory rates	(1,535)	(9,013)
Change in valuation allowance	1,066	(1,951)
Change in statutory rates	—	233
Sale of Intangible Assets to Subsidiary	—	9,250
Stock-based compensation	805	1,458
Other	<u>(336)</u>	<u>41</u>
	<u>0</u>	<u>18</u>

## 15. Directors Dealings and Executive Compensation

The table below shows the shares, stock options and convertible bonds, and changes of ownership of the same, which were held by the Management and the Supervisory Board during the year 2003:

Shares	01/01/03	Additions	Sales	12/31/2003
<b>Management</b>				
Dr. Simon Moroney (held through a controlled entity)	113,461	-	-	113,461
Dave Lemus	-	-	-	-
Dr. Thomas von Rüden	-	-	-	-
<b>Total</b>	<b>113,461</b>	<b>-</b>	<b>-</b>	<b>113,461</b>
<b>Supervisory Board</b>				
Dr. Gerald Möller	-	-	-	-
Dr. Daniel Camus	-	-	-	-
Prof. Dr. Jürgen Drews	-	-	-	-
Prof. Dr. Andreas Plückthun	59,300	-	-	59,300
Dr. Jörg Reinhardt	-	-	-	-
Dr. Geoffrey N. Vernon	-	-	-	-
<b>Total</b>	<b>59,300</b>	<b>-</b>	<b>-</b>	<b>59,300</b>
<b>Stock Options</b>				
<b>Management</b>				
Dr. Simon Moroney	25,000	22,000	-	47,000
Dave Lemus	21,000	-	-	21,000
Dr. Thomas von Rüden	50,700	14,000	-	64,700
<b>Total</b>	<b>96,700</b>	<b>36,000</b>	<b>-</b>	<b>132,700</b>
<b>Supervisory Board</b>				
Dr. Gerald Möller	6,100	-	-	6,100
Dr. Daniel Camus	-	-	-	-
Prof. Dr. Jürgen Drews	5,930	-	-	5,930
Prof. Dr. Andres Plückthun	3,500	-	-	3,500
Dr. Jörg Reinhardt	3,500	-	-	3,500
Dr. Geoffrey N. Vernon	3,500	-	-	3,500
<b>Total</b>	<b>22,530</b>	<b>-</b>	<b>-</b>	<b>22,530</b>
<b>Convertible Bonds</b>				
<b>Management</b>				
Dr. Simon Moroney	12,000	12,000	-	24,000
Dave Lemus	10,000	24,000	-	34,000
Dr. Thomas von Rüden	10,000	10,000	-	20,000
<b>Total</b>	<b>32,000</b>	<b>46,000</b>	<b>-</b>	<b>78,000</b>
<b>Supervisory Board</b>				
Dr. Gerald Möller	-	2,500	-	2,500
Dr. Daniel Camus	-	1,500	-	1,500
Prof. Dr. Jürgen Drews	-	-	-	-
Prof. Dr. Andres Plückthun	-	1,500	-	1,500
Dr. Jörg Reinhardt	-	1,500	-	1,500
Dr. Geoffrey N. Vernon	-	1,500	-	1,500
<b>Total</b>	<b>-</b>	<b>8,500</b>	<b>-</b>	<b>8,500</b>

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Compensation for the Management Board consisted of fixed and variable components. Fixed compensation for the Management Board in 2003 amounted to EUR 570,886, compared to EUR 533,541 in the year 2002. Variable compensation for the Management Board in 2003 amounted to EUR 232,780, compared to EUR 181,636 in 2002. Other Compensatory benefits amounted to EUR 275,268 in 2003 and EUR 178,999 in 2002.

Total compensation for the Supervisory Board in 2003 amounted to EUR 193,839 (2002: EUR 163,466).

### **16. Corporate Governance**

The Company issued its statement according to Section 161 of the German Stock Corporation Act (Aktiengesetz). This declaration has been published and made accessible to stockholders accordingly on December 22, 2003.

### **17. Research and Development Agreements**

The Company has a significant number of research and development agreements related to its discovery and development strategy. The following is a brief description of certain of these agreements, which have had, or may have, a significant financial impact (in chronological order).

#### ***GPC Biotech AG, Munich, Germany***

In April 1999, the Company signed a collaboration and license agreement with GPC Biotech AG ("GPC AG"), Munich. The objective of the Collaboration Program is to utilize the Company's technologies to generate human antibodies against GPC targets and to deliver such antibody products to GPC for confirmation of achievement of pre-defined success criteria. The Company received from GPC upfront research and development funding/exclusivity payments as well as the potential for milestone and royalty payments.

#### ***Bayer Corporation, Berkeley, U.S.A.***

In December 1999, the Company announced a collaboration with Bayer AG encompassing a research collaboration and license agreement for the application of the Company proprietary technologies in a number of Bayer's research and development programs. The agreement specified four areas in which the two companies apply the Company technologies. The Company's HuCAL<sup>®</sup> (Human Combinatorial Antibody Library) technology is being used to generate fully human therapeutic antibodies against up to ten targets provided by Bayer. In addition, Bayer has an option to develop antibodies generated using the HuCAL<sup>®</sup> technology as in vitro diagnostics. Furthermore, HuCAL<sup>®</sup> is being used to identify antibodies for use in monitoring the progress of clinical trials with selected drugs. The fourth and last area of application is the use of MorphoSys technologies to identify and validate new targets emerging from Bayer's genomics program, which will be used by Bayer in screens for new drug candidates.

Under the terms of the agreement, Bayer made an up-front payment to the Company upon signing the agreement, and pays in addition annual license fees and support for research and development funding at the Company. Furthermore, Bayer pays exclusivity fees for using the HuCAL<sup>®</sup> technology on up to ten potential targets, as well as milestone fees on antibodies delivered by the Company that meet pre-agreed success criteria. Any antibody-based products

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developed in the collaboration trigger development-related milestone and royalty payments by Bayer to the Company. Over the course of the agreement, Bayer has thus far taken two exclusive licenses on antibodies from MorphoSys, and cross licensed their HKB-11 cell line against installation of HuCAL GOLD at selected Bayer sites.

### ***ProChon Biotech Limited, Israel***

In May 2000, the Company signed a cooperation and license agreement with ProChon, Rehovot, Israel. The firms will collaborate in the development of human therapeutic antibodies against a ProChon target. The fees payable to the Company include payments representing a license payment, as well as program-related milestones upon achievement of certain success-related criteria. ProChon will also pay royalties to the Company on marketed products derived from the collaboration. In May 2002, the two companies expanded their existing agreement whereby MorphoSys acquired the rights to a portfolio of anti-cancer antibodies in development at ProChon. The agreement gave MorphoSys the exclusive right to develop and commercialize the antibodies for therapeutic applications in the field of oncology, and in particular against the target FGFR-3.

In July 2003 the agreement was amended. It is intended that MorphoSys continues with Prochon to develop up to 4 antibodies with MorphoSys HuCAL Gold library, but MorphoSys will return all rights concerning FGFR3 antibodies to Prochon.

### ***F.Hoffmann-La Roche, Switzerland***

In September 2000, the Company entered into a collaboration and license agreement for the development of human therapeutic antibodies against a Roche target. Under the terms of the agreement, the Company receives a license payment, development-related milestone payments, and royalties on marketed products. The Company will apply its (HuCAL<sup>®</sup>) Fab technology to the generation and optimization of antibodies for the Roche target. Roche will be responsible for the clinical development, regulatory approval and worldwide marketing of any resulting products.

### ***ImmunoGen, U.S.A.***

In September 2000, the Company signed a collaboration and license agreement with ImmunoGen, U.S.A. The parties will collaborate in the discovery and development of human monoclonal antibodies against certain specified targets. ImmunoGen will be responsible for developing one or more antibodies generated by the Company into a marketable product. Under the agreement, the Company will receive a license payment, as well as development-related milestone payments and royalties on marketed products.

The existing agreement between the two companies was expanded in June 2001, whereby the expanded agreement provided for a research license from the Company to ImmunoGen for the Company's HuCAL<sup>®</sup> antibody library technology for the generation of research antibodies for use in ImmunoGen's functional genomics programs, in order to help validate new targets. The expanded agreement has a duration of four years.

### ***Biogen, U.S.A.***

In December 2000, the Company signed a collaboration agreement with Biogen. Under the agreement, the two companies will collaborate in applying the Company's proprietary EST-Technology for generating antibodies against Expressed Sequence Tags to validate drug targets in Biogen's genomics programs. The agreement includes an option for Biogen to develop selected antibodies identified during the collaboration as therapeutics. Biogen will pay

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MorphoSys a technology access fee, as well as research and development funding. In the event that any antibody-based therapeutics will be developed, Biogen will make milestone and royalty payments to the Company. In December 2001, Biogen expanded the agreement to include an additional amount of ESTs beyond those defined in the original agreement. In addition, the duration of the original license granted to Biogen was extended.

### ***Centocor, U.S.A.***

In December 2000, the Company signed a subscription and license agreement with Centocor Inc ("Centocor"). The intention of the collaboration is to facilitate the research, discovery and development of novel antibody therapeutics. Centocor will have access to the HuCAL<sup>®</sup> technology at various sites; in addition, the Company will generate antibodies against Centocor targets. Under the agreement, the Company will receive committed technology license fees, exclusivity fees, research and development funding, and milestone payments. Should Centocor market any drugs as a result of the collaboration, the Company will receive royalty payments. The contract has duration of 5 years unless otherwise extended. Centocor will be responsible for development and marketing of any potential drugs.

### ***Oridis Biomed, Austria***

In September 2001, Oridis Biomed ("Oridis") and the Company entered into a wide-ranging agreement under which the Company gained preferred access to Oridis' tissue collection, residing at the Institute of Pathology, University of Graz, Austria.

The goal of the collaboration is the characterization and validation of new therapeutic targets. The Company will apply its HuCAL<sup>®</sup> technology to make antibodies to candidate targets, which Oridis Biomed will use to carry out high throughput protein expression analysis on a range of human tissues. In return, Oridis received a license to the Company's HuCAL<sup>®</sup> technology, and will have access to certain antibodies from the Company. The Company received a first right of negotiation to all antibody products resulting from the collaboration. The Company receives and pays license fees from Oridis.

### ***Schering AG, Germany***

In December 2001, the Company and Schering AG ("Schering") formed a strategic alliance for the development of antibody therapeutics and in-vivo diagnostics. As part of the agreement, Schering and the Company will combine their resources over the three year collaboration term to exclusively pursue a minimum of five therapeutic and several in-vivo diagnostic projects. Furthermore, the two partners will jointly undertake research to identify additional potential therapeutic and diagnostic targets emerging from Schering's genomics program.

Over the lifetime of the agreement, the Company will receive license fees, milestone payments and royalties on any end products emerging from the collaboration. Additionally, Schering purchased 357,880 shares at an average price of EUR 66.79 per share in February 2002 as part of their strategic commitment to the partnership.

***Pfizer Inc., USA***

In December 2003, the Company announced a collaboration and license agreement with Pfizer Inc. The intention of the collaboration is to facilitate the research, discovery and development of novel antibody therapeutics. The Company will apply its HuCAL<sup>®</sup> GOLD technology to the generation and optimization of antibodies for multiple Pfizer targets. Under the agreement, the Company received a committed upfront fee, research support, and depending on collaboration progress, milestone payments and royalties. Pfizer is responsible for the clinical development, regulatory approval and worldwide marketing of any resulting products.

## 18. Acquired License Agreements

The Company is party to license agreements covering certain patented technology.

### ***Dyax Corporation, U.S.A.***

In October 1996, the Company signed a License Agreement with Dyax Corporation, under which the Company received a royalty-bearing, non-exclusive, worldwide license to patents owned by Dyax covering certain technologies relating to the use and practice of phage display. The Company may use the licensed technologies for research and discovery of novel therapeutic agents and targets, and may sub-license the technology to its commercial partners. The Company paid an upfront technology access fee, in addition to annual maintenance and transfer fees.

### ***SCA Ventures Inc, U.S.A.***

In December 1999, the Company concluded a non-exclusive product derived license agreement with SCA Ventures Inc, U.S.A., in which the Company obtained a non-exclusive license from SCA Ventures in order to design, discover, develop, make, use, sell, offer for sale and import HuCAL<sup>®</sup> derived products under SCA Ventures patent rights in single chain antibodies. The Company may use the SCA Ventures licensed technologies for the research and discovery of novel therapeutic agents and targets, and may sub-license the technology to its commercial partners. The Company may terminate this agreement for any reason upon 6 months prior written notice to SCA Ventures. The Company pays an upfront license fee, annual maintenance and transfer fees.

### ***Biosite Diagnostics, Inc., U.S.A.***

In January 2000, the Company signed a Collaboration Agreement with Biosite Diagnostics, Inc., under which the Company receives a royalty-bearing, non-exclusive, world-wide license to patents owned by Biosite and XOMA Corporation covering certain technologies relating to the display and screening of multi-chain antibodies. The Company may use the licensed technologies for research and discovery of novel therapeutic agents and targets, and may sub-license the technology to its commercial partners. Unless earlier terminated, the term of this agreement shall be the later of expiration of the parties' respective obligations to pay royalties or the expiration of the last patent right licensed by one party to the other. The Company pays an upfront technology access fee, in addition to annual maintenance and transfer fees.

### ***Genentech, U.S.A.***

In May 2000, the Company concluded a license agreement with Genentech Inc., granting the Company rights under Genentech patents relating to monovalent phage display screening technology. The Company may use the licensed technologies for research and discovery of novel therapeutic agents and targets, and may sub-license the technology to its commercial partners. The Company pays an upfront technology access fee, in addition to annual maintenance and transfer fees.

### ***XOMA Ireland Limited***

In February 2002, the Company concluded a cross-licensing agreement for antibody-related technologies with XOMA Ireland Ltd. Under the agreement, the Company received a license to use the XOMA antibody expression technology for developing antibody products (including Fab and scFv formats) using MorphoSys' phage display-based HuCAL<sup>®</sup> antibody library. MorphoSys

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also received a license for the production of antibodies (including Fab and scFv formats) under XOMA patents. Under the agreement XOMA obtained a license to use the MorphoSys HuCAL<sup>®</sup> antibody library for its target discovery and research programs. The agreements also provide for the release of the Company from any past activities using the Company's technology to the extent they also use XOMA's antibody expression technology.

Pursuant to the agreement, MorphoSys paid EUR 1.1 million to XOMA with a second payment of EUR 4.6 million due September 2002. At the Company's option, the second installment could be paid in cash or with new shares of the Company's common stock equivalent to EUR 5.5 million. The Company recorded EUR 2.5 million as a charge to Research and Development expenses in the year 2002. The remaining EUR 3.2 million represents the value of the license received and has been capitalized as an intangible asset and will be amortized over its expected useful life of 10 years.

In October 2002, the Company exercised the option to pay the second installment with 363,466 new shares of its common stock, which was determined with reference to the market price of the Company's common stock at the time of the notice. The Company recorded a charge to interest expense related to this exercise of the option at the time the shares were issued in May 2003, which equaled EUR 0.7 million.

### ***Cambridge Antibody Technologies PLC, Cambridge, UK***

In December 2002 and effective July 2003, the Company entered into a licensing and settlement agreement with CAT. The settlement agreement covers MorphoSys' past, present and future use, the commercialization of all versions of its HuCAL<sup>®</sup> libraries, and all patents in the ongoing disputes between the two companies. This includes the litigation in the United States regarding CAT's Griffiths, McCafferty, WinterII and Winter/Lerner/Huse patents as well as oppositions launched by MorphoSys at the European Patent Office against CAT's Winter II and McCafferty patents.

The companies agreed to terms under which MorphoSys will be free to develop and commercialize its HuCAL<sup>®</sup> technologies. CAT undertook not to sue MorphoSys in relation to present HuCAL<sup>®</sup> GOLD libraries and all future derivatives thereof. In addition MorphoSys received a license to the CAT patent estate in respect of previous HuCAL<sup>®</sup> libraries. CAT will receive an annual payment of EUR 1 million over the next five years. It will also receive other financial consideration from MorphoSys' activities related to its HuCAL<sup>®</sup> GOLD libraries for a defined period of time. CAT will receive milestone and royalty payments under the license for products developed using previous HuCAL<sup>®</sup> libraries. In addition, CAT received an equity stake of 588,160 ordinary shares in MorphoSys under the license agreement. MorphoSys retains the option to buy out its obligations to CAT for a pre-defined fixed amount at any time during the duration of the agreement.

## **Summary of Significant Differences between German GAAP and U.S. GAAP**

The financial statements of the Company are prepared in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP"), which differs in certain respects from German generally accepted accounting principles ("German GAAP") as prescribed by the German Commercial Code. The following is a summary of the significant differences between applied U.S. GAAP and German GAAP that may affect the Company's net income and equity for the periods presented.

Deferred tax assets - Under U.S. GAAP, deferred tax assets arising from a tax loss carry forwards and temporary differences are generally recorded and must be analyzed in light of whether realization of the assets is "more likely than not". This means a level of likelihood that is greater than 50%. As a result of this analysis, a deferred tax asset may be subject to a valuation allowance. Under German GAAP, deferred tax assets generally may not be recognized with respect to a tax loss carry forwards because expected future tax savings are not recognizable before the realization of such profits.

Intangible assets - Under U.S. GAAP, certain expenses (i.e., costs associated with obtaining one's own patent) are capitalized as intangible assets and amortized on a straight-line basis over their estimated useful lives. Under German GAAP, such costs are expensed as incurred. The capitalization of certain acquired license rights are accounted for according to an expert valuation under US GAAP. Under German GAAP, the splits based on the net present value or acquisition cost.

Amortization life of acquired license rights - Under U.S.-GAAP, these rights are amortized over their estimated useful economic life of 10 years. Under German GAAP, the amortization period of 8 years follows the rates used for tax purposes

Revenue recognition - Under U.S. GAAP, more stringent revenue recognition criteria exist which can result in differences in the periods in which revenue is recognized under German GAAP. In the fourth Quarter of 2000, the Company has implemented the U.S. Securities and Exchange Commission SAB 101, which require non-refundable technology access payments revenue to be amortized over future periods of benefit. Although not required to do so, the Company will also use the same practice of revenue recognition in its German GAAP (HGB) accounts starting for the year 2001 and onwards.

Stock based compensation – The Company accounts for stock option and convertible bonds grants in accordance with SFAS No. 123 and recognizes compensation expense. Under German GAAP compensation expense is not being recognized.

Private placement and initial public offering costs - Under U.S. GAAP, certain costs in connection with a private placement or an initial public offering of equity are recorded as a reduction of additional-paid-in-capital. Under German GAAP, such costs are expensed as incurred.

Unrealized holding gains and losses on available-for-sale securities - Under U.S. GAAP, unrealized holding gains and losses on available-for-sale securities are recorded as a component of equity. Unrealized losses are only recorded in the statement of operations, when the unrealized loss is deemed to be other than temporary. If the reasons for an impairment in prior years are no longer applicable, under German GAAP the investment is written up to its net

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realizable value, at most to its acquisition cost. Under German GAAP, unrealized losses are recorded in the statement of operations.

Unrealized holding gains and losses on derivative financial instruments - Under U.S. GAAP, unrealized gains and losses on derivatives are recorded as other income/expense. Under German GAAP, increased market value is not recorded.

Non Current Liabilities - U.S. GAAP requires to record long-term liabilities with its present value of the future payments using an interest rate commensurate with the risk involved. Under HGB the long term liabilities are recorded with their repayment amounts.

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## Roll-Forward of Fixed Assets

	Aquisition and Production Cost				Accumulated Depreciation				Net Book Values	
	Januar 1, 2003	Additions	Disposals	Dezember 31, 2003	Januar 1, 2003	Depreciation	Disposals	Dezember 31, 2003	Dezember 31, 2003	Dezember 31, 2002
	EUR	EUR	EUR	EUR	EUR	EUR	EUR	EUR	EUR	EUR
<b>I Intangible Assets</b>										
Patents	8,616,089	58,746	0	8,674,835	1,717,099	854,061	0	2,571,160	6,103,675	6,898,990
License Rights	3,810,297	8,330,102	0	12,140,399	457,693	783,802	0	1,241,495	10,898,904	3,352,604
	12,426,386	8,388,848	0	20,815,234	2,174,792	1,637,863	0	3,812,655	17,002,579	10,251,594
<b>II, Property and Equipment</b>										
Purchased Software	1,043,890	141,793	0	1,185,683	472,826	307,365	0	780,191	405,492	571,064
Office and Laboratory Equipment	3,120,604	532,652	41,954	3,611,302	2,390,651	414,649	21,719	2,783,581	827,721	729,953
Furniture and Fixtures	1,259,429	7,632	0	1,267,061	462,650	129,729	0	592,379	674,682	796,779
	5,423,923	682,077	41,954	6,064,046	3,326,127	851,743	21,719	4,156,151	1,907,895	2,097,796

## MORPHOSYS AG

### Chart of the Consolidated Entity as of December 31, 2003

	<b>Currency</b>	<b>Exchange Rate at December 31, 2003 One Unit of Foreign Currency in EUR</b>	<b>Share of Capital %</b>	<b>Equity in Foreign Currency</b>	<b>Profit/Loss in Foreign Currency</b>
MorphoSys USA. Inc. Charlotte, North Carolina, USA	US\$	1.25800	100,00	269,101	24,221
MorphoSys IP GmbH	EUR	-	100,00	23,891	0

## **INDEPENDENT AUDITOR'S REPORT**

We issue the following opinion on the consolidated financial statements and the Group management report:

“We have audited the consolidated financial statements, comprising of the balance sheet, statement of operations, statement of changes in stockholders' equity and statement of cash flows, as well as the notes to the consolidated financial statements, prepared by MorphoSys AG, Martinsried, Germany, for the business year from January 1 to December 31, 2003. The preparation and the content of the consolidated financial statements are the responsibility of the Company's executive board. Our responsibility is to express an opinion whether the consolidated financial statements are in accordance with accounting principles generally accepted in the United States of America (US GAAP) based on our audit.

We conducted our audit of the consolidated financial statements in accordance with German auditing regulations and generally accepted standards for the audit of financial statements promulgated by the Institut der Wirtschaftsprüfer (IDW). Those standards require that we plan and perform the audit such that it can be assessed with reasonable assurance whether the consolidated financial statements are free of material misstatements.

Knowledge of the business activities and the economic and legal environment of the Company and evaluations of possible misstatements are taken into account in the determination of audit procedures. The evidence supporting the amounts and disclosures in the consolidated financial statements are examined on a test basis within the framework of the audit. The audit includes assessing the accounting principles used and significant estimates made by management and Company's executive board, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that our audit provides reasonable basis for our opinion.

In our opinion, the consolidated financial statements give a true and fair view of the net assets, financial position, results of operations and cash flows of the Group for the business year in accordance with US GAAP.

Our audit, which also extends to the Group's management report presentation of additional disclosures required by Article 36 of the 7<sup>th</sup> EU Directive prepared by the executive board, for the business year from January 1 to December 31, 2003, has not led to any reservations. In our opinion, on the whole the Group's management report together with the other disclosures in the consolidated financial statements provides a suitable understanding of the Group's position and suitably presents the risks of future development.

In addition, we confirm that the consolidated financial statements and the Group's management report for the business year from January 1 to December 31, 2003 satisfy the conditions required for the Company's exemption from its obligation to prepare consolidated financial statements and the Group's management report in accordance with German law."

Munich, February 9, 2004

Ernst & Young  
Deutsche Allgemeine Treuhand AG  
Wirtschaftsprüfungsgesellschaft

von Petrikowsky  
Wirtschaftsprüfer

Dr. Napolitano  
Wirtschaftsprüfer