

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This management's discussion and analysis has been prepared as of August 21, 2009 and should be read in conjunction with the unaudited consolidated financial statements of iCo Therapeutics Inc. ("iCo" or the "Company") for the quarter ended June 30, 2009 and the related notes thereto. Our consolidated financial statements are prepared in accordance with Canadian generally accepted accounting principles ("GAAP") and all dollar amounts are expressed in Canadian dollars unless otherwise noted. Certain statements in this discussion, other than statements of historical fact, are forward-looking statements. Statements regarding future events, expectations and beliefs of management and other statements that do not express historical facts are forward-looking statements. In this discussion, the words "believe", "may", "will", "estimate", "continue", "anticipate", "intend", "expect", "plan", "predict", "potential" and similar expressions, as they relate to us, our business and our management, are intended to identify forward looking statements. We have based these forward-looking statements largely on our current expectations and projections about future events and financial trends affecting the financial condition of our business. Forward-looking statements should not be read as a guarantee of future performance or results, and will not necessarily be accurate indications of the times at, or by, which such performance or results will be achieved. Forward-looking statements are based on information available at the time those statements are made and/or management's good faith belief as of that time with respect to future events, and are subject to risks and uncertainties that could cause actual performance or results to differ materially from those expressed in or suggested by the forward-looking statements.

Except as may be required by applicable law or stock exchange regulation, we undertake no obligation to update publicly or release any revisions to these forward-looking statements to reflect events or circumstances after the date of this document or to reflect the occurrence of unanticipated events. Accordingly, readers should not place undue reliance on forward-looking statements. If we do update one or more forward-looking statements, no inference should be drawn that additional updates will be made with respect to those or other forward-looking statements. Additional information relating to our Company, including our annual information form, is available by accessing the SEDAR website at [www.sedar.com](http://www.sedar.com).

In this discussion, unless the context requires otherwise, references to "we" or "our" are references to iCo Therapeutics Inc.

### **Business Overview and Strategy**

We are a Canadian biotechnology company focused on the identification, development and commercialization of drug candidates that treat sight and other life threatening diseases through a development-only business model.

We principally focus on in-licensing drug candidates with a clinical history and redose, reformulate and develop drug candidates for the treatment of sight-threatening conditions such as diabetic macular edema and severe allergic conjunctivitis and life threatening diseases such as severe systemic fungal infections. We assume the clinical, regulatory and commercial development activities for our product candidates and advance them along the regulatory and clinical pathway toward commercial approval. We believe that our approach reduces the risk, time and cost of developing ocular therapeutics by avoiding the uncertainty associated with research and pre clinical stages of drug development. We use our expertise to manage and perform what we believe are the critical aspects of the drug development process, including the design and conduct of clinical trials, the development and execution of strategies for the protection and maintenance of intellectual property rights and interaction with drug regulatory authorities.

The main elements of our strategy are as follows:

#### Identification of Product Candidates

We directly perform scientific evaluation and market assessment of pharmaceutical products and research developed by other biopharmaceutical companies. As part of this process, we evaluate the related scientific research and pre-clinical and clinical research, if any, and the intellectual property rights in such products and research, with a view to determining the therapeutic and commercial potential of the applicable product candidates. We intend to mitigate the risks associated with our development and commercialization efforts by targeting drug candidates that:

- are approved for clinical trials or are in late-stage pre-clinical trials;
- have well-established safety profiles;
- have been successfully manufactured on a clinical grade basis in quantities sufficient for clinical trials; and
- have data suggestive of potential efficacy as a treatment for ocular indications.

Our initial focus has been on sight threatening diseases because we believe that there is an unmet need for new and effective therapeutics in this field. In addition, several members of our management team and Strategic Advisory Board (“SAB”) have considerable expertise in ophthalmology. Although we may in the future develop product candidates targeting conditions other than ocular disease, our current emphasis is on leveraging our expertise in ophthalmology to focus on the development of product candidates targeting ocular diseases such as diabetic macular edema and allergic conjunctivitis.

#### In-Licensing

Upon identifying a promising biopharmaceutical product, we seek to negotiate a license to the rights for the product from the holder of those rights. The terms of such licenses vary, but generally our goal is to secure licenses that permit us to engage in further development, clinical trials, intellectual property protection (on behalf of the licensor or otherwise) and further licensing of manufacturing and marketing rights to any resulting products. This process of securing license rights to products is commonly known as “in-licensing”. In certain instances, we have taken the “option” approach, whereby we gain an exclusive right to in-license a drug candidate for a defined period of time. This approach allows us to review additional data before making a decision to in-license a particular drug candidate.

#### Product Advancement

Upon in-licensing a product candidate, our strategy is to apply our skills and expertise to advance the product toward regulatory approval and commercial production and sale in major markets. These activities include implementing intellectual property protection and registration strategies, formulating or reformulating existing drug products, making regulatory submissions, performing or managing clinical trials in target jurisdictions, and undertaking or managing the collection, collation and interpretation of clinical and field data and the submission of such data to the relevant regulatory authorities in compliance with applicable protocols and standards.

## Developing Partnerships with Biopharmaceutical Companies

In order to augment our ability to develop our product candidates and effectively market any products in respect of which we obtain regulatory approval, we may enter into an agreement or partnership with a biopharmaceutical company that has drug development or sales and marketing capabilities, or both. Entering into an agreement or partnership with a pharmaceutical or biotechnology company that has these capabilities may enable us to increase our returns from our product candidates by utilizing that company's development or sales and marketing capabilities, or both, to further accelerate development of our product candidates or enable us to develop the candidate in more than one indication simultaneously.

## Outsourcing

In order to optimize the development of our product candidates, we outsource certain of our product development activities. Factors that we consider in determining which activities to outsource include cost, relative expertise, capacity and quality assurance. The product development functions that we have chosen to outsource include pre-clinical activities in support of regulatory filings, clinical trials and manufacturing. We believe that our relationships with external laboratories enable us to complete pre-clinical testing faster and more efficiently than if we performed these activities ourselves. Because our manufacturing needs are currently sporadic, we believe that it is more efficient to outsource manufacturing.

## Products

We currently in-license three product candidates (iCo-007, iCo-008 and iCo-009) that we believe have the potential to treat sight threatening and life threatening conditions.

### ***iCo-007***

iCo-007 is a second generation anti-sense compound that we believe reduces levels of a key protein, C-Raf Kinase, which is associated with diabetic retinopathy, including diabetic macular edema. Diabetic retinopathy, including diabetic macular edema, is an ocular complication characterized by new blood vessel growth and increased vascular permeability in the back of the eye. Fluid leaks into the macula, the part of the eye where the sharpest vision occurs, causing it to swell, and impairing vision. We are currently running a Phase I dose-escalating clinical trial at four trial sites in the United States using a single injection of iCo-007 in patients with diffuse diabetic macular edema. The primary endpoint for the trial is to assess the safety of iCo-007 at four different dosage levels in four groups ("cohorts") of patients – fifteen patients in total. However as the trial is being conducted in patients with disease as opposed to healthy volunteers, as secondary endpoints we are also able to collect limited data on what effect the drug may be having on the disease itself. We began treating patients in February 2008 and we reached the midpoint of the Phase I trial in the third quarter of 2008 having dosed two cohorts. We expect to complete dosing of all four patient cohorts by the fourth quarter of 2009.

### ***iCo-008***

iCo-008 is a human monoclonal antibody that we believe may treat sight threatening forms of allergic conjunctivitis by neutralizing eotaxin-1, a ligand to the chemokine receptor CCR3. It is our view that iCo-008 neutralizes eotaxin-1 by binding to it and, as a consequence, preventing it from binding to CCR3. We believe that iCo-008 has the potential to inhibit intracellular signalling associated with mast cell degranulation and the recruitment of eosinophils to the site of allergic reactions and, as a result, potentially inhibit both early stage and late stage development of severe allergic conjunctivitis. We also believe that iCo-008 could also be

used to treat a variety of systemic disease indications which involve eosinophils including severe asthma, food allergies, and inflammatory bowel disease.

Before we licensed iCo-008 from Medimmune Limited (“MedImmune”), MedImmune (then known as Cambridge Antibody Technology) conducted Phase I clinical trials testing the safety, tolerability and pharmacokinetics of iCo-008 and Phase II clinical trials testing the efficacy of iCo-008 as a treatment for allergic rhinitis and allergic conjunctivitis. To date we have developed a clinical plan for iCo-008, assembled a key opinion leader advisory group and manufactured active pharmaceutical ingredient (“API”). The API is currently being stored at a fill-finish manufacturer. Subject to obtaining sufficient financing, we plan to begin complete the final fill-finish manufacturing step and run a Phase II clinical trial to test efficacy and safety of iCo-008 in individuals with a serious sight threatening form of allergic conjunctivitis known as vernal keratoconjunctivitis. However the global credit crisis which began in 2008 severely restricted our ability to raise equity capital. In response to the crisis we made the strategic decision to reserve our cash resources for developing iCo-007 and consequently, we are currently exploring various strategic initiatives to partner with other firms or license the systemic applications for iCo-008 for a fee as a means to fund further development of iCo-008.

### *iCo-009*

iCo-009 is an experimental oral formulation of Amphotericin B (“AmpB”) currently being developed at the University of British Columbia (“UBC”). Although AmpB has been used to treat systemic fungal infections intravenously for approximately 50 years, an oral formulation of AmpB has yet to be developed. Intravenous AmpB has historically been a potent but toxic option for the treatment of serious systemic fungal infections. Systemic fungal infections are fungal infections that affect the entire body and are particularly prevalent among people whose immune systems have been weakened by certain treatments, such as organ transplant recipients, or certain conditions, such as cancer, diabetes or AIDS. Although other drugs have been developed for the treatment of systemic fungal infections, systemic fungal infection remains a leading cause of death for organ transplant recipients and others with compromised immune systems. In addition, in developing nations, oral therapy is needed for a disease called Visceral Leishmaniasis (“VL”), known for its high mortality rates. Current AmpB therapy requires repeated infusions in the hospital setting and is often associated with infusion-related adverse events, including renal toxicity. Successful oral formulation could resolve the safety issues associated with parenteral application and enable a much broader patient access to this highly effective treatment option. Oral dosing of AmpB has not been successful in the past due to inactivation of the drug in the gut before it could get into the systemic circulation.

We have completed a number of pre-clinical studies with iCo-009 which has shown promising pharmacokinetic and tissue distribution results in two anti-fungal animal models. We are currently generating additional pre-clinical data to further demonstrate oral bioavailability, safety and efficacy prior to commencing a clinical program with iCo-009 to support an Investigational New Drug application (“IND”) to the US Food and Drug Administration (“FDA”) prior to commencing a Phase I clinical trial in humans. iCo-009 has also demonstrated promising results in animal models for VL conducted at independent laboratories in the United States. Formal GLP toxicology studies, manufacturing of drug product under GMP standards and other pre-clinical studies will also be required to support a Phase I clinical trial. These development programs will only be undertaken subject to obtaining appropriate financing. To this end we have been working in cooperation with UBC to obtain third party financing, primarily through government and private granting agencies such as the Canadian Institute of Health Research (“CIHR”) to fund certain pre-clinical studies. As of March 2009, UBC and iCo has been awarded two grants for up to \$600,000, subject to certain matching requirements from iCo.

## 2009 Q2 Highlights

The second quarter of 2009 was marked primarily by the following two highlights:

- On June 25, 2009 we announced that positive oral Amphotericin B data in an animal model of Visceral Leishmaniasis had been published in the Journal of Infectious Diseases in an article entitled “*Highly Effective Oral Amphotericin B Formulation against Murine Visceral Leishmaniasis*”. The article represents the first ever publication of an oral AmpB eradicating the parasite responsible for VL, which affects 12 million people worldwide. Administration of the highest dose of iCo-009 resulted in 99.8% inhibition of the parasite; and
- At the Annual General Shareholders Meeting held on June 5<sup>th</sup>, 2009 all matters put before the meeting had been approved, including: the election of Andrew Rae, John Clement, William Jarosz, Richard Barker and Noel Hall as directors; the appointment of PriceWaterHouseCoopers as auditors for the ensuing fiscal year; and an increase in the amount of shares reserved for the granting of stock options to 3,200,000 from 2,686,977.

In addition to the specific highlights indicated above, we continued to advance patient enrollment of the last cohort (6 patients) in our iCo-007 Phase I clinical trial during the second quarter of 2009. We also continued with our pre-clinical development program for iCo-009 in the labs of Professor Kishor Wasan at the University of British Columbia.

In general, although there are signs that the global economic situation is improving as compared to the fourth quarter of 2008 and first quarter of 2009, we remain guarded about the economic prospects for the life sciences sector for the next 12 months and it is our expectation that capital markets may continue to experience additional volatility throughout the remainder of 2009. We continue to manage our expenditures very carefully and direct the majority of our internal financial resources to completion of the iCo-007 Phase I trial. We currently have enough cash resources to last until the end of the first quarter of 2010, at which point we will need to obtain additional capital through further equity offerings or alternatively, striking a strategic partnership with a third party pharmaceutical developer. As we have 3,143,750 warrants that remain outstanding exercisable at \$0.30 which expire January 31, 2010 and February 10, 2010 respectively, we are also exploring several near term strategies which may facilitate the exercise of these warrants which, if exercised in their entirety, would contribute approximately \$943,125 in gross proceeds. However there can be no assurance that we will be successful in this endeavor.

## Selected Financial Information

The financial information reported here in has been prepared in accordance with Canadian GAAP. The Company uses the Canadian dollar (“CDN”) as its reporting currency. The following table represents selected financial information for the Company’s fiscal three and six month periods ending June 30, 2009 and June 30, 2008:

*Selected Statement of Operations Data*

	<b>Three Months ended June 30</b>		<b>Six Months ended June 30</b>	
	<b>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>
Gain (loss) from operations	\$ (556,886)	\$ (671,290)	\$ (1,142,309)	\$ (1,440,866)
Weighted average number of shares outstanding, basic and diluted	18,562,866	15,798,575	24,331,262	18,140,687
Net gain (loss) per share, basic and diluted	\$(0.03)	\$(0.04)	\$(0.05)	\$(0.08)

The loss from operations decreased in 2009 mainly as a result of overall corporate expenditure reductions to both research and development and general and administrative expenses.

*Selected Balance Sheet Data*

	<b>Six Months ended June 30, 2009</b>	<b>Year ended December 31, 2008</b>
Cash and cash equivalents . . . . .	\$781,488	\$620,276
Net working capital . . . . .	\$464,390	\$234,196
Total assets . . . . .	\$1,552,703	\$1,465,831
Long term liabilities . . . . .	-	-
Total shareholders' equity . . . . .	\$1,191,088	\$1,023,031

Cash and cash equivalents increased by \$161,212 from \$620,276 in December 31, 2008 to \$781,488 at June 30, 2009.

**Comparison of the Quarters ending June 30, 2009 and June 30, 2008**

*Results of Operations*

We incurred a net and comprehensive loss of \$556,886 for the three months ended June 30, 2009 compared to a net and comprehensive loss of \$671,290 for the three months ended June 30 2008, representing a decrease of approximately \$114,404. The decrease in our net and comprehensive loss was principally caused by a decrease in both research and development expenses and general and administrative expenses.

We incurred a net loss of \$1,142,309 for the six months ended June 30, 2009 compared to a net loss of \$1,440,866 for the same period in 2008, representing a decrease of approximately \$298,557. The decrease in our net loss was principally caused by a decrease in research and development expenses for the six months ended June 30, 2009.

As we are in the development stage and our products will not reach approval or become commercially viable for several years, if at all, we anticipate that the Company will continue to generate net losses for the foreseeable future. We did not have any product revenues for the three months ended June 30, 2009 and 2008 and do not anticipate generating any product revenues in the foreseeable future.

### *Interest Income*

Interest income is earned primarily through interest on excess cash balances that are invested in short term, high quality investments that are highly liquid. Interest income for the three months ended June 30, 2009 was \$621, compared to \$4,646 for the three month period ending June 30, 2008, resulting in a decrease of \$4,025. Interest income for the six months ended June 30, 2009 was \$2,247, compared to \$14,946 for the six months ended June 30, 2008, resulting in a decrease of \$12,699.

The lower interest income earned in the three month period ending June 30, 2009, as compared to the same period in 2008 was a result of smaller cash and short term investments balances held in our treasury in 2009 combined with lower interest rates. The lower interest income earned in the six month period ending June 30, 2009, as compared to the same period in 2008 is also the result of smaller cash and short term investment balances held in treasury in 2009 combined with lower interest rates.

As a result of the issues surrounding the global financial crisis and the concern over the stability of financial institutions in general, towards the end of the second quarter of 2009 we made changes to our cash management procedures which would assist in both diversifying our risk exposure to financial institutions and increase the income earned on our cash deposits, while at the same time ensuring the security and flexibility to manage our cash balances.

### *Research and Development*

Our research and development expenses consist primarily of employee compensation, fees paid to consultants and contract research organizations and other costs associated with the clinical trials of our drug candidates and the manufacture of clinical supplies of drug product for clinical testing.

Research and development expenses were \$280,116 for the three months ended June 30, 2009 compared to \$365,276 for the three months ended June 30, 2008, representing a decrease of \$85,160. This decrease in the three months ending June 30, 2009 compared to the three months ending June 30, 2008 were attributable to a reduction in personnel salaries and consultants' fees. Research and development expenses were \$591,651 for the six months ended June 30, 2009 compared to \$803,251 for the same period in 2008, representing a decrease of \$211,600. This decrease was also attributable to a reduction in personnel salaries and consultants' fees. Research and development expenses for six months ended June 30, 2009 primarily consisted of salaries, consultants' fees, contract research organization expenses related to the Phase I clinical trial for iCo-007 and research expenses related to pre-clinical studies for iCo-009.

### *General and Administrative*

General and administrative expenses primarily comprise salaries and benefits for company employees not involved in research and development, professional fees such as legal and accounting expenses, and expenses related to office overheads. For the three months ended June 30, 2009 general and administrative expenses were \$201,940 compared to \$243,742 for the three months ending June 30, 2008, representing a decrease of \$41,802. This decrease in the three months ending June 30, 2009 compared to the three months ending June 30, 2008 were attributable to decreases in personnel salaries and professional fees. For the six months ended June 30, 2009 general and administrative expenses were \$395,584 compared to \$511,658 for the same period in 2008, representing a decrease of \$116,074. This decrease was also attributable to lower professional fees incurred for the six month period ending June 30, 2009 as compared to the same period for 2008.

We believe the Company has sufficient personnel to manage both its research and development and public company activities and do not anticipate any increase in staffing in the foreseeable future. Accordingly, we believe that general and administrative expenses should remain at current levels in the foreseeable future.

### *Amortization*

Amortization is comprised primarily of technology licenses that are recorded at cost and then amortized on a straight-line basis over the term of related licenses, which range from 10 to 15 years. We also amortize certain office and computer equipment on a straight-line basis over the estimated useful lives of the equipment, ranging from 2 to 5 years. The majority of the amortization recorded during the three months ended June 30, 2009 is in connection to the in-licensing of iCo-007 and iCo-008.

Amortization for the three months ended June 30, 2009 was \$28,825 compared to amortization of \$28,792 for the three months ended June 30, 2008, an increase of \$33. Amortization for the six months ended June 30, 2009 was \$57,764 compared to amortization of \$57,957 for the six months ended June 30, 2008, an increase of \$193. For both the three and six months ended June 30, 2009, the increase is attributable to new computer equipment.

### *Foreign Exchange*

Because our licenses are dominated in U.S. dollars and because of our dealings with contract research organizations, consultants and suppliers in other countries (primarily the United States), our financial results are subject to fluctuations between the Canadian dollar and other international currencies, in particular the U.S. dollar. Foreign exchange loss for the three months ended June 30, 2009 was \$8,918 compared to foreign exchange gain of \$7,673 for the same period in 2008, representing a decrease of \$16,591. Foreign exchange loss for the six months ended June 30, 2009 was \$27,070 compared to foreign exchange gain of \$8,632 for the same period in 2008, representing a decrease of \$35,702. The changes for both the three and six month periods reflect fluctuations in the exchange rate for U.S. dollars.

### *Stock Based Compensation*

Stock based compensation relates to options granted under our employee stock option plan to directors, officers, employees and consultants. Compensation expense is recorded using the fair value method over the vesting period of the option. The fair value of each option granted is estimated as at the date of grant using the Black-Scholes option pricing model. Stock based compensation for the three months ended June 30, 2009 was \$37,708 compared to \$45,799 for the three months ended June 30, 2008, a decrease of \$8,091. Stock based compensation for the six months ended June 30, 2009 was \$72,294 compared to \$91,771 for the six months ended June 30, 2008, a decrease of \$19,477.

### **Selected Quarterly Information**

The table below sets forth unaudited quarterly results prepared by management for the eight quarters to June 30, 2009.

(unaudited)	<b>2009 Q2</b>	<b>2009 Q1</b>	<b>2008 Q4</b>	<b>2008 Q3</b>
Interest income	621	1,626	5,158	10,425
Total expenses	557,507	587,049	686,346	630,745
Loss and comprehensive (loss)	(556,886)	(585,422)	(681,188)	(620,320)
Basic and diluted (loss) per share	(0.03)	(0.02)	(0.03)	(0.03)
(unaudited)	<b>2008 Q2</b>	<b>2008 Q1</b>	<b>2007 Q4</b>	<b>2007 Q3</b>
Interest income	4,646	10,300	1,354	14,584
Total expenses	675,936	779,876	815,279	2,802,492
Loss and comprehensive (loss)	(671,290)	(769,576)	(813,924)	(2,787,908)
Basic and diluted (loss) per share	(0.04)	(0.04)	(0.05)	(0.23)

Net and comprehensive loss, quarter over quarter, is influenced by a number of factors including the scope of clinical development and research programs pursued; the stage (i.e. Phase I, II or III) of clinical trials undertaken; the number of clinical trials that are active during a particular period of time and the rate of patient enrollment. Each of these factors is ultimately a function of decisions made to continue the development and testing of a product candidate based on supporting safety and efficacy from clinical trial results. Consequently, expenses may vary from period to period. General and administrative expenses are dependent on the infrastructure required to support the corporate, clinical and business development objectives and initiatives of the Company. No material increase in general and administrative costs is expected over the short term.

### **Liquidity, Capital Resources and Outlook**

As at June 30, 2009, we had cash and cash equivalents of \$781,488 compared to \$620,276 as at December 31, 2008. Surplus cash is invested in redeemable, short-term money market investments. As at June 30, 2009, the Company had working capital of \$464,390 compared to \$234,196 as at December 31, 2008. We anticipate that the combination of our current cash on hand, plus our July 16, 2009 private placement financing, will be sufficient to fund operations into the first quarter of 2010, at which time we will need to obtain additional proceeds through equity or debt financing or by selling or licensing our technology for cash proceeds. As mentioned previously, we are also exploring near term strategies to facilitate the exercise of 3,143,750 outstanding warrants which would provide approximately \$943,125 in gross proceeds to the Company. However our working capital position may not be sufficient enough to meet our business objectives in the event of unforeseen circumstances or a change in our strategic direction.

The crisis in the financial markets has severely restricted access to capital for life science companies over the course of the 2<sup>nd</sup> half of 2008 and the first half of 2009, particularly in Canada. As a result, our industry is experiencing significant consolidation which we expect to continue for some time. Very recently we have seen a general improvement in the global financial markets, particularly in the United States. However, the situation remains unclear as to whether the improvement is merely a transient one or more reflective of an actual return to global economic growth. Consequently, we remain cautious in our outlook. As at June 30, 2009, we had \$781,488 in cash and cash equivalents on hand and in conjunction with the gross proceeds of \$475,000 we received from the private placement financing announced on July 16, 2009, we anticipate this will provide sufficient cash resources into the first quarter of 2010.

Like many companies in our sector, we had previously taken a number of steps to preserve cash resources and manage operations through this difficult economic climate. These included:

- a) postponement of capital intensive projects until appropriate cash resources are secured to fully fund those projects;
- b) reducing operational expenditures wherever possible to preserve cash and increase our liquidity, including a 20% reduction in compensation for six of seven employees; and
- c) exploring a number of strategic initiatives in parallel which including various financing scenarios, strategic partnerships, mergers and acquisitions that would add additional resources to our Company and its development programs.

The programs remain ongoing. Note that there can be no assurance that we will be successful with any of the strategic initiatives noted above.

## **Comparison of Cash Flow**

We realized a net cash inflow of \$161,212 for the quarter ended June 30, 2009 reflecting overall operating costs for the Company for the six months ending June 30, 2009 of \$1,076,863 less \$1,238,075 of cash inflows coming from financing proceeds received in the same period. This compares to a net cash outflow of \$490,648 for the quarter ended June 30, 2008 which consisted of a cash outflow from operations of \$1,562,735 less \$1,072,087 of cash inflows coming from financing proceeds and the exercise of options and warrants. The primary reason for the increase in net cash inflows is due to a combination of both the expense reduction initiatives implemented by the Company and our ability to raise equity capital.

We expect cash outflows for the next few months will remain fairly consistent with outflows experienced for the quarter ended June 30, 2009. Any cash inflows will be highly dependent on our ability to raise additional capital.

## **Long-Term Obligations and Other Contractual Commitments**

In January 30, 2009, we signed an additional three year extension for our operating lease extending the expiration date to May 31, 2012. We will need to negotiate an extension to use our current facilities beyond this date or find new office space. We cannot be assured that any new arrangement will be negotiated at similar or lower office rental and related costs.

## **Transactions with Related parties**

During the six months ended June 30, 2009, directors provided consulting services to the Company totalling \$3,000 (for the six months ended June 30, 2008 - \$14,048).

## **Critical Accounting Estimates**

Our consolidated financial statements are prepared in accordance with GAAP. These principles require management to make estimates and assumptions that affect the reported amounts of assets, liabilities, expenses and disclosures within the notes. While management believes that these estimates and assumptions are reasonable, actual results could vary significantly.

We believe the following policies to be critical to understanding our financial position and results of operations as these policies require management to make significant estimates, assumptions and judgments about matters that are inherently uncertain.

### *Stock based compensation*

We account for stock based compensation under the fair value-based method. Under the fair value based method, stock based payments to employees and non-employees are measured at the fair value of the equity instruments issued. The fair value of stock based payments to non-employees is periodically re-measured until the services are provided or the options vest, and any change therein is recognized over the period. We use the Black-Scholes option pricing model to calculate stock option values, which requires certain assumptions about future stock price volatility. Changes to any of these assumptions could produce different results, which could have a material impact on results.

### *Intangible assets*

Our intangible assets are our licenses to use various technologies, and include proprietary rights, intellectual property, patent rights and technology rights which have been acquired from third parties. Intangibles assets

are amortized on a straight line basis over the terms of the related license, ranging from 10 to 15 years. Intangible assets are reviewed for impairment upon the occurrence of events or changes in circumstances indicating that the carry value of the asset may not be recoverable. A significant change in the estimates used for valuing the intangible assets or the amortization may impact its remaining useful life and therefore would impact results.

### *Income Taxes*

The Company follows the liability method of accounting for income taxes. Under this method, current income taxes are recognized for the estimated income taxes payable for the current period. Future income tax assets and liabilities are recognized in the current period for temporary differences between the tax and accounting basis of assets and liabilities as well as for the benefit of losses available to be carried forward to future years for tax purposes. Future income tax assets and liabilities are measured using substantively enacted tax rates and laws expected to apply in the years in which those temporary differences are expected to be recovered or settled. The effect of a change in tax rates on future income tax assets and liabilities is recognized in operations in the period that includes the substantive enactment. The amount of future income tax assets recognized will be limited to the amount of the benefit that is more likely than not to be realized.

### **Financial Instruments**

The Company's financial instruments consist of cash and cash equivalents, short term investments, accounts receivable and accounts payable. The carrying amounts reported in the consolidated balance sheets for these financial instruments approximate fair value because of the immediate or short-term maturity.

The Company, through its financial assets and liabilities, is exposed to various risks. The following analysis provides a measurement of risks as at June 30, 2009:

#### **a) Foreign exchange risk**

Foreign exchange risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates. The Company is exposed to foreign exchange risk on its cash and cash equivalents and its obligations under accounts payable.

The Company incurs expenditures in US currencies. Fluctuations in the value of the U.S. dollar relative to the Canadian dollar will impact the Company's results from operations.

The Company does not hold or issue financial instruments to manage its exposure to currency rate fluctuations.

#### **b) Interest rate risk**

The only financial instruments that expose the Company to interest rate risk are its cash and cash equivalents. Cash and cash equivalents which are in excess of day-to-day requirements are placed in short-term deposits with high quality credit financial institutions and earn interest at rates available at that time.

**c) Currency risk**

The Company has expenditures in foreign currency and therefore is exposed to foreign exchange risk arising from transactions denominated in USD. A significant change in the currency rates could have an effect on the Company's results of operations. The Company has not hedged its exposure to currency fluctuations.

**d) Liquidity risk**

Liquidity risk is the risk that the Company will encounter difficulty in raising funds to meet cash flow requirements associated with financial instruments. The recent problems in the global credit markets have resulted in a drastic reduction in the ability of companies to raise capital through the public markets.

On July 16, 2009, the Company completed a private placement for gross proceeds of \$475,000.

The Company continues to manage its liquidity risk by being fairly consistent with outflows experienced for the six months ended June 30, 2009 and are undertaking efforts to conserve cash resources wherever possible.

**e) Credit risk**

The Company's exposure to credit risk consists of the carrying value of its cash and cash equivalents.

The Company limits its exposure to credit risk, with respect to cash and cash equivalents, by placing them with high quality credit financial institutions. The Company's cash equivalents consist primarily of operating funds and deposit investments with commercial banks. Of the amounts with financial institutions on deposit, the following table summarizes the amounts at risk should the financial institutions with which the deposits are held cease trading:

	<b>Cash and cash equivalents</b>	<b>Insured amount</b>	<b>Non insured amount</b>
	<b>\$</b>	<b>\$</b>	<b>\$</b>
CIBC	393,412	100,000	293,412
Manulife	80,059	80,059	-
Raymond James	308,017	308,017	-
	<u>781,488</u>	<u>488,076</u>	<u>293,412</u>

**New Accounting Pronouncements**

*Goodwill and intangible assets*

In February 2008, the CICA issued Section 3064 "Goodwill and Intangible Assets". This new accounting standard, which is effective for fiscal periods beginning on or after January 1, 2009, replaces existing Section 3062 "Goodwill and Other Intangible Assets" and Section 3450 "Research

*and Development Costs*” and establishes the standards for the recognition, measurement, presentation and disclosure of goodwill and intangible assets. We are currently assessing the future impact of this new standard on our consolidated financial statements.

#### *Business combinations, consolidated financial statements and non-controlling interests*

In January 2008, the CICA introduced Handbook Section 1582, to replace Handbook section 1581 “Business Combinations” and sections 1601 and 1602 together replace Handbook section 1600 “Consolidated Financial Statements”. The adoption of section 1582, and collectively, 1601 and 1602 provides the Canadian equivalent to International Financial Reporting Standard (“IFRS”) 3 “Business Combinations” and International Accounting Standards (IAS) 27 “Consolidated and Separate Financials Statements”, respectively. CICA 1582 applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after January 1, 2011. CICA 1601 and CICA 1602 apply to interim and annual consolidated financial statements relating to years beginning on/after January 1, 2011. The impact of these standards, effective for the Company on January 1, 2011, has not been determined on the Company’s consolidated financial statements.

#### *International Financial Reporting Standards (IFRS)*

In February 2008, the Canadian Accounting Standards Board (“AcSB”) announced that the change over for publically-listed companies to adopt IFRS, replacing Canadian GAAP will be effective for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. We are currently assessing the future impact of the transition to IFRS on our consolidated financial statements.

### **Risks and Uncertainties**

The primary risk factors affecting the Company are set fourth in our annual information form for 2009. A copy of our annual information form is available on SEDAR at [www.sedar.com](http://www.sedar.com).

### **Disclosure Controls and Procedures**

The Company’s Chief Executive Officer (“CEO”) and Chief Financial Officer (“CFO”) are responsible for establishing and maintaining the disclosure controls and procedures of the Company, and have so certified, as required by Multilateral Instrument 52-109. These officers have evaluated the effectiveness of the Corporation’s disclosure controls and procedures and have concluded that the disclosure controls and procedures at the Company provide management a reasonable level of assurance that information required to be disclosed by the Company on a continuous basis and in annual and interim filings or other reports is recorded, processed, summarized, and reported or disclosed on a timely basis as required.

It should be noted that while the CEO and CFO believe that the Company’s disclosure controls and internal control procedures provide a reasonable level of assurance that they are effective, they do not expect disclosure controls and internal control procedures over financial reporting will prevent all errors and fraud. A control system no matter how well conceived or operated can provide only reasonable, not absolute assurance that the objectives of the control system are met.

## **Outstanding Share Capital**

As at August 21, 2009, we had an unlimited number of authorized common shares with 29,512,093 common shares issued and outstanding.

As at August 21, 2009, we had 3,143,750 warrants outstanding. Each warrant entitles the holder to purchase one additional common share at an exercise price of \$0.30 and they expire in two tranches, one on January 31, 2010 and the second on February 10, 2009.

As at August 21, 2009, we had 1,721,429 options outstanding. Each option entitles the holder to purchase one additional common share at exercise prices ranging from \$0.15 to \$1.00 and expiry dates ranging from April 7, 2010 to July 16, 2014.

For a detailed summary of all outstanding securities convertible or exercisable into equity securities of the Company, refer to Note 7 of the Consolidated Financial Statements for the six month period ended June 30, 2009.