

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

*This management discussion and analysis ("MD&A") was performed by management using information available as of February 16, 2009 and should be read in conjunction with our unaudited interim consolidated financial statements and the notes thereto for the three and nine months ended December 31, 2008, as well as audited consolidated financial statements and the notes thereto and the MD&A for the year ended March 31, 2008. All financial information has been prepared in accordance with Canadian generally accepted accounting principles ("Canadian GAAP"), and all amounts are expressed in Canadian dollars unless otherwise indicated. Additional information relating to Pacgen Biopharmaceuticals Corporation (the "Company") can be obtained from SEDAR at [www.sedar.com](http://www.sedar.com).*

*The forward-looking statements in this discussion regarding our expectations of our future performance, liquidity and capital resources and other non-historical statements include numerous risks and uncertainties, as described in the "Risk Factors" section of our Annual Information Form, which is available on SEDAR at [www.sedar.com](http://www.sedar.com). The words "anticipates", "believes", "estimates", "expects", "intends", "may", "could", "plans", "projects", "will", "would" and similar expressions are intended to identify forward-looking statements, although not all forward-looking statements contain these identifying words. Such statements involve known and unknown risks, uncertainties and other factors that may cause actual results, level of activity, performance or achievements to be materially different from those implied by such statements. Such factors include, among others, our stage of development, lack of product revenues, additional capital requirements, risk associated with completion of clinical trials and obtaining regulatory approval, dependence on collaborative partners, our ability to protect our intellectual property, and our ability to stay competitive in a rapid changing industry environment. We undertake no obligation to revise or update forward looking statements in this discussion whether as a result of new information, future events or otherwise. Accordingly, readers should not place undue reliance on forward looking statements in this discussion.*

### OVERVIEW

We are a life sciences company focused on the development of novel therapeutic drugs for the treatment of infectious and inflammatory diseases. Our current development efforts are focused on PAC-113, an anti-fungal for the treatment of oral candidiasis and PAC-G31P, a novel peptide therapeutic designed to treat inflammatory diseases characterized by non-beneficial neutrophil.

Oral candidiasis, or thrush, is usually seen as a secondary consequence arising from one of a number of primary or underlying medical conditions including HIV/AIDS, cancer, diabetes, asthma and xerostomia (abnormal dryness of the mouth). In February 2005, we completed a sublicense agreement with Demegen, Inc. (the "Demegen Sublicense"). The Demegen Sublicense provides us exclusive worldwide rights to develop and commercialize PAC-113 for human oral disease conditions. PAC-113 is a 12 amino-acid antimicrobial peptide derived from a naturally occurring histatin protein found in saliva. This peptide alters the permeability of fungal cell membranes causing cell death. We are developing PAC-113 in a mouthrinse formulation for the topical treatment of oral candidiasis. In May 2007, we announced positive top-line results from our proof of concept clinical trial (the "Phase I/II clinical trial") demonstrating that PAC-113 is generally safe, well-tolerated and effective in the treatment of oral candidiasis. Also in May 2007, we received results from our formulation studies indicating that the anti-fungal activity of PAC-113 can be increased when the drug is formulated with lower buffer molarity. Based on these results, we initiated a Phase IIb clinical trial in November of 2007 using the optimized PAC-113 formulation. In June 2008, we announced positive results from our Phase IIb clinical trial demonstrating that PAC-113 is effective in the treatment of oral candidiasis and compares favourably to the efficacy demonstrated by Nystatin, a current standard of care. Subject to raising additional working capital, we plan to meet the United States Food & Drug Administration (the "FDA") to discuss our proposed Phase III clinical development plan.

Non-beneficial neutrophil recruitment is a key characteristic of a number of acute and chronic inflammatory conditions, including acute respiratory distress syndrome, severe asthma, chronic obstructive pulmonary disease, pneumonia, Crohn's Disease, rheumatoid arthritis and ischemia/reperfusion injury. In April 2006, through the acquisition of IL Therapeutics Inc. ("ILT"), we obtained exclusive worldwide rights to PAC-G31P technology for the prevention and treatment of severe inflammatory diseases characterized by neutrophil over-recruitment. PAC-G31P is a small recombinant protein that is a synthetic analogue of the human cytokine called Interleukin-8 which is the key chemokine involved in neutrophil recruitment. We are developing PAC-G31P to treat inflammatory diseases. Since taking over the PAC-G31P program, we

conducted a number of preclinical and mechanistic studies, and initiated formulation development work. PAC-G31P is currently in preclinical development. In order to determine the optimal first clinical indication for PAC-G31P we plan to complete a number of preclinical studies, as well as conduct manufacturing development and formulation work, over the next year. The results of this preclinical program in conjunction with a successful Investigational New Drug (“IND”) filing will directly support our out-licensing initiatives.

We currently hold the rights to 32 patents and 19 patent applications in the United States and other jurisdictions relating to products in our development pipeline. We also hold 2 granted patents and 12 patent applications and intellectual properties to two other research compounds that we no longer develop. We plan to invest the majority of our efforts and resources to advance PAC-113 through late stage clinical development and complete preclinical studies on PAC-G31P to support an IND application and out-licensing initiatives.

## **CORPORATE DEVELOPMENT**

During the quarter ended December 31, 2008, we announced that we have terminated our letter of intent for a business combination with Medigen Biotechnology Corp. (“Medigen”). In accordance with the letter of intent signed in October 2008, the closing of the proposed business combination was subject to certain terms and conditions, including obtaining necessary approvals to enter into a definitive agreement. The parties determined that, in a share for share exchange transaction, the regulatory requirements in Taiwan would require an issuer to redeem dissenting shareholder interests for cash. Both parties anticipated that this requirement would negatively affect the liquidity and capital resources of the combined company, and that the proposed merger would be a significant undertaking given current financial market conditions. As a result, both parties have mutually elected not to proceed with the signing of a definitive agreement.

During the quarter ended December 31, 2008, we also made arrangements to settle our outstanding accounts of approximately US\$1.3 million with a vendor. We received a credit note for out of scope charges and recovered approximately US\$603,000 of research and development expenditures from this vendor, and arranged to settle the remaining balance of approximately US\$708,500 by installment payments. We subsequently made our first installment payment of US\$128,000 in February 2009.

Subsequent to the quarter ended December 31, 2008, we announced that we intended to offer, through one or more tranches of closings of a non-brokered private placement, convertible debentures in an aggregate principal amount of up to approximately \$610,000 (the “Offering”). On February 3, 2009, we completed the first tranche of the Offering for an aggregate principal amount of \$364,500.

## **CRITICAL ACCOUNTING POLICIES AND SIGNIFICANT ESTIMATES**

Our unaudited interim consolidated financial statements are prepared in accordance with Canadian GAAP. These accounting principles require us to make certain estimates and assumptions. We believe that the estimates and assumptions upon which we rely are reasonable based upon information available at the time that these estimates and assumptions are made. Actual results could differ from these estimates. Significant areas requiring the use of estimates relate to the assessment for impairment and useful lives of intangible assets, determination of share value in transactions where shares are issued as a consideration, accrued liabilities, estimation of income tax expense and determination of fair value of stock-based compensation. The significant accounting policies that we believe are the most critical in fully understanding and evaluating the reported financial results include those which follow:

### ***Intangible Assets***

Intangible assets are comprised of technology licenses and rights acquired from third parties. Technology licenses and rights are initially recorded at the fair value based on consideration paid and are amortized on a straight-line basis over the estimated useful life of the underlying technologies. We determine the estimated useful lives for intangible assets based on a number of factors: legal, regulatory or contractual limitations; known technological advances; anticipated market size; and the existence or absence of competition. A significant change in any of the above factors may require a revision of the expected useful life of the intangible asset, resulting in accelerated amortization or an impairment charge, which could have a material impact on our results of operations. We evaluate the recoverability of the net book value of our intangible assets whenever events or changes in circumstances indicate the carrying value may not be recoverable. If the carrying value of

the underlying technology exceeds the estimated net recoverable value, calculated based on estimated undiscounted future cash flows, then the carrying value is written down to its fair value, based on the related estimated discounted cash flows. The amounts shown for technology licenses and rights do not necessarily reflect present or future values and the ultimate amount recoverable will be dependent upon the successful development and commercialization of products based on these rights.

### ***Research and Development Costs***

Research costs, including costs for new patents and patent applications, are expensed in the period in which they are incurred. Development costs are expensed in the period in which they are incurred unless such development costs meet the criteria under Canadian GAAP for deferral and amortization. No development cost has been deferred to date.

Contract research and development expenses, including fees paid to contract research organizations, investigators and other vendors who conduct certain product development activities on our behalf, are recognized in an accounting period based on estimates of the work performed during the period using an accrual basis of accounting. Since the service agreements with these vendors may be in force over a number of accounting periods and payments may not coincide with the period in which the services are rendered, judgment is required in estimating the amount of research and development expense to be recorded in each accounting period. Judgment and estimates are also involved in determining the amount of expenditures that are contractually committed under the various agreements. We consider the following factors in estimating the amount of clinical trial expense for an accounting period: the level of patient enrolment; the level of services provided and goods delivered; and the proportion of the overall contracted time that elapsed during the accounting period. In making these assessments, we monitor patient enrolment levels and related activities at a given point in time through internal reviews, correspondence and discussions with contractors and review of contractual terms. We may sometimes rely on the information provided by our contractors. A significant change in the above factors and the accuracy of information provided by our contractors may alter our estimate of our clinical trial expenditure for the accounting period and prepaid expenses or accrued liabilities as of the end of the accounting period. This could have a material impact on our results of operations and accrued liabilities.

Amounts advanced to third parties in connection with planned future research and development activities are deferred as prepaid expenses and are expensed as research and development costs based on estimates of the activities.

### ***Stock-based Compensation and other stock based payments***

We grant stock options to employees, directors, and consultants pursuant to a stock option plan. We use the fair value method to account for all stock-based awards granted, modified or settled, and the Black-Scholes option pricing model to determine the fair value of stock options granted. A compensation expense is recorded based on the estimated fair value of options with a corresponding credit to contributed surplus. Any consideration received on the exercise of stock options is credited to share capital. The fair value of stock-based awards to employees and directors is measured on the date of grant and amortized over the vesting period. The fair value of stock-based awards to consultants is measured at the performance commitment date or the date that the service is delivered. We amortize the fair value of stock options over the vesting terms of the options which are generally two to three years from grant.

The estimation of the fair value of stock options using the Black-Scholes option pricing model involves subjective assumptions of the expected life of the option, the expected volatility at the time the options are granted, and risk-free interest rate. Changes in these assumptions can materially affect the measure of the estimated fair value of our stock options, hence our results of operations.

## **CHANGE OF ACCOUNTING POLICIES**

### ***General Standards of Financial Statement Presentations***

In May 2007, the Canadian Accounting Standards Board (the "AcSB") amended CICA Handbook Section 1400, "General Standards of Financial Statement Presentation", to change the guidance related to management's responsibility to assess the ability of the entity to continue as a going concern.

The main features of the changes are as follows:

- (i) management is required to make an assessment of an entity's ability to continue as a going concern;
- (ii) in making its assessment, management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the balance sheet date;
- (iii) financial statements must be prepared on a going concern basis unless management either intends to liquidate the entity, to cease trading or cease operations, or has no realistic alternative but to do so;
- (iv) disclosure is required of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern; and
- (v) when financial statements are not prepared on a going concern basis, that fact should be disclosed, together with the basis on which the financial statements are prepared and the reason the entity is not regarded as a going concern.

This section became effective for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2008. We adopted these standards commencing April 1, 2008. The new disclosure requirements pertaining to this section are contained in note 2 of our unaudited interim consolidated financial statements.

### ***Capital Disclosures***

The AcSB issued Section 1535, "*Capital Disclosures*". This section establishes standards for disclosing information about an entity's capital and how it is managed in order that a user of the financial statements may evaluate the entity's objectives, policies and processes for managing capital. This section became effective for interim and annual financial statements relating to fiscal years beginning on or after October 1, 2007. We adopted these standards commencing April 1, 2008. The adoption of these new standards did not have a material impact on our unaudited interim consolidated financial statements. The new disclosure requirements pertaining to this section are contained in note 4 of our unaudited interim consolidated financial statements.

### ***Financial Instruments***

The AcSB issued two new Sections in relation to financial instruments: Section 3862, "*Financial Instruments – Disclosure*", and Section 3863, "*Financial Instruments – Presentation*". The new disclosure standard increases the emphasis on the risks associated with both recognized and unrecognized financial instruments and how these risks are managed. The new presentation standard carries forward the former presentation requirements. Both sections became effective for interim and annual financial statements relating to fiscal years beginning on or after October 1, 2007. We adopted these standards commencing April 1, 2008. The adoption of these new standards did not have a material impact on our unaudited interim consolidated financial statements. The new disclosure requirements pertaining to this section are contained in note 5 of our unaudited interim consolidated financial statements.

## **NEW ACCOUNTING PRONOUNCEMENTS**

In January 2006, the AcSB adopted a strategic plan for the direction of accounting standards in Canada. As part of that plan, accounting standards in Canada for public companies are expected to converge with International Financial Reporting Standards ("IFRS") for accounting periods commencing on or after January 1, 2011. IFRS uses a conceptual framework similar to Canadian GAAP, but there are some significant differences on recognition, measurement and disclosures. We continue to monitor and assess the impact of convergence of Canadian GAAP and IFRS.

In February 2008, the CICA issued Section 3064, "Goodwill and Intangible Assets", which replaces Section 3062, "Goodwill and Other Intangible Assets" and Section 3450, "Research and Development Costs". Various changes have been made to other sections of the CICA Handbook for consistency purposes. Section 3064 establishes standards for the recognition, measurement, presentation and disclosure of goodwill subsequent to its initial recognition and of intangible assets. The new Section will be applicable to our consolidated financial statements for its fiscal year beginning April 1, 2009. We are currently evaluating the impact of the adoption of this new Section on our consolidated financial statements.

## SELECTED CONSOLIDATED FINANCIAL INFORMATION

The following table sets forth consolidated financial data for the fiscal years ended March 31, 2008, 2007 and 2006:

	For the year ended March 31,		
	2008	2007	2006
Net loss for the period	\$(5,974,712)	\$(4,353,837)	\$(1,568,057)
Per share loss, basic and fully diluted	\$(0.19)	\$(0.20)	\$(0.15)
Total assets	\$3,024,237	\$7,834,666	\$1,419,348

## RESULTS OF OPERATIONS

### *Overall Performance*

We recorded a net loss of \$21,698 (\$0.00 per common share) for the three months ended December 31, 2008 (“Q3 2009”), compared to a net loss of \$970,985 (\$0.03 per common share) for the three months ended December 31, 2007 (“Q3 2008”). On a year-to-date basis, we recorded a net loss of \$1,971,653 (\$0.06 per common share), compared to a net loss of \$4,310,495 (\$0.14 per common share) for the same period in the preceding fiscal year. The decrease in net loss in each of the periods in Q3 2009 and on a year-to-date basis, as compared to the same periods in the preceding year, was largely due to a recovery of \$746,516 (approximately US\$603,000) of research and development expenditures and reduced operating expenditures.

We initiated our cost control program, which involved eliminating of administrative support positions, reduction of management salaries and focus our development efforts primarily on our lead program, PAC-113, in November 2007. A further reduction in management salaries was implemented in February 2008. Following the completion of our Phase IIb clinical trial of PAC-113 in June 2008, we reduced our operational activities in research and development and primarily focused in financing and business development activities. We are exploring different financing alternatives, including equity financing, debt arrangement, merger and acquisition, research and development collaboration and licensing arrangement, to finance our operations. As part of these efforts, we made arrangements to settle our outstanding accounts of approximately US\$1.3 million with a vendor. We received a credit note for out of scope charges and recovered approximately US\$603,000 of research and development expenditures from this vendor, and arranged to settle the remaining balance of approximately US\$708,500 by installment payments. We subsequently made our first installment payment of US\$128,000 in February 2009. We announced in late January 2009 that we intended to offer, through one or more tranches of closings of a non-brokered private placement, convertible debentures in an aggregate principal amount of up to approximately \$610,000. We completed the first tranche of the Offering for an aggregate principal amount of \$364,500 on February 3, 2009.

For the remaining of the fiscal year ending March 31, 2009 (“Fiscal 2009”), we expect to incur significant lower operating expenditures compared to those in the preceding year (“Fiscal 2008”).

### *Revenues*

We have not generated any revenue from sales of commercial products since our incorporation and we do not expect to generate any revenues until we secure collaborative partners who provide funding on our research and clinical development or upon sales of our product candidates.

### *Research and Development Expenditures*

Research and development expenditures were \$208,858, offset by a recovery of out of scope charges from a vendor in the amount of \$746,516 (approximately US\$603,000), resulting in a net expense recovery of \$537,658 for Q3 2009, compared to research and development expenditures of \$431,197 for Q3 2008. On a year-to-date basis, research and development expenses were \$1,245,309, offset by a recovery of out of scope charges from a vendor in the amount of \$746,516, resulting in a net expenditures of \$498,793 as compared to \$2,408,620 for the same period in the preceding year.

The decrease of \$222,339 in research and development expenditures before giving effect to the recovery from a vendor in Q3 2009, as compared to Q3 2008, was primarily due to a decrease in research and development activities. We incurred lower development cost for all of our projects in Q3 2009, as compared to Q3 2008, due to funding constraints. Since the implementation of our initial cost control program in November 2007, we have devoted our research and development efforts primarily on our lead program, PAC-113. Our research and development activities were further reduced after we completed the Phase IIb clinical trial of PAC-113 in June 2008.

The decrease of \$1,163,311 in research and development expenditures before giving effect to the recovery from a vendor in the nine months ended December 31, 2008 ("YTD 2009"), as compared to the same period in the preceding year ("YTD 2008"), was due to our focus on Phase II clinical development of PAC-113. Research and development expenditures for PAC-113 in YTD 2009 were slightly lower than those in YTD 2008. While research and development expenditures for PAC-G31P project were significantly lower in YTD 2009, as compared to YTD 2008.

The following provides a summary of the research and development expenditures by programs for the comparative three and nine months ended December 31, 2008 and since inception:

Project	For the three months ended		For the nine months ended		Cumulative from Inception on April 23, 2004 to December 31, 2008
	December 31, 2008	2007	December 31, 2008	2007	
PAC-113					
Expense	\$181,502	\$350,860	\$1,109,120	\$1,273,250	\$5,423,364
Recovery	(746,516)	–	(746,516)	–	(746,516)
	(565,014)	350,860	362,604	1,273,250	4,676,848
PAC-G31P	10,308	74,340	111,927	1,104,229	1,939,224
Other Projects	17,048	5,997	24,262	31,141	213,151
	\$(537,658)	\$431,197	\$498,793	\$2,408,620	\$6,829,223

#### *PAC-113*

The decrease of PAC-113 development cost in Q3 2009, compared to those in Q3 2008, was primarily due to the reduced research and development activities following the completion of Phase IIb clinical study in June 2008. The development cost for YTD 2009 was slightly lower than those incurred in YTD 2008. The development cost in YTD 2009 covered part of the cost associated with the Phase IIb clinical trial. The development cost in YTD 2008 covered part of the cost associated with the Phase IIb clinical trial, as well as Phase I/II clinical trial completed in May 2007.

External cost composed of all development costs other than internal overhead, for the Phase I/II trial was approximately \$1.6 million. The Phase I/II trial which involved 107 patients was initiated in March 2006 and completed in May 2007. As a result, the related cost was spread over three fiscal years ended March 31, 2008. The external cost for the Phase IIb study, which involved 223 patients, was approximately \$2.5 million. The Phase IIb study was initiated in November 2007 and completed in June 2008. The related cost for Phase IIb was incurred over two fiscal years ending March 31, 2009.

We are exploring different alternatives, including seeking research and development collaborative partner, to provide funding for PAC-113 development. Upon securing additional funding, we intend to meet with the FDA to discuss our Phase III clinical development plan. For the remaining period of Fiscal 2009, we expect to incur minimal research and development expenditures for PAC-113.

#### *PAC-G31P*

The decreased research expenditures for PAC-G31P in Q3 2009 and in YTD 2009, compared the same periods in the preceding year, were primarily due the reduced research and development activities associated with this project. As described earlier, we devoted our research and development efforts primarily on our clinical program of PAC-113 since the implementation of our cost control program in November 2007. Research cost for PAC-G31P in each of the current fiscal periods is mainly composed of internal overhead associated with our research personnel. Research cost for PAC-G31P in the same fiscal periods in the preceding year covered expenditures associated with preclinical studies, mainly through our collaboration with the University of Saskatchewan, and manufacturing development of PAC-G31P.

We initiated our manufacturing development and formulation work in February 2007 and successfully reproduced PAC-G31P at Good Laboratory Practices Standards (“GLP”) level in July 2007. In order to determine the optimal first clinical indication for PAC-G31P, we plan to complete a number of preclinical studies, as well as continue our manufacturing development and formulation work at Good Manufacturing Practice Standards (“GMP”) level when we secure additional funding. The results of these studies in conjunction with a successful IND application filing will directly support our out-licensing initiatives. For the remaining period of Fiscal 2009, we expect to incur minimal research and development expenditures for PAC-G31P.

### ***General and Administration Expenditures***

General and administration expenditures for Q3 2009 were \$277,673, compared to \$406,920 for Q3 2008. On a year-to-date basis, general and administration expenditures were \$881,375 as compared to \$1,594,128 for the same period in the preceding year. The decreased general and administration expenditures in Q3 2009 and in YTD 2009, as compared to the same periods in the preceding year, was primarily due to the implementation of our cost control programs.

The following provides a summary of the general and administration expenditures for the comparative three and nine months ended December 31, 2008 and since inception:

General and Administration Expenditures	For the three months ended		For the nine months ended		Cumulative from Inception on April 23, 2004 to December 31, 2008
	December 31, 2008	2007	December 31, 2008	2007	
Salaries and benefits	\$68,577	\$184,569	\$279,901	\$665,596	\$2,412,808
Consulting and professional	162,316	144,761	434,173	438,162	1,791,069
Travel and accommodation	6,931	13,574	36,756	86,136	325,962
Market research for product candidate	—	—	—	121,238	136,149
Other general overhead	39,849	64,016	130,545	282,996	1,242,355
	<b>\$277,673</b>	<b>\$406,920</b>	<b>\$881,375</b>	<b>\$1,594,128</b>	<b>\$5,908,343</b>

The decrease in salaries and benefits in each of the periods in Q3 2009 and YTD 2009, compared to the same periods in the preceding year, reflects the result of our precautionary measures to reduce our cash burn. We implemented a cost management program which involved elimination of two administrative support positions and 30% reduction in management salaries in November 2007. A further 20% reduction in management salaries was implemented in February 2008. The decrease in each of the other line items, except consulting and professional fees in Q3 2009, was also primarily due to our cost control programs. The decrease of these general and administration expenditures in Q3 2009 was offset by an increase in consulting and professional fees associated with our previous merger discussion with Medigen and our business development activities.

For the remaining quarters in Fiscal 2009, we expect our general and administration expenditures to be lower than those incurred in Q3 2009.

### ***Stock-based Compensation***

Stock-based compensation, a non-cash item included in operating expenses, was \$51,410 in Q3 2009 compared to \$68,928 in Q3 2008. For Q3 2009, stock-based compensation attributable to research and development operations and general administration was \$8,820 [Q3 2008 - \$14,057] and \$42,590 [Q3 2008 - \$54,871], respectively. The decrease in stock-based compensation was primarily due to the recognition of stock-based compensation for options vested in the preceding periods. Year-to-date stock-based compensation was \$201,566 compared to \$226,751 for the same period last year. Year-to-date stock based compensation attributable to research and development operations and general administration was \$56,319 [YTD 2008 - \$63,972] and \$145,247 [YTD 2008 - \$162,779], respectively.

### Amortization

Amortization was \$66,307 in Q3 2009 compared to \$68,661 in Q3 2008. Year-to-date amortization was \$198,921 compared to \$205,340 for the same period last year. Amortization related to technology, licenses and rights remained the same at \$59,244 in Q3 2009 and \$177,731 in YTD 2009, compared to the same periods in the preceding year.

### Other Income (Loss)

Other loss in Q3 2009 was \$163,966 compared to \$7,358 in Q3 2008. On a year-to-date basis, other loss was \$190,998 compared to other income of \$67,066 for the same period in the preceding year. The increase in other loss of \$156,608 in Q3 2009 and \$258,064 in YTD 2009, compared to the same periods in the preceding year, was mainly due to a lower interest income and a higher foreign exchange loss. The decreased interest income was the result of lower interest rates earned on lower average amounts held in interest bearing accounts. A net foreign exchange loss of \$173,565 was recorded in Q3 2009 compared to \$25,194 in Q3 2008. A net foreign exchange loss of \$225,793 was recorded in YTD 2009 compared to \$21,556 in YTD 2008. The significant increase of foreign exchange loss was primarily due to the appreciation of the United States dollar, in comparison with the Canadian dollar, on our US denominated accounts payable and accrued liabilities. We are exposed to market risk related to currency exchange rates in the United States because the majority of our clinical development and manufacturing development expenditures are incurred in United States dollars.

## SUMMARY OF QUARTERLY RESULTS

Set forth below is the selected consolidated financial data for each of the last eight quarters:

	3rd Quarter Ended December 31, 2008 ("Q3 2009")	2nd Quarter Ended September 30, 2008 ("Q2 2009")	1st Quarter Ended June 30, 2008 ("Q1 2009")	4th Quarter Ended March 31, 2008 ("Q4 2008")
Research and development	\$537,658	\$(155,264)	\$(881,187)	\$(1,071,903)
General and administration	(277,673)	(298,815)	(304,887)	(307,439)
Stock based compensation	(51,410)	(91,346)	(58,810)	(119,597)
Amortization	(66,307)	(66,307)	(66,307)	(63,905)
Other income (loss)	(163,966)	(30,722)	3,690	(129,095)
Future income tax recovery	—	—	—	27,722
Net loss for the period	(21,698)	(642,454)	(1,307,501)	(1,664,217)
Basic and diluted loss per common share	\$(0.00)	\$(0.02)	\$(0.04)	\$(0.05)

	3rd Quarter Ended December 31, 2007 ("Q3 2008")	2nd Quarter Ended September 30, 2007 ("Q2 2008")	1st Quarter Ended June 30, 2007 ("Q1 2008")	4th Quarter Ended March 31, 2007 ("Q4 2007")
Research and development <sup>(1)</sup>	\$(431,197)	\$(912,203)	\$(1,065,220)	\$(1,146,359)
General and administration <sup>(1)</sup>	(406,920)	(550,878)	(636,330)	(754,348)
Stock based compensation <sup>(1)</sup>	(68,928)	(71,418)	(86,405)	(166,676)
Amortization <sup>(1)</sup>	(68,661)	(68,569)	(68,110)	(58,516)
Other income	(7,358)	28,015	46,409	58,343
Future income tax recovery	12,079	30,199	15,000	94,000
Net loss for the period	(970,985)	(1,544,854)	(1,794,656)	(1,973,556)
Basic and diluted loss per common share	\$(0.03)	\$(0.05)	\$(0.06)	\$(0.07)

<sup>(1)</sup> Stock based compensation and amortization figures have been presented as separate line items to conform to the presentation adopted in the quarter ended March 31, 2007.

## ***Summary of Quarterly Results***

The primary factors affecting the magnitude of our losses in the various quarters were (i) development costs associated with the PAC-113 program in-licensed in February 2005; (ii) research costs associated with the PAC-G31P program acquired in April 2007; (iii) general and administration expenditures to support our initial public offering (“IPO”) in December 2007; (v) stock based compensation following the adoption of our stock option plan in August 2006; and (iv) cost control program initiated in November 2007.

Research and development expenditures were relatively the same throughout the Fiscal 2008 except in Q3 2008. The decline in research and development expenditures in Q3 2008 was primarily due to the lower level operational activities during the quarter as we prepared to advance PAC-113 into Phase IIb and completed PAC-G31P GLP manufacturing development. The significant timelines impacting our research and development cost in Fiscal 2008 were: the completion of PAC-113 Phase I/II clinical trial in May 2007, the completion of PAC-G31P manufacturing development at GLP level in July 2007, and the initiation of PAC-113 Phase IIb trial in November 2007. General and administration expenditures were in a declining trend throughout Fiscal 2008. This was primarily due to the elimination of non-routine expenditures associated with the IPO in December 2007 and PAC-113 market research in Q1 2008, as well as the initiation of our cost control program in November 2007.

During Fiscal 2009, research and development expenditures continued to decline due to our decision to devote our development efforts primarily on our lead program, PAC-113, until further funding is raised. Research and development expenditures further declined as we wrapped up our Phase IIb clinical trial for PAC-113 in June 2008. During Q3 2009, we received a credit note for out of scope charges and recovered \$746,516 (approximately US\$603,000) of research and development expenditures from a vendor, resulting in a net research and development income. General and administration expenditures in each of the quarters in Fiscal 2009 remained relatively the same as those in Q4 2008 following the implementation of our cost control program in November 2007.

## **LIQUIDITY AND CAPITAL RESOURCES**

### ***Sources and Uses of Cash***

Since inception to December 31, 2008, our operational activities were financed from equity financings, and the cash acquired from IL Therapeutics Inc. in April 2006.

Cash used in operating activities for Q3 2009 was \$199,352 compared to \$901,049 for Q3 2008. Year-to-date cash used in operating activities was \$1,398,470 compared to \$4,089,725 for the same period in the preceding year. Cash used in operating activities was composed of net loss, add-backs or adjustments not involving cash and net change in non-cash working capital items. The decrease cash used in operating activities in each of the current fiscal periods was primarily due to the decreased operating loss.

There was no cash provided by or used in investing activities in Q3 2009 and in YTD 2009, as compared to cash provided by investing activities of \$6,221 in Q3 2008 and cash used in investing activities of \$13,265 in YTD 2008. The cash provided by investing activities in the preceding year consisted of disposal of property and equipment. The cash used in investing activities in the preceding year consisted of purchases of property and equipment. There was no cash provided by financing activities in Q3 2009 and in YTD 2009, as compared to cash used in financing activities of \$40,214 and \$54,332 in Q3 2008 and in YTD 2008, respectively.

As at December 31, 2008, we had available cash reserves comprised of cash and cash equivalents of \$40,221, compared to \$1,438,691 at March 31, 2008. We had working capital deficiency of \$1,041,205 as at December 31, 2008, compared to working capital of \$535,149 at March 31, 2008. We are currently seeking additional capital to finance our operations. Management is considering all financing alternatives, including equity financing, debt arrangement, merger and acquisition, corporate collaboration and licensing arrangement. During the quarter ended December 31, 2008, we made arrangements to settle our outstanding accounts of approximately US\$1.3 million with a vendor. We received a credit note for out of scope charges and recovered approximately US\$603,000 of research and development expenditures from this vendor, and arranged to settle the remaining balance of approximately US\$708,500 by installment payments. We subsequently made our first installment payment of US\$128,000 in February 2009.

Subsequent to the quarter ended December 31, 2008, we announced that we intended to offer, through one or more tranches of closings of a non-brokered private placement, convertible debentures in an aggregate principal amount of up to approximately \$610,000. On February 3, 2009, we completed the first tranche of the Offering for an aggregate principal amount of \$364,500.

As of December 31, 2008 and in the normal course of business we have obligations to make future payments, representing contracts and other commitments that are known, committed and non-cancellable.

	Contractual Obligations payment due by period				
	Total	2009-2010	2011-2012	2013	Thereafter
Operating Leases	\$179,475	\$124,561	\$54,914	\$ –	\$ –
Clinical Research Agreements <sup>(1)</sup>	2,810,289	2,810,289	–	–	–
License Agreements <sup>(2)</sup>	546,225	302,625	121,800	60,900	60,900
<b>Total</b>	<b>\$3,535,989</b>	<b>\$3,237,475</b>	<b>\$176,714</b>	<b>\$60,900</b>	<b>\$60,900</b>

<sup>(1)</sup> The total commitment of \$2,810,289 reflects \$45,988 and \$473,787 (\$465,594 has been paid and withheld by a vendor) of commitments that are non-cancellable and \$18,850 and \$2,271,664 of commitments that are cancellable for the fiscal years ending March 31, 2009 and 2010, respectively, should we decide to discontinue the related clinical research work.

<sup>(2)</sup> Pursuant to the Demegen Sublicense, we have a commitment to pay minimum annual royalties of US\$50,000 described in Note 7(a) of our annual consolidated financial statements for the fiscal year ended March 31, 2008. This commitment is converted into Canadian Dollars at the USD/CAD closing rate of 1.0642 on September 30, 2008. Pursuant to a license agreement between ILT and the University of Saskatchewan (the “US License”), we have a commitment to sponsor \$500,000 for research to be performed at the University of Saskatchewan, including, but not necessarily limited to, research related to the licensed technology PAC-G31P, within 5 years of the term of the agreement (\$273,000 has been paid as of December 31, 2008).

## OUTSTANDING SHARE CAPITAL

As of January 31, 2009, there were 35,144,693 common shares issued and outstanding, 4,691,133 common share purchase warrants outstanding at a weighted average price of \$0.30 per share, and 2,450,000 incentive stock options outstanding at a weighted average exercise price of \$0.93 per share.

## OFF-BALANCE SHEET ARRANGMENTS

We have no off-balance sheet arrangements.

## RELATED PARTY TRANSACTIONS

During Q3 2009 and YTD 2009, except for the \$503 fees [Q3 2008 and YTD 2008 – \$1,598] incurred for consulting services provided by a director, there was no other related party transaction. In the preceding year, we incurred \$nil and \$4,000 for consulting services provided by a consulting firm of which a director is a related party, and \$31,875 and \$95,625 for research services provided by a consulting firm of which an officer is the principal in Q3 2008 and YTD 2008, respectively.

## **RISKS AND UNCERTAINTIES**

Due to the inherent nature of our business, investing in our securities involves a high degree of risk and uncertainties. Such risk factors include, among others, our stage of development, lack of product revenues, additional capital requirements, risk associated with completion of clinical trials and obtaining regulatory approval, dependence on collaborative partners, our ability to protect our intellectual property and our ability to stay competitive in a rapid changing industry environment.

We are in the early stage of development and have limited operating history. We have not generated any revenues to date from product sales, nor do we expect any product revenues for the immediate future. To achieve profitable operations, we must successfully develop our products that are currently in the research and development phase on our own or with collaborative partners. These product developments may take a number of years and involve significant risks and uncertainties. As a result, we require substantial additional capital to finance our product developments.

We are currently seeking additional capital to finance our operations. Management is considering all financing alternatives, including equity financing, debt arrangement, merger and acquisition, corporate collaboration and licensing arrangement, and has engaged in discussions with multiple parties on some of these alternatives. There can be no assurance that such financing will materialize on a timely basis or obtained on favorable terms. If we are unable to obtain additional financing, we may be required to curtail or discontinue our operations.

We are exposed to credit risks, interest rate risk, currency risk and liquidity risks as described in Note 5 in our unaudited interim consolidated financial statements. We are also subject to other significant risks and uncertainties listed in the section entitled "Risk Factors" in our Annual Information Form dated July 31, 2008.