



May 29, 2007

Dear Shareholders:

On behalf of the Board of Directors, I wish to thank you for your interest and continued support of Medicago. These are exciting times for our Company as we are glad to see you put your confidence in our ability to successfully deliver innovative solutions in protein production.

The first quarter of 2007 was one of diversification and progress. We made significant advances in our protein development programs as our activity focus is now mainly directed towards the vaccine market. In that respect, we initiated key research that should provide vital information for the subsequent clinical trials to come. First, we launched a pre-clinical study for an influenza vaccine with Hemagglutinin (HA). This study is pivotal to bring our proprietary technological platform to operational and commercial status.

Aware of market expectations in regards to a possible influenza pandemic, we have also accelerated our development timetable to start work on an Avian Influenza vaccine (H5N1). News of sporadic influenza-related deaths across the globe has generated increased awareness among health authorities to develop a new, faster, and more reliable approach for H5N1 vaccine production. Being at the forefront of this scientific challenge, Medicago intends to respond innovatively to this global health threat and has now deployed the necessary resources to rapidly produce an H5N1 influenza vaccine.

Financially, the Company has exercised a rigorous control over R&D expenses in the last quarter, cutting them down by almost 40% compared to the same period last year. This result has been achieved by the closing of our European subsidiary, salary control and refocusing of our activities. On May 29, 2007, Medicago completed a private placement financing of \$4M ensuring the Company has sufficient funding to pursue its research programs and provide it with enough working capital through the fourth quarter of 2007. We are exercising strict control over the Company's cash flow and have taken the necessary steps to maximize capital use and generate long term value creation for shareholders.

In the near future, we intend to meet a number of milestones that should provide additional momentum to our research programs. The completion of preclinical studies on a H5N1 vaccine, the submission of the first IND for a H5N1 vaccine and the publication of the phase I clinical study results. Our ultimate goal for fiscal year 2008 remains to initiate our first-in-man clinical trials of vaccines and we are on track to achieve it.

Medicago also continues to actively seek out new partnerships and to expand existing ones.

On behalf of the management team and the Board of Directors, I would like to thank you for your support and interest in Medicago and I encourage you to follow our progress.

Sincerely,

A handwritten signature in black ink that reads "Andrew J. Sheldon".

Andrew J. Sheldon  
President and CEO

# Medicago Inc.

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## FIRST QUARTER ENDED MARCH 31, 2007

### MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL POSITION AND OPERATING RESULTS

All amounts included in this report are expressed in Canadian dollars unless otherwise stated.

#### General

The following analysis provides a review of the Company's results of operations, financial condition and cash flows for the three-month period ended March 31, 2007 and 2006. This analysis should be read in conjunction with the information contained in the consolidated financial statements and related notes for the years ended December 31, 2006 and 2005, appearing in the annual report of the company, which are prepared in accordance with generally accepted accounting principles ("GAAP") in Canada.

The 2006 Annual Report of the company and many other data regarding the business of the company are available on SEDAR at the following Internet address: [www.sedar.com](http://www.sedar.com).

The consolidated financial statements and the accompanying notes included in this quarterly report have not been subject to a review engagement by the external auditors of the company. At present, Medicago believes that the cost related to a review engagement of its interim financial statements exceed the benefits inherent in such a review.

#### Forward-looking statements

This document contains forward-looking statements, which reflect the Company's current expectations regarding future events. The forward-looking statements involve risks and uncertainties, including the early stage development of the Company, history of operating losses, regulation of drug and product approval, regulation of genetically engineered plants and other risks. Many risks are inherent in the biotechnology industry; others are more specific to Medicago. For additional information on risks and uncertainties relating to these forward-looking statements, investors should consult the Company's annual report.

#### Company Overview

Medicago (TSX-V: MDG) is focused on the development, production and commercialization of biopharmaceutical products, leveraging its unique plant-based manufacturing system. This platform has broad applications. In top of the production of vaccines, it may be used in the production of therapeutic proteins, antibodies and enzymes, for industries ranging from pharmaceuticals to biofuel production. The Company is leveraging its platform in two ways: first by developing its own internal pipeline of proprietary vaccines; and second by offering value added development and manufacturing to partners. This strategy allows the Company to maximize value for shareholders through the development of proprietary vaccines and generate ongoing revenues to grow its business.

This proprietary and proven technology platform, Proficia™, allows Medicago to produce vaccines and other proteins in plants with speed and flexibility, reducing development times and improving costs when compared with traditional protein manufacturing technologies and even against novel emerging technologies.

The manufacturing infrastructure is already established and operational, a key competitive advantage. The Company has a 14,000 square foot state-of-the-art manufacturing facility that is unique, consisting of a secure, confined, high-tech greenhouse and a pharmaceutical grade purification suite. This facility, located in Quebec City, is currently being validated for its rapid Transient Expression Production, which we anticipate will be achieved by the end of 2007.

Medicago's lead internal program is focused on vaccine development. The rapid development time enabled by its Transient Expression Production technology is well suited for the development of vaccines, where speed to market is essential.

# Medicago Inc.

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## **Going Concern**

These financial statements have been prepared on a going concern basis in accordance with Canadian generally accepted accounting principles ("GAAP"). The going concern basis of presentation assumes that the Corporation will continue in operation for the foreseeable future and be able to realize its assets and discharge its liabilities and commitments in the normal course of business. The Company continues to seek out new and expand existing partnerships to increase its revenue stream. This along with other financing opportunities will help ensure that the Company can continue on with its current research activities.

The ability of the Company to continue as a going concern and to realize on the carrying value of its assets and discharge its liabilities when due, is dependent on the successful completion of the actions planned. There is no certainty that the planned actions will be sufficient to permit the Company to continue to operate during the next 12 months. The financial statements do not reflect any adjustments that would be necessary if the going concern assumption were not appropriate. If the going concern basis was not appropriate for these financial statements, then adjustments would be necessary in the carrying value of assets and liabilities, the reported revenues and expenses, and the balance sheet classifications used.

## **Revenues and Expenses**

Revenues are generated from contract research and related milestone payments.

Research and development expenses consist primarily of personnel and related costs associated with contract research activities and the development of the Company's portfolio of pharmaceutical product candidates and non-pharmaceutical products.

General and administrative, business development and intellectual property costs consist of personnel and related costs associated with the Company's administrative, finance and business development functions as well as its professional fees, office rent and utilities, insurance and other corporate expenses. It also includes intellectual property-related costs that consist of personnel and related costs associated with the development and maintenance of the Company's intellectual property portfolio.

## **Critical Accounting Policies and Estimates**

There have been no significant changes in Medicago's accounting policies and estimates since December 31, 2006. Please refer to the corresponding section in the company's annual report for a complete description of our critical accounting policies and estimates.

## **New Accounting Standards**

In January 2005, the CICA issued four new accounting standards in relation with financial instruments: Section 3855 "Financial Instruments – Recognition and Measurement", Section 3865 "Hedges", section 1530 "Comprehensive Income" and Section 3251 "Equity".

Sections 3855, 3865 and 1530 have been adopted by the Company on January 1, 2007. Adoption of these standards is described in note 2 of our interim consolidated financial statements for the first quarter ended March 31, 2007.

# Medicago Inc.

## Consolidated Statements of Earnings

<i>Unaudited</i>	Quarters ended			
	March 31, 2007	December 31, 2006	September 30, 2006	June 30, 2006
Revenues	\$18,500	\$20,000	\$14,000	\$77,000
Net loss	(\$1,647,000)	(\$2,274,000)	(\$1,784,000)	(\$1,716,000)
Basic and diluted net loss per share	(\$0,10)	(\$0,13)	(\$0,16)	(\$0,20)
	March 31, 2006	December 31, 2005	September 30, 2005	June 30, 2005
Revenues	\$44,000	\$42,000	\$155,000	\$57,000
Net loss	(\$1,983,000)	(\$1,954,000)	(\$1,498,000)	(\$1,936,000)
Basic and diluted net loss per share	(\$0,23)	(0,23)	(\$0,17)	(\$0,22)

### *Comparison of the three-month periods ended March 31, 2007 and 2006*

Revenues from research agreements decreased by \$26,000 to \$19,000 for the three-month period ended March 31, 2007 compared to the three-month period ended March 31, 2006. This decrease is due to a milestone payment in 2006 higher than a milestone payment in 2007.

Research and development expenses decreased by \$449,000 to \$739,000 in 2007 compared to 2006. This decrease is mainly a result of lower wages and salaries (\$243,000), lower consultant fees (\$87,000), lower laboratory supplies (\$38,000) and no expenses in our European subsidiary (\$39,000) that we closed at the end of 2006. The decrease of wage and salaries and laboratory supplies is related to the decrease in revenues and the fact that we decided to not replace certain departing employees in 2006. The decrease of consultant fees is explained by the fact that, in 2006, we were completing our regulatory strategy and the development of the process at the pilot plant.

Research grants and contribution increased by \$35,000 to \$63,000 for the three-month period ended March 31, 2007 compared to the three-month period ended March 31, 2006. This increase is due to the grant portion (\$59,000) of the proceeds of a non-bearing interest loan (TPC) in the quarter. This grant comes from the implementation in 2007 of new accounting standards in relation with financial instruments as described in note 2 of the financial statements.

Investment tax credits were at \$76,000 for the three-month period ended March 31, 2007, \$189,000 lower than the three-month period ended March 31, 2006. The decrease is due to the fact that federal investment tax credits were not refundable once the Company became public in August 2006 and the lower level of research and development expenses in 2007.

General and administrative, business development and intellectual property expenses decreased by \$152,000 to \$542,000 for the three-month period ended March 31, 2007 compared to 2006. This decrease is mainly attributable to lower wages and salaries (\$93,000) and is related to the fact that we decided to not replace certain departing employees in 2006 and 2007 and the grant portion (\$34,000) of the proceeds of a non-bearing interest loan in the quarter. This grant comes from the implementation in 2007 of new accounting standards in relation with financial instruments as described in note 2 of the financial statements.

# Medicago Inc.

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Depreciation of property, plant and equipment amounted to \$138,000 for the three-month period ended March 31, 2007, \$10,000 lower than the corresponding period in 2006. This decrease is mainly a result of the lower depreciation on equipment. Amortization of intangible assets stood at \$31,000 during the three-month period ended March 31, 2007 compared to \$28,000 for 2006. The increase is due to the amortization expense related to the acquisition of intangible assets in fiscal 2006.

Other net financial expenses amounted to \$350,000 for the three-month period ended March 31, 2007, \$88,000 higher compared to the three-month period ended March 31, 2006. This increase is mainly the result of higher interest on the long-term Bio-Levier debt. Concerning the Bio-Levier debt, interest amounting to \$301,000 was capitalized to the principal during 2007 (\$209,000 in 2006).

Consolidated loss for the three-month period ended March 31, 2007 was \$1,647,000 or \$0.10 per basic and diluted share compared to a loss of \$1,983,000 or \$0.23 per basic and diluted share in 2006.

Generally, our quarterly losses increased during 2006 as a result of lower revenues and higher financial expenses primarily from interest on the long-term debt related to the Bio-Levier loan. Although there was a decrease in R&D expenses, this expense reduction was mostly offset by a decrease in R&D tax credits, which was due to lower R&D expenses, the contribution from Technology Partnership Canada that reduced tax credits and the fact that federal investment tax credits are not refundable for public Companies. These losses are expected to decrease in 2007, as we can see for the first quarter, related to the fact that the Company has less employees compared to a year ago.

## Financial position

<i>Unaudited</i>	<b>As at March 31, 2007</b>	<b>As at December 31, 2006</b>
Current assets	\$1,049,000	\$2,623,000
Property, plant and equipment	\$ 4,410,000	\$4,537,000
Current liabilities	(\$787,000)	(\$1,303,000)
Long term debt	(\$13,193,000)	(\$13,067,000)
Shareholders' deficiency	\$7,099,000	\$5,758,000

Total consolidated assets were \$6.9 million as of March 31, 2007, a decrease of \$1.7 million from \$8.6 million as of December 31, 2006 due to a decrease in the current assets of term deposit for \$1.2 million and investment tax credits receivable for \$0.3 million. Long-term debt increased by \$0.1 million to \$13.2 million, mainly the result of the capitalized interest on the Bio-Levier debt.

The Company's primary capital needs are the funds required to support its scientific research and development activities including preclinical and clinical trials and capital expenditures for development of its pilot plant facilities and working capital. Since its inception, the Company has financed its cash requirements primarily through issuances of securities, investment tax credits, government funding, cost recoveries, contract research revenues, long-term debt and interest income.

With the private placement of \$2 million completed on May 29, 2007 (see note 9 of the financial statements), the Company believes that it has adequate financial resources to meet anticipated expenditures until the end of third quarter of 2007.

The Company's ability to continue as a going concern is contingent upon its ability to obtain additional financing. The company seeks additional forms of debt or equity financing, but cannot provide assurance that it will be successful in doing so. See 'Risk Factors' in the 2006 Annual Report.

# Medicago Inc.

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The investment activities are subject to the guidelines contained in the Company's investment policy. The Company invests only in liquid, high grade investment securities of reputable banks.

The Company had cash and cash equivalents totalling \$0.4 million at March 31, 2007, a decrease of \$1.3 million from December 31, 2006. The Company had working capital of \$0.3 million as at March 31, 2007.

At March 31, 2007, the Company's long-term debt amounted to \$13.2 million (an amount of \$0.4 million is available under the Technology Partnerships Canada program). Under the terms of the Bio-Levier loan agreement, the Company needs to maintain its current ratio at 1.3/1 or higher. As at March 31, 2007, this ratio stood at 1.33/1 (2.0/1 as at December 31, 2006).

## Cash flow

<i>Unaudited</i>	For the quarters ending	
	March 31, 2007	March 31, 2006
Operating activities	(\$962,000)	(\$1,166,000)
Financing activities	(\$250,000)	(\$478,000)
Investing activities	(\$1,176,000)	(\$1,488,000)
Net variation in cash and cash equivalents	(\$37,000)	(\$156,000)

### *Operating Activities*

Cash used in operating activities decreased by \$0.2 million, from \$1.2 million for the three-month period ended March 31, 2006 to \$1.0 million for the three-month period ended March 31, 2007. This decrease is largely explained by the smaller loss in 2007.

### *Financing Activities*

Cash from financing activities (excluding variation in bank loan) increased by \$0.1 million for the three-month period ended March 31, 2007 compared to 2006. This variation is attributable to the use of the long term debt in 2007 for \$0.1 million.

### *Investing Activities*

Cash used in investing activities (excluding the term deposit) amounted to \$0.1 million for the three-month period ended March 31, 2007 compared to \$0.2 million for the three-month period ended March 31, 2006, a decrease of \$2.2 million. This decrease is due mainly to lower capital expenditures in 2007.

### *Use of proceeds of the IPO*

The following table provides information concerning the use of proceeds resulting from the Company's initial public offering pursuant to a final prospectus dated July 31, 2006.

# Medicago Inc.

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<u>Use of Proceeds</u>	<u>Per prospectus</u>	<u>From September 1, 2006 through March 31, 2007</u>
Development of the Company's endogenous molecule of alfalfa and aprotinin product candidates, including preclinical trials	\$250,000	\$196,729
Investment in business development activities to secure partnerships and alliances	\$1,000,000	\$512,370
General corporate purposes	\$111,000	\$111,000
Total:	\$1,360,000	\$820,099

The Company completed most of the preclinical trials on its endogenous molecule prior the closing of the IPO and did not start preclinical trials on aprotinin. The Company does not anticipate doing any work on aprotinin as Bayer's Trasylol product is actually under review by the FDA for safety reasons. This money is still dedicated to preclinical trials but for an influenza vaccine based on Hemagglutinin (HA). The remaining money dedicated to business development is going to be invested in the first half of 2007 as the Company continues to focus on obtaining new contracts.

## **Contractual Obligations**

There has been no significant change in contractual obligations and commercial commitments facing Medicago, as described in the Company's 2006 annual MD&A.

## **Related Party Transactions and Off-Balance Sheet Agreements**

There were no related party transactions and no off-balance sheet agreements.

## **Outstanding Share Data**

As of May 30, 2007, there were 21,112,440 common shares issued and outstanding, 1,696,312 stock options outstanding, 3,872,321 warrants outstanding and 420,268 compensation options outstanding.

## **Outlook for the remaining of 2007**

The Company plans to complete the major scientific milestones necessary to proceed into first-in-man clinical trials of vaccines in 2008. Other upcoming milestone events expected in 2007 and 2008 include:

- Completion of preclinical studies on a H5N1 vaccine
- Submission of the first IND for H5N1 Vaccine
- Phase I clinical studies results
- Signature of new strategic partnership

## **Financial and Other Instruments**

### *Foreign Currency Risk*

The Company is exposed to currency risks due to its operations on an international scale. The Company has no forward exchange contract as of March 31, 2006.

# Medicago Inc.

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## *Credit Risk*

Financial instruments, which potentially subject the Company to concentrations of credit risk, consist primarily of cash and cash equivalents, and term deposits. Cash and cash equivalents, and term deposits are maintained with high-credit quality financial institutions. Therefore, management considers the risk of non-performance on these instruments to be remote.

## **Risk factors and uncertainties**

There has been no significant change in the risk factors and uncertainties facing the Company as described in Medicago's 2006 annual report.

## **Changes in Internal Controls over Financial Reporting**

There has been no change in the Company's internal control over financial reporting that occurred during the quarter ended March 31, 2007 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

On behalf of management,

(signed)

Vincent Bélanger, CA  
Chief Financial Officer

May 30, 2007

# **Medicago Inc.**

Interim consolidated financial statements  
(unaudited)  
**March 31, 2007**

# Medicago Inc.

## Interim Consolidated Balance Sheets (unaudited)

	March 31, 2007 \$ (unaudited)	December 31, 2006 \$ (audited)
<b>Assets</b>		
<b>Current assets</b>		
Cash and cash equivalents	406,359	442,929
Term deposit	-	1,230,188
Current portion of security deposit on a lease agreement	20,000	20,000
Accounts receivable	59,389	79,130
Financing receivable (note 4)	165,694	171,926
Investment tax credits receivable	256,700	581,167
Grants receivable	7,500	23,125
Prepaid expenses	132,895	74,312
	<u>1,048,537</u>	<u>2,622,777</u>
<b>Security deposit on a lease agreement</b>	20,000	20,000
<b>Property, plant and equipment</b>	4,410,299	4,536,560
<b>Intangible assets</b>	<u>1,403,091</u>	<u>1,433,552</u>
	<u>6,881,927</u>	<u>8,612,889</u>
<b>Liabilities</b>		
<b>Current liabilities</b>		
Bank loan	-	300,000
Accounts payable and accrued liabilities	774,083	990,338
Current portion of long-term debt	13,072	13,072
	<u>787,155</u>	<u>1,303,410</u>
<b>Long-term debt (note 4)</b>	13,193,384	13,067,121
	<u>13,980,539</u>	<u>14,370,531</u>
<b>Shareholders' Deficiency</b>		
<b>Share capital (note 5)</b>	22,152,413	22,152,413
<b>Contributed surplus</b>	798,034	798,034
<b>Other equity components</b>	1,596,106	1,561,858
<b>Deficit</b>	<u>(31,645,165)</u>	<u>(30,269,947)</u>
	<u>(7,098,612)</u>	<u>(5,757,642)</u>
	<u>6,881,927</u>	<u>8 612 889</u>
<b>Going concern (note 3)</b>		

The accompanying notes are an integral part of these interim consolidated financial statements.

### Approved by the Board of Directors

(signed)  
Randal Chase, Ph.D.  
Director

(signed)  
Andrew J. Sheldon,  
Director

# Medicago Inc.

## Interim Consolidated Statements of Earnings (unaudited)

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	<b>Three-Month Periods Ended March 31</b>	
	<b>2007</b>	<b>2006</b>
	<b>\$</b>	<b>\$</b>
<b>Revenues from research agreements</b>	18,500	44,485
<b>Expenses</b>		
Research and development	739,481	1,187,626
Research grants and contributions	(63,068)	(27,583)
Research and development tax credits	(76,000)	(264,762)
General and administrative	542,452	694,163
Exchange loss (gain)	2,759	(426)
Depreciation of property, plant and equipment	138,324	148,420
Amortization of intangible assets	31,021	27,629
Other financial expenses, net	350,117	262,453
	1,665,086	2,027,520
<b>Loss and comprehensive loss for the period</b>	<b>(1,646,586)</b>	<b>(1,983,035)</b>
<b>Basic and diluted loss per share</b> (note 7)	<b>(0.10 )</b>	<b>(0.23)</b>
<b>Going concern</b> (note 3)		

## Interim Consolidated Statements of Deficit (unaudited)

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	<b>Three-Month Periods Ended March 31</b>	
	<b>2007</b>	<b>2006</b>
	<b>\$</b>	<b>\$</b>
<b>Balance at the beginning of the period</b>	30,269,947	22,512,316
Adjustment related to the implementation of new accounting standards (note 2)	(271,368)	-
Loss for the period	1,646,586	1,983,035
<b>Balance at the end of the period</b>	<b>31,645,165</b>	<b>24,495,351</b>

The accompanying notes are an integral part of these interim consolidated financial statements.

# Medicago Inc.

## Consolidated Statements of Cash Flows (unaudited)

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	<b>Three-Month Periods Ended March 31</b>	
	<b>2007</b>	<b>2006</b>
	<b>\$</b>	<b>\$</b>
<b>Cash flows from operating activities</b>		
Loss and comprehensive loss for the period	(1,645,586)	(1,983,035)
Items not affecting cash and cash equivalents		
Stock-based compensation costs	34,247	6,263
Depreciation and amortization	198,719	214,457
Interest capitalized on long-term debt	318,584	209,133
	<u>(1,095,036)</u>	<u>(1,553,182)</u>
Change in non-cash working capital items (note 6)	133,055	386,735
	<u>(961,981)</u>	<u>(1,166,447)</u>
<b>Cash flows from financing activities</b>		
Bank loan repaid	(300,000)	(477,606)
Long-term debt contracted	56,210	-
Payments on long-term debt	(6,536)	-
	<u>(250,326)</u>	<u>(477,606)</u>
<b>Cash flows investing activities</b>		
Term deposit	1,230,188	1,675,000
Additions to property, plant and equipment	(22,111)	(116,898)
Additions to intangible assets	(32,340)	(70,424)
	<u>1,175,737</u>	<u>1,487,678</u>
<b>Net change in cash and cash equivalents</b>	<u>(36,570)</u>	<u>(156,375)</u>
<b>Cash and cash equivalents at the beginning of the period</b>	<u>442,929</u>	<u>189,121</u>
<b>Cash and cash equivalents at the end of the period</b>	<u>406,359</u>	<u>32,746</u>
<b>Additional information</b>		
Interest paid	2,658	19,430

The accompanying notes are an integral part of these interim consolidated financial statements.

# Medicago Inc.

## Notes to Consolidated Financial Statements

### For the Three-Months periods ended March 31, 2007 and 2006

(unaudited)

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#### 1 Interim financial information

The financial information for the three-month periods ended March 31, 2007 and 2006 is unaudited. However, in the opinion of management, all adjustments necessary to present fairly the results of these periods have been included. The adjustments made were of a normal recurring nature. Interim results may not necessarily be indicative of results anticipated for the year.

The unaudited interim consolidated financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles (GAAP), using the same accounting policies as the audited consolidated financial statements for the year ended December 31, 2006 with the exception of the application of new accounting standards as described in note 2 hereunder. All disclosures required for annual financial statements have not been included in these financial statements. These consolidated financial statements should be read in conjunction with the company's most recent annual consolidated financial statements.

#### 2 New accounting standards

In January 2005, the CICA issued four new accounting standards in relation with financial instruments: section 3855 "Financial Instruments – Recognition and measurement", section 3865 "Hedges", section 1530 "Comprehensive Income" and section 3251 "Equity".

Section 3855 expands on section 3860 "Financial Instruments – Disclosure and Presentation", by prescribing when a financial instrument is to be recognized on the balance sheet and at what amount. It also specifies how financial instrument gains and losses are to be presented.

Section 3865 provides alternative treatments to section 3855 for entities which choose to designate qualifying transactions as hedges for accounting purposes. It replaces and expands on Accounting Guideline AcG-13 "Hedging Relationships", and the hedging guidance in Section 1650 "Foreign Currency Translation" by specifying how hedge accounting is applied and what disclosure is necessary when it is applied.

Section 1530 "Comprehensive Income" introduces a new requirement to temporarily present certain gains and losses outside net income.

Consequently, Section 3250 "Surplus" has been revised as Section 3251 "Equity".

Sections 1530, 3251, 3855 and 3865 were adopted by the company on January 1, 2007.

#### **Recognition of financial assets and liabilities**

##### *Short-term investments*

The short-term investments are classified as available-for-sale investments. The company recognizes transactions on the settlement date.

# Medicago Inc.

## Notes to Consolidated Financial Statements

### For the Three-Month periods ended March 31, 2007 and 2006

(unaudited)

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These investments are recognized at fair value. Unrealized gains and losses are recognized, net of income taxes, if any, in "Accumulated other comprehensive income". Upon the disposal or impairment of these investments, these gains or losses are reclassified in the consolidated statement of operations.

#### *Effective interest rate method*

Premiums and discounts on short-term investments and long-term debt are accounted for using the effective interest rate method.

The impact of the use of the effective interest rate method on long-term debt for an amount \$271,368 is recognized as an adjustment to the opening balance of deficit.

#### *Impact of the adoption of these new standards*

The adjustments related to the classification of short-term investments as financial instruments held for trading were nil and therefore no adjustment was recorded in the deficit's opening balance as at January 1<sup>st</sup>, 2007. Adjustments due to the classification of long-term debt in the category *other liabilities*, net from related transaction fees depreciated, were recorded in the opening balance of deficit as at January 1st, 2007. The result of this adjustment is a decrease in the opening balance of deficit of \$271,368.

Here is a summary of the impact of these new accounting standards on the opening balance

	<b>December 31, 2006</b>	<b>Adjustments</b>	<b>January 1, 2007</b>
	\$	\$	\$
	<b>(audited)</b>	<b>(unaudited)</b>	<b>(unaudited)</b>
<b>Assets</b>			
Deferred financing expenses	938,189	<u>(938,189)</u>	-
<b>Liabilities and Shareholder's Deficiency</b>			
Long-term debt	14,005,310	(1,209,557)	12,795,753
Deficit	(30,269,947)	<u>271,368</u>	(29,998,579)
		<u>(938,189)</u>	

#### *Transition*

The recognition, derecognition and measurement methods used as well as the hedge accounting policies used to prepare the consolidated financial statements of periods prior to the effective date of the new standards were unchanged and, therefore those financial statements have not been restated.

# Medicago Inc.

Notes to Consolidated Financial Statements

**For the Three-Month periods ended March 31, 2007 and 2006**

(unaudited)

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### **3 Going concern**

While the accompanying consolidated financial statements have been prepared on a going concern basis, which contemplates the realization of assets and liquidation of liabilities during the normal course of operations, certain adverse conditions and events cast substantial doubt upon the validity of this assumption. The company has not yet realized profitable operations and has relied mostly on non-operational sources of financing to fund operations. The company's ability to continue as a going concern will be dependent on management's ability to successfully execute its business plan, which includes an increase in revenue and product development. The company seeks additional forms of debt or equity financing, but cannot provide assurance that it will be successful in doing so. These financial statements do not include adjustments or disclosures that may result from the company's inability to continue as a going concern. If the going concern assumption is not appropriate for these financial statements, then adjustments would be necessary in the carrying value of assets and liabilities and the reported losses and balance sheet classifications used.

The company's current strategy is to increase its revenues from existing products by entering into additional product development agreements. Medicago will generate revenues through timely delivery of clinical quantities, milestone payments on successful completion of clinical studies and royalties from product sales or from product development agreements.

Management believes that additional equity or debt-based financing may be required to continue the company's operations. Furthermore, in management's opinion, the company's continued existence is dependent on the latter's ability to increase revenue from existing products through product development with selected partners. There is no assurance that management will be successful in these actions.

# Medicago Inc.

## Notes to Consolidated Financial Statements

### For the Three-Month periods ended March 31, 2007 and 2006

(unaudited)

#### 4 Long-term debt

	March 31, 2007 \$	December 31, 2006 \$ (audited)
Loan from Investissement Québec ("IQ"), bearing interest at prime rate plus 3%, payable annually from March 2008 at a rate of 25% of net earnings plus depreciation and amortization generated in the preceding year over a period ending no later than December 21, 2014, secured by a senior fixed and floating charge of \$16,000,000 over all property, plant and equipment and intellectual property of the company	(a) 12,833,266	12,503,391
Contribution under an innovation program, payable in semi-annual instalments of \$6,536 since April 2005, non-interest bearing	(b) 24,689	39,213
Refundable contribution granted under the Technology Partnerships Canada program, non-interest bearing	(c) 256,059	395,300
Contribution under an innovation program, payable in annual instalments of \$28,458 from January 2009, non-interest bearing	(d) 92,442	142,289
	13,206,456	13,080,193
Less: Current portion	13,072	13,072
	<u>13,193,384</u>	<u>13,067,121</u>

- (a) On July 28, 2003, the company signed a loan agreement of \$12,000,000 with IQ under the Bio-Levier Program. As at December 31, 2006, the company has used \$12,000,000 plus capitalized interest of \$1,742,081.

The terms and conditions of the loan agreement are as follows:

- i) For the first three years, the company may defer the principal instalments and may capitalize interest. Afterwards, interest is payable on a monthly basis from December 21, 2007.
- ii) The interest rate may be converted into a fixed rate upon the complete use of the available balance of the loan.
- iii) At the company's request, and under certain conditions, IQ may release the fixed and floating senior charge on any selected intellectual property in the event the company executes a license agreement, a commercialization agreement or an operating agreement.

With the implementation of new accounting standards in relation with financial instruments (see note 2) the debt balance was decreased by \$938,189 corresponding to Deferred financing expenses.

# Medicago Inc.

## Notes to Consolidated Financial Statements

### For the Three-Month periods ended March 31, 2007 and 2006

(unaudited)

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- (b) With the implementation of new accounting standards in relation with financial instruments (see note 2) the opening debt balance was decreased by \$9,475 to take into account an effective interest rate of 20 %.
- (b) Under the federal contribution program called Technology Partnerships Canada ("TPC"), the company is entitled to receive a refundable contribution equivalent to 33% of the eligible expenses incurred by the company in the optimization and scale-up of its production unit up to a maximum of \$848,200. Royalties of 2% on gross cash proceeds of any kind will be payable from January 1, 2009 based on gross cash proceeds of the prior year. These royalties will be payable at the earlier of the complete repayment of the contribution or by January 1, 2019; subsequent to this date, no further payments will be required. As at March 31, 2007, an amount of \$165,694 is receivable under this program. Under this program, the company undertook to meet a current ratio exceeding 1.3:1.

With the implementation of new accounting standards in relation with financial instruments (see note 2) the opening debt balance was decreased by \$181,461 to take into account an effective interest rate of 20 %.

- (c) Under a federal innovation program, the company is entitled to receive a refundable contribution equivalent to 47.1% of the eligible expenses incurred by the company for business development and intellectual property up to a maximum of \$300,000. This contribution is refundable in annual instalments, beginning after a two-year period following the end of the project, which project shall not end later than September 1, 2007.

With the implementation of new accounting standards in relation with financial instruments (see note 2) the opening debt balance was decreased by \$80,432 to take into account an effective interest rate of 20 %.

- i) The principal instalments for each of the next five years, excluding IQ loan, TPC refundable contribution and the uncompleted federal innovation program, are as follows:

	\$
2007	6,536
2008	13,072
2009	41,528
2010	28,458
2011	28,457

# Medicago Inc.

Notes to Consolidated Financial Statements

**For the Three-Month periods ended March 31, 2007 and 2006**

(unaudited)

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## 5 Share capital

- a) The share capital of the company, which was made up of an unlimited number of Class A, B and C shares, all of them without par value, was modified as follows on July 31, 2006. The effective date of the reorganization was concurrent with the closing of the initial public offering, being August 30, 2006:
- Creation of common shares, without par value, voting and participating;
  - Creation of preferred shares, without par value, with rights, privileges and conditions to be determined by the Board of Directors before issuance;
  - Three-for-one consolidation of Class A, B and C shares into common shares;
  - Cancellation of Class A, B and C shares.

The authorized share capital of the company is now as follows:

- Authorized
  - Unlimited number of shares, without par value, of the following classes:
    - Common shares, voting and participating
    - Preferred shares, with rights, privileges and conditions to be determined by the Board of Directors before issuance

# Medicago Inc.

## Notes to Consolidated Financial Statements

### For the Three-Month periods ended March 31, 2007 and 2006

(unaudited)

The share capital issued has varied as follows:

	For the three-month period ended March 31, 2007		For the year ended December 31, 2006 (audited)	
	Number	\$	Number	\$
<b>Common shares</b>				
Balance – Beginning of period	17,112,440	22,152,413	-	-
Conversion of Class A shares	-	-	4,870,408	6,186,433
Conversion of Class B shares	-	-	3,785,617	4,309,957
Conversion of Class C shares	-	-	1,111	1,666
Conversion of retractable Class A shares	-	-	480,163	809,664
Conversion of retractable Class B shares	-	-	5,971,307	10,044,118
Retractable share issue expenses Issued pursuant to the initial public offering (i)	-	-	-	(141,521)
Issue expenses *	-	-	2,003,834	1,623,864
	-	-	-	(681,768)
Balance – End of period	17,112,440	22,152,413	17,112,440	22,152,413
<b>Class A shares</b>				
Balance – Beginning of period	-	-	4,870,408	6,186,433
Conversion into common shares	-	-	(4,870,408)	(6,186,433)
Balance – End of period	-	-	-	-
<b>Class B shares</b>				
Balance – Beginning of period	-	-	3,785,617	4,309,957
Conversion into common shares	-	-	(3,785,617)	(4,309,957)
Balance – End of period	-	-	-	-
<b>Class C shares</b>				
Balance – Beginning of period	-	-	1,111	1,666
Conversion into common shares	-	-	(1,111)	(1,666)
Balance – End of period	-	-	-	-
<b>Total share capital</b>	17,112,440	22,152,413	17,112,440	22,152,413

\* Issue expenses were shared out between common shares and warrants pro rata to their fair market value.

# Medicago Inc.

## Notes to Consolidated Financial Statements

### For the Three-Month periods ended March 31, 2007 and 2006

(unaudited)

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- i) On August 30, 2006, the company issued 2,003,834 units at a price of \$1.00 per unit for total gross proceeds of \$2,003,834 ("the Offering"). Each unit consists of one common share of the company and one common share purchase warrant. Each warrant entitles the holder thereof to purchase one common share at a price of \$1.10.
- ii) Prior to the closing of the Offering, the shareholders of the company approved a three-for-one consolidation of all the company's common and retractable shares and warrants and the conversion into common shares of all retractable shares. In addition, a similar consolidation was made regarding all outstanding common share options. The share consolidation has been reflected in these financial statements.
- iii) Prior to the closing of the Offering, the company completed a corporate reorganization as follows: each of Dr. Louis-P. Vézina and François Arcand have each sold to a holding company entirely controlled by each of them (respectively, "LPV NewCo" and "FA NewCo") shares that they respectively owned in the share capital of the company, in consideration for shares of those newly created holding companies. Immediately thereafter, Dr. Vézina sold to another wholly-owned holding company, ("LPV HoldCo"), the balance of its shares of Medicago. In consideration for such sale, LPV HoldCo issued, in favour of Dr. Vézina, shares of its share capital. On May 30, 2006, the company, LPV NewCo and FA NewCo have entered into an amalgamation agreement pursuant to which the company, LPV NewCo and FA NewCo have filed articles, as of July 31, 2006, of amalgamation pursuant to Part IA of the *Companies Act* (Québec) to form a new company named Medicago Inc.
- iv) The gross proceeds of the Offering of \$2,003,834 is shared out between the 2,003,834 common shares for a gross amount of \$1,623,864 and the 2,003,834 warrants attached to each unit for a gross amount of \$379,970 (d). In connection with this investment, the company paid a cash compensation equivalent to 7 % of the gross proceeds from the investment, being \$140, 268. The company has also granted a non-transferable unit option to the agent entitling to subscribe, before August 30, 2008, for 140,268 units at a price of \$1.00 per unit as financing expenses (c). Each unit consists of one common share of the company and one common share purchase warrant. Each warrant entitles the holder thereof to purchase one common share at a price of \$1.10.

(b) Stock option plan

On April 27, 2006, the Board of Directors of the company adopted amendments to the company's stock option plan (the "Plan"), which had entered into effect upon the closing of the company's initial public offering. All options issued and outstanding under the company's original stock option plan were subject to these amendments to the Plan. Under the Plan, the Board of Directors may, from time to time, at its discretion, and in accordance with the Exchange requirements, grant non-transferable options to purchase common shares of the company (an "option"). The number of common shares reserved under the Plan is fixed at 1,710,000 common shares.

# Medicago Inc.

## Notes to Consolidated Financial Statements

### For the Three-Month periods ended March 31, 2007 and 2006

(unaudited)

The Board of Directors may grant options to directors, officers, key employees and consultants of the company expiring after a maximum period of ten years. The number of common shares that may be issued (i) to any one individual, in any 12-month period, cannot exceed 5% of the total number of issued and outstanding common shares; (ii) to any consultant, in any 12-month period, cannot exceed 2% of the total number of issued and outstanding common shares; and (iii) to any employee, who provides investor relations services, in any 12-month period, cannot exceed 2% of the total number of issued and outstanding common shares. Except as the Board of Directors may otherwise decide upon the grant of an option, the options are vested and may only be exercised as follows: (i) 1/3 of the options upon the first anniversary of the grant; (ii) 1/3 of the options upon the second anniversary of the grant; and (iii) 1/3 of the options upon the third anniversary of the grant.

The following table summarizes the stock option activity since January 1, 2006:

	For the Three-Month period ended March 31, 2007		For the year ended December 31, 2006	
	Number	Weighted average exercise price \$	Number	Weighted average exercise price \$
Outstanding – Beginning of period	1,628,978	1.12	708,188	1.65
Granted	72,000	1.00	1,096,400	1.04
Exercised	-	-	-	-
Forfeited	(4,666)	1.00	(175,610)	2.15
Outstanding – End of period	1,696,312	1.12	1,628,978	1.12
Options exercisable – End of period	492,220	1.20	436,657	1.17

The following table summarizes information about outstanding and exercisable stock options as at March 31, 2007:

Exercise price	Stock options outstanding			Stock options currently exercisable	
	Number	Weighted average remaining contractual life (months)	Weighted Average exercise price \$	Number	Weighted average exercise price \$
\$1.00	1,092,329	51	1.00	70,329	1.00
\$1.11	412,872	42	1.11	366,990	1.11
\$1.50 to \$1.68	181,112	49	1.50	44,902	1.65
\$4.08	9,999	9	4.08	9,999	4.08
	1,696,312	48	1.12	492,220	1.20

# Medicago Inc.

Notes to Consolidated Financial Statements

For the Three-Month periods ended March 31, 2007 and 2006

(unaudited)

## Assumptions used in determining stock-based compensation costs

The table below shows the assumptions used in determining stock-based compensation costs under the Black-Scholes option pricing model:

	<b>Three-Month ended March 31, 2007</b>	<b>Year ended December 31, 2006</b>
Dividend yield	Nil	Nil
Expected volatility	79.16%	72.11%
Risk-free interest rate	4.03%	4.04%
Expected life (years)	5	4.78
Number of stock options granted	72,000	1,096,400
Weighted average fair value of options granted (\$)	0.662	0.49
<b>Compensation costs</b>	<b>\$34,247</b>	<b>\$57,239</b>

### (c) Unit options

The following table summarizes information about unit options outstanding and exercisable as at March 31, 2007:

	<b>Number</b>	<b>Carrying value \$</b>	<b>Weighted average exercise price \$</b>	<b>Weighted average remaining contractual life (years)</b>
Outstanding and exercisable – Beginning and end of period	140,268	55,495	1.00	1.42

### (d) Warrants

The following table summarizes the information relating to warrants outstanding as at March 31, 2007:

	<b>Number</b>	<b>Weighted average exercise price \$</b>	<b>Weighted average remaining contractual life (years)</b>
Outstanding and exercisable – Beginning and end of period	3,872,321	1.11	2.40

# Medicago Inc.

Notes to Consolidated Financial Statements

For the Three-Month periods ended March 31, 2007 and 2006

(unaudited)

## 6 Additional information on cash flows

	Three-Month Periods Ended March 31	
	2007 \$	2006 \$
Accounts receivable, financing and grants receivable	41,598	49,233
Investment tax credits receivable	324,467	442,206
Prepaid expenses	(58,583)	14,962
Accounts payable and accrued liabilities	(174,427)	(103,921)
Deferred revenues on research agreements	-	(15,745)
	<u>133,055</u>	<u>386,735</u>

## 7 Earnings per share

The following table summarizes the reconciliation of the basic weighted average number of shares outstanding and the diluted weighted average number of shares outstanding used in the diluted earnings per share calculations:

	Three-Month Periods Ended March 31	
	2007	2006
Basic and diluted weighted average number of shares outstanding	<u>17,112,440</u>	<u>8,657,136</u>

For the Three-Month period ended March 31, 2007 and 2006, the diluted loss per share was the same as the basic net loss per share since there were no dilutive items. Accordingly, the diluted loss per share for those periods and years was calculated using the basic weighted average number of shares outstanding. All the stock options and warrants are anti-dilutive.

## 8 Comparative figures

Certain comparative figures have been reclassified to conform with the current year's presentation.

# **Medicago Inc.**

Notes to Consolidated Financial Statements

**For the Three-Month periods ended March 31, 2007 and 2006**

(unaudited)

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## **9 Subsequent event**

On May 29, 2007 the Company completed a private placement of 4,000,000 units (the “Units”) at a price of \$0.50 per Unit for gross proceeds of \$2 million, each Unit consisting of one common share of Medicago and one common share purchase warrant. Each share purchase warrant entitles the holder thereof to purchase one common share at a price of \$0.75 until May 29, 2009. The common shares, the warrants and the common shares and warrants underlying the compensation options as well as the common shares underlying the warrants are subject to a four-month hold period expiring on September 30, 2007.

Dundee Securities Corporation (“Dundee”) acted as agent in the private placement on a best efforts basis. As such, Dundee received a compensation of \$140,000, representing 7% of the amount raised from purchasers identified by it. Furthermore, Medicago has agreed to issue to Dundee, a number of compensation options, exercisable at the offering price for a period of 24 months following the closing of the private placement, representing 7% of the number of Units issued pursuant to the private placement.