



November 29, 2007

Dear Shareholders:

On behalf of the board of directors, our management team of Medicago, I wish to thank you for your ongoing support. Doing the 3<sup>rd</sup> fiscal quarter of 2007, I am pleased to report that we attained our milestones and are on-track with avian influenza vaccine candidate development plan. Over and above this, the discovery of our virus like particles and their demonstration immunogenicity is a major breakthrough that will allow Medicago to produce products quickly and cost efficiency in the future.

In the third quarter of 2007, results obtained in our key influenza vaccine development program have ensured that Medicago remains on track with a Phase 1 clinical filing in 2008.

I am pleased to announce that we have now succeeded in producing a vaccine candidate designed to protect against the H5N1 Influenza virus otherwise known as Avian Flu. In about four weeks from receiving the genetic sequences, Medicago's scientists were able to produce the two principal components of Avian Flu H5N1 Indonesia clade 2 strain currently circulating in Asia and parts of Europe. The two antigens Hemagglutinin and Neuraminidase were successfully produced at commercially viable levels and Medicago intends to start pre-clinical testing shortly.

This is an excellent result and a major milestone for Medicago which takes us one step further toward full realization of the value of our technology. It is also a real-life demonstration of the power of our technology to deliver fast response and critical surge capacity to assist in protecting the worldwide population against new emerging Influenza strains.

These results allow Medicago to move ahead with its Influenza program and further planned milestones that are to be attained in the coming weeks and months culminating in the deposition of our regulatory file in 2008 that precedes phase I clinical testing.

The advantages of Medicago's technology in preparation for an Influenza Pandemic are being recognized worldwide as authorities recognize the vulnerability of the world's population with current vaccine technologies and supplies. Medicago has received invitations to speak at several well recognized conferences including a closed door conference at the World Health Organization in December 2007.

#### Financing & Partnering

Our biggest challenge in the immediate short- term is to find partners for its technology and to raise additional capital to fund the ongoing activities of Medicago.

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

## **THIRD QUARTER ENDED SEPTEMBER 30, 2007**

### **MANAGEMENT'S REPORT ON 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 and nine-month periods ended September 30, 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.

On April 1 2007, the Company completed a corporate reorganization resulting in the creation of new entities to perform all of its research and development activities.

The 2006 Annual Report of the Company and additional information 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 Annual Report of the Company.

#### **Company Overview**

Medicago is committed to provide highly effective and affordable vaccines based on our proprietary Virus-Like Particles (VLPs) and manufacturing technologies. Medicago is developing VLP vaccines to protect against H5N1 pandemic influenza, using a transient expression system which produces recombinant vaccine antigens in the cells of non-transgenic plants. This technology has potential to offer advantages of speed and cost over competitive technologies. It can deliver a vaccine for testing in about a month after the identification and reception of genetic sequences from a pandemic strain. This production time frame has the potential to allow vaccination of the population before the first wave of a pandemic strikes and to supply large volumes of vaccine antigens to the world market.

#### **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.

Management believes that additional equity or debt-based financing is required to continue the Company's operations. There is no assurance that management will be successful in raising additional funding.

## 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 second quarter ended September 30, 2007.

## Consolidated Statements of Earnings

<i>Unaudited</i>	Quarters ended			
	September 30, 2007	June 30, 2007	March 31, 2007	December 31, 2006
Revenues	-	-	\$18,500	\$20,000
Loss	(\$1,002,838)	(\$1,550,000)	(\$1,647,000)	(\$2,274,000)
Basic and diluted net loss per share	(\$0.06)	(\$0.09)	(\$0.10)	(\$0.13)
	September 30, 2006	June 30, 2006	March 31, 2006	December 31, 2005
Revenues	\$14,128	\$77,000	\$44,000	\$42,000
Loss	(\$1,784,324)	(\$1,716,000)	(\$1,983,000)	(\$1,954,000)
Basic and diluted net loss per share	(\$0.16)	(\$0.20)	(\$0.23)	(\$0.23)

### *Comparison of the three and nine-month periods ended September 30, 2007 and 2006*

Revenues from research agreements decreased by \$14,000 to nil for the three-month period ended September 30, 2007 compared to the three-month period ended September 30, 2006. For the nine-month period ending September 30, 2007, revenues from research agreements decreased by \$118,000 to \$18,500 compared to the same period in 2006. This decrease is due to milestone payments in 2006 higher than milestone payments in 2007.

Research and development expenses decreased by \$359,000 to \$582,000 in the third quarter of 2007 compared to 2006 and by \$1,051,000 to \$2,196,000 in the period of nine months ending September 30, 2007 compared to 2006.

The decrease in research and development expenses in the third quarter is mainly the results of a lower level of outsourced contract work (\$167,000) and lower wages and salaries (\$51,000). The decrease in research and development in the nine-month period ended September 30, 2007 compared to the same period in 2006 is primarily due to lower levels of wages and salaries (\$426,000), outsourced contract work (\$177,000) and supplies (\$74,000). These reductions result from the fact that the Company has been focusing on fewer but, in its opinion, more promising research and development projects since mid-2006.

Research grants and contribution increased by \$79,000 to \$89,000 for the quarter ended September 30, 2007 compared to the same period in 2006 and increased by \$246,000 to \$312,000 in the nine-month period ended September 30, 2007 compared to the same period in 2006. This increase is due to the grant portion of the proceeds of a non-bearing interest loan (TPC) of \$89,000 in the quarter and of \$307,000 in the nine-month period ending September 30, 2007. 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 \$468,000 for the three-month period ended September 30, 2007, \$218,000 higher than the three-month period ended September 30, 2006. The investment tax credits reached \$854,000 for the nine-month period ended September 30, 2007, the same level as in 2006. The increase in the last quarter is due to the fact that the Company could not claim federal 35% investment tax credits from its initial public offering in August 2006 until March 31, 2007; on April 1 2007, the Company completed a corporate reorganization resulting in the creation of new entities to perform all of its research and development activities and thus maximizing its credit rates. Moreover, the Company has amended its 2006 provincial tax returns during the quarter claiming an additional \$176,000 more credits.

General and administrative, business development and intellectual property expenses decreased by \$147,000, or 24%, to \$465,000 for the three-month period ended September 30, 2007 compared to 2006 and decreased by \$274,000, or 14%, to \$1,621,000 during the nine-month period ended September 30, 2007 compare to 2006.

The main variations in general and administrative, business development and intellectual property expenses in the third quarter of 2007 compared to the same quarter in 2006 are a decrease in salaries (\$92,000) and in outsourced contract work (\$49,000).

The main variations in general and administrative, business development and intellectual property expenses in the nine-month period ended September 30, 2007 compared to the same period in 2006 are a decrease in salaries (\$240,000). Moreover, the Company decreased its contract charges by \$144,000 and travelling charges by \$45,000.

Depreciation of property, plant and equipment amounted to \$130,000 for the three-month period ended September 30, 2007, \$28,000 higher than the corresponding period in 2006. These charges were \$422,000 for the nine-month period ended September 30, 2007, \$36,000 lower than the same period in 2006. The variations are not material.

Amortization of intangible assets stood at \$45,000 during the three-month period ended September 30, 2007, \$16,000 higher than the corresponding period in 2006. These charges were \$94,000 during the nine-month period ended September 30, 2007, \$11,000 higher than the same period in 2006. The variations are not material.

Other net financial expenses amounted to \$358,000 for the three-month period ended September 30, 2007, \$43,000 higher compared to the same period in 2006. These expenses amounted to \$1,069,000 for the nine-month period ended September 30, 2007, \$218,000 higher than the same period in 2006. This increase is mainly the result of higher interest on the long-term Bio-Levier debt. Concerning the Bio-Levier debt, interests amounting to \$329,000 and \$940,000 were capitalized to the principal during the three and nine-month periods, respectively, ended September 30, 2007 (\$294,000 and \$752,000 in 2006).

Consolidated loss for the three and nine-month period ended September 30, 2007 was respectively \$1,002,000 and \$4,220,000, or \$0.06 and \$0.24 per basic and diluted share compared to a loss of respectively \$1,784,000 and \$5,484,000, or \$0.16 and \$0.57 per basic and diluted share in 2006.

Generally, our quarterly losses decreased during 2007. Revenues have been lower but expenses have decreased to a higher degree. The main reduction occurred in research and development activities where management decided to focus on fewer but promising activities and, as a consequence, expenses have decreased by 30%. Investment tax credits have increased since the completion of a corporate reorganization in April 2007. As a consequence, investment tax credits have been maximized thus reducing the net cost of research and development activities.

## Financial position

	As at September 30, 2007 (unaudited)	As at December 31, 2006 (audited)
Current assets	\$1,274,000	\$2,623,000
Property, plant and equipment	\$4,197,000	\$4,537,000
Current liabilities	(\$773,000)	(\$1,303,000)
Long-term debt	(\$13,942,000)	(\$13,067,000)
Shareholders' deficiency	\$7,856,000	\$5,758,000

The Company had cash and cash equivalents totaling \$127,000 at September 30, 2007, a decrease of \$316,000 from December 31, 2006. The Company had working capital of \$0.6 million as at September 30, 2007.

Total consolidated assets were \$6.9 million as of September 30, 2007, a decrease of \$1.7 million from \$8.6 million as of December 31, 2006. The variation is mainly due to a decrease in the total of cash and term deposit for \$1.5 million. Long-term debt increased by \$0.9 million to \$13.9 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 short-term debt guaranteed by its investment tax credits.

The Company believes that, with the financial resources currently at its disposal, it needs to raise additional funds to be able to continue operations. The Company is in the process of seeking investment in both equity and debt.

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.

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.

At September 30, 2007, the Company's long-term debt amounted to \$13.9 million. 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 September 30, 2007, this ratio stood at 1.8/1 (2.0/1 as at December 31, 2006).

## Cash flow

<i>Unaudited</i>	Periods ending September 30, 2007		Periods ending September 30, 2006	
	Q3	Nine months	Q3	Nine months
Operating activities	(\$979,000)	(\$3,207,000)	(\$724,000)	(\$3,790,000)
Financing activities	\$226,000	\$1,773,000	\$1,039,000	\$3,700,000
Investing activities	\$6,000	\$1,118,000	(\$495,000)	(\$402,000)
Net change in cash	(\$747,000)	(\$316,000)	(\$180,000)	(\$492,000)

### *Operating Activities*

Cash used in operating activities increased by \$0.3 million to \$1.0 million for the quarter ended September 30, 2007 and decreased by \$0.6 million to \$3.2 million for the nine-month period ended September 30, 2007, compared to the same periods in 2006. Although the loss in this quarter is smaller than the one in the same quarter in 2006, changes in non-cash working capital items required \$0.3 million of cash in this quarter compared to the same quarter in 2006; this is mainly due to the increase of \$0.5 million in investment tax credits. Cash used in operating activities decreased by \$0.6 million during the nine-month period ending September 30, 2007 compared to the same period in 2006. This reduction is mainly the result of the decrease of \$1.3 million in the loss for that period; this is however partially compensated by the changes in non-cash working capital items which required \$0.7 million more cash during the last nine-month period compared to the same period in 2006.

### *Financing Activities*

Cash from financing activities decreased by \$0.8 million to \$0.2 million during the quarter ended September 30, 2007 and by \$1.9 million to \$1.7 for the nine-month period ended September 30, 2007, compared to the same periods in 2006. The reduction in the last quarter is due result of the fact that the Company raised \$1.2 million of equity in the third quarter in 2006 compared to nil in the third quarter of 2007. Although the Company raised \$2.0 million in equity in May 2007, it did contract \$2.6 million of long-term debt in the nine-month period ending September 30, 2006 compared to \$0.3 million in 2007.

### *Investing Activities*

Cash used in investing activities (excluding the term deposit) during 2007 has been minimal.

### *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.

<u>Use of Proceeds</u>	<u>Per prospectus</u>	<u>From September 1, 2006 through September 30, 2007</u>
Development of the Company's endogenous molecule of alfalfa and aprotinin product candidates, including preclinical trials	\$250,000	\$250,000
Investment in business development activities to secure partnerships and alliances	\$1,000,000	\$1,000,000
General corporate purposes	\$111,000	\$111,000
Total:	\$1,360,000	\$1,360,000

The Company completed most of the preclinical trials on its endogenous molecule prior to 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 was used in preclinical trials but for an influenza vaccine based on Hemagglutinin (HA).

### **Contractual Obligations**

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

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

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

### **Outstanding Share Data**

As of November 29, 2007, there were 21,112,440 common shares issued and outstanding, 1,450,613 stock options outstanding, 7,872,321 warrants outstanding and 420,268 compensation options outstanding.

## **Outlook for the Remaining of 2007**

The Company expects the following milestones to be completed in 2007 and 2008:

- Presentation at WHO Influenza closed conference: “Influenza vaccines that induce broad spectrum and long lasting immune responses”
- Completion of challenge study in mice
- Process and pilot facility ready to manufacture under cGMP
- Pre-IND meeting with regulatory authorities
- Completion of toxicology study
- IND filing and initialization of Phase I studies

In order to attain these milestones, Medicago needs to raise additional financing in the near future.

## **Financial and Other Instruments**

### *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 September 30, 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

November 29, 2007

# **Medicago Inc.**

Interim Consolidated Financial Statements  
(unaudited)  
**September 30, 2007**

# Medicago Inc.

## Consolidated Balance Sheets

	As at September 30, 2007 \$ (unaudited)	As at December 31, 2006 \$ (audited)
<b>Assets</b>		
<b>Current assets</b>		
Cash and cash equivalents	126,955	442,929
Term deposit	100	1,230,188
Current portion of security deposit on a lease agreement	20,000	20,000
Accounts receivable	106,953	79,130
Financing receivable (note 4)	95,343	171,926
Investment tax credits receivable	785,197	581,167
Grants receivable	3,202	23,125
Prepaid expenses	135,955	74,312
	<u>1,273,705</u>	<u>2,622,777</u>
<b>Security deposit on a lease agreement</b>	20,000	20,000
<b>Property, plant and equipment</b>	4,196,904	4,536,560
<b>Intangible assets</b>	<u>1,368,847</u>	<u>1,433,552</u>
	<u>6,859,456</u>	<u>8,612,889</u>
<b>Liabilities</b>		
<b>Current liabilities</b>		
Bank loan	-	300,000
Accounts payable and accrued liabilities	760,384	990,338
Current portion of long-term debt	13,072	13,072
	<u>773,456</u>	<u>1,303,410</u>
<b>Long-term debt (note 4)</b>	<u>13,942,377</u>	<u>13,067,121</u>
	<u>14,715,833</u>	<u>14,370,531</u>
<b>Shareholders' Deficiency</b>		
<b>Share capital (note 5)</b>	23,463,903	22,152,413
<b>Contributed surplus</b>	801,868	798,034
<b>Other equity components</b>	2,096,091	1,561,858
<b>Deficit</b>	<u>(34,218,239)</u>	<u>(30,269,947)</u>
	<u>(7,856,377)</u>	<u>(5,757,642)</u>
	<u>6,859,456</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  
Director

(signed) ANDREW J. SHELDON Director  
Director

# Medicago Inc.

## Interim Consolidated Statements of Earnings (unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007 \$	2006 \$	2007 \$	2006 \$
<b>Revenues from research agreements</b>	-	14,128	18,500	136,087
<b>Expenses</b>				
Research and development	581,597	941,101	2,196,508	3,247,788
Research grants and contributions	(89,122)	(10,069)	(311,548)	(65,312)
Research and development tax credits	(468,347)	(250,319)	(854,347)	(853,518)
General and administrative	464,742	611,437	1,621,355	1,895,773
Exchange loss (gain)	802	5,009	445	2,836
Depreciation of property, plant and equipment	129,971	158,128	422,105	457,797
Amortization of intangible assets	45,117	27,843	94,350	83,315
Other financial expenses, net	358,078	315,322	1,069,292	851,137
	1,022,838	1,798,452	4,238,160	5,619,816
<b>Loss and comprehensive loss for the period</b>	<b>(1,022,838)</b>	<b>(1,784,324)</b>	<b>(4,219,660)</b>	<b>(5,483,729)</b>
<b>Basic and diluted loss per share</b> (note 7)	<b>(0.06)</b>	<b>(0.16)</b>	<b>(0.24)</b>	<b>(0.57)</b>
<b>Going concern</b> (note 3)				

## Interim Consolidated Statements of Deficit (unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007 \$	2006 \$	2007 \$	2006 \$
<b>Balance at the beginning of the period</b>	33,195,401	26,211,721	30,269,947	22,512,316
Adjustment related to the implementation of new accounting standards (note 2)	-	-	(271,368)	-
Loss and comprehensive loss for the period	(1,022,838)	(1,784,324)	(4,219,660)	(5,483,729)
<b>Balance at the end of the period</b>	<b>34,218,239</b>	<b>27,996,045</b>	<b>34,218,239</b>	<b>27,996,045</b>

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

# Medicago Inc.

## Interim Consolidated Statements of Cash Flows (unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007 \$	2006 \$	2007 \$	2006 \$
<b>Cash flows from operating activities</b>				
Loss and comprehensive loss for the period	(1,022,839)	(1,784,324)	(4,219,660)	(5,483,729)
Items not affecting cash and cash equivalents				
Stock-based compensation costs	34,663	18,646	73,524	34,291
Depreciation and amortization	204,464	221,369	604,580	653,326
Interest capitalized on long-term debt	336,635	292,967	1,000,447	751,049
Government assistance	(239,220)	-	(239,220)	-
	(686,297)	(1,251,342)	(2,780,329)	(4,045,063)
Change in non-cash working capital items (note 6)	(292,536)	527,785	(426,946)	255,227
	(978,833)	(723,557)	(3,207,275)	(3,789,836)
<b>Cash flows from financing activities</b>				
Bank loan repaid	-	(213,000)	(300,000)	(112,606)
Long-term debt contracted	232,297	31,000	310,346	2,597,651
Payments on long-term debt	(6,536)	(6,536)	(13,072)	(13,072)
Issuance of units	-	1,227,693	2,000,000	1,227,693
Issue expenses	-	-	(223,969)	-
	225,761	1,039,157	1,773,305	3,699,666
<b>Cash flows investing activities</b>				
Term deposit	-	(330,000)	1,230,088	(39,965)
Additions to property, plant and equipment	(11,732)	(145,144)	(82,447)	(271,487)
Additions to intangible assets	18,185	(19,814)	(29,645)	(90,602)
	6,453	(494,958)	1,117,996	(402,054)
<b>Net change in cash and cash equivalents</b>	(746,619)	(179,358)	(315,974)	(492,224)
<b>Cash and cash equivalents at the beginning of the period</b>	873,574	(123,745)	442,929	189,121
<b>Cash and cash equivalents at the end of the period</b>	126,955	(303,103)	126,955	(303,103)
<b>Additional information</b>				
Interest paid	597	11,987	5,433	42,338

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

# Medicago Inc.

Notes to Interim Consolidated Financial Statements (Unaudited)  
September 30, 2007

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## 1 Interim financial information

The financial information for the nine-month periods ended September 30, 2007 and 2006 is unaudited. However, in the opinion of management, all adjustments necessary to present fairly the results of these periods have been recorded. 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 Accounting policies

### *Consolidated financial statements*

On April 1, 2007, the Company completed a corporate reorganization resulting in the creation of new entities to perform all of its research and development activities. Consequently, the consolidated financial statements include the accounts of Medicago Inc. and those of Medicago R&D Inc., 9177-4083 Québec Inc., 9157-4265 Québec Inc., 9177-4299 Québec Inc., Fiducie Financière Medicago and SAS Medicago Europa.

## 3 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.

# Medicago Inc.

Notes to Interim Consolidated Financial Statements (Unaudited)  
September 30, 2007

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## Recognition of financial assets and liabilities

### *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 of \$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, 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 1, 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>
	\$	\$	\$
	<u>(audited)</u>	<u>(unaudited)</u>	<u>(unaudited)</u>
<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 Interim Consolidated Financial Statements (Unaudited)

**September 30, 2007**

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## **4 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.

Management is of the opinion that additional equity or debt-based financing is required immediately to continue the company's operations. There is no assurance that management will be successful in this action.

# Medicago Inc.

Notes to Interim Consolidated Financial Statements (Unaudited)  
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## 5 Long-term debt

	As at September 30, 2007 \$	As at 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) 13,531,404	12,503,391
Contribution under an innovation program, payable in semi-annual instalments of \$6,536 since April 2005, non-interest bearing	(b) 20,622	39,213
Refundable contribution granted under the Technology Partnerships Canada program, non-interest bearing	(c) 234,692	395,300
Contribution under an innovation program, payable in annual instalments of \$28,458 from January 2009, non-interest bearing	(d) 168,731	142,289
	<u>13,955,449</u>	<u>13,080,193</u>
Less: Current portion	13,072	13,072
	<u>13,942,377</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 Interim Consolidated Financial Statements (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%.
- (c) 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 September 30, 2007, an amount of \$88,528 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%.

- (d) 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 ended on 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%.

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 Interim Consolidated Financial Statements (Unaudited)

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## 6 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 Interim Consolidated Financial Statements (Unaudited)  
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The share capital issued has varied as follows:

	Nine Months Ended September 30, 2007		Twelve Months Ended December 31, 2006	
	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	-	-	-	(141,521)
Issued pursuant to the initial public offering (i)	-	-	2,003,834	1,623,864
Issue expenses	-	-	-	(681,768)
Issued pursuant to a private placement (vi)	4,000,000	1,535,459	-	-
Issue expenses	-	(223,969)	-	-
Balance – End of period	21,112,440	23,463,903	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>	21,112,440	23,463,903	17,112,440	22,152,413

# Medicago Inc.

## Notes to Interim Consolidated Financial Statements (Unaudited)

September 30, 2007

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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 (note 5d). 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 (note 5c). 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.
- (v) On May 29, 2007, the company issued 4,000,000 units at a price of \$0.50 per unit for total gross proceeds of \$2,000,000 ("the Private Placement"). 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 \$0.75.
- (vi) The gross proceeds of the Private Placement of \$2,000,000 is shared out between the 4,000,000 common shares for a gross amount of \$1,535,459 and the 4,000,000 warrants attached to each unit for a gross amount of \$464,541 (note 5d). In connection with this investment, the company paid a cash compensation equivalent to 7% of the gross proceeds from the investment, being \$140,000. The company has also granted a non-transferable unit option to the agent entitling to subscribe, before May 29, 2009, for 280,000 options at a price of \$0.50 per share as financing expenses (note 5c). Each option entitles the holder thereof to purchase one common share at a price of \$0.50.

# Medicago Inc.

Notes to Interim Consolidated Financial Statements (Unaudited)

September 30, 2007

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(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.

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:

	<b>Nine Months Ended September 30, 2007</b>		<b>Twelve Months Ended December 31, 2006</b>	
	<b>Number</b>	<b>Weighted average exercise price \$</b>	<b>Number</b>	<b>Weighted average exercise price \$</b>
Outstanding – Beginning of period	1,628,978	1.12	708,188	1.65
Granted	97,000	0.91	1,096,400	1.04
Exercised	-	-	-	-
Forfeited	(275,365)	1.02	(175,610)	2.15
Outstanding – End of period	1,450,613	1.12	1,628,978	1.12
Options exercisable – End of period	460,759	1.20	436,657	1.17

# Medicago Inc.

Notes to Interim Consolidated Financial Statements (Unaudited)

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The following table summarizes information about outstanding and exercisable stock options as at September 30, 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 \$
\$0.65	25,000	59	0.65	8,250	0.65
\$1.00	870,832	46	1.00	48,832	1.00
\$1.11	389,817	36	1.11	359,027	1.11
\$1.50 to \$1.68	154,965	45	1.68	34,651	1.68
\$4.08	9,999	3	4.08	9,999	4.08
	<b>1,450,613</b>	<b>43</b>	<b>1.12</b>	<b>460,759</b>	<b>1.20</b>

## 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:

	Nine Months Ended September 30, 2007	As at December 31, 2006
Dividend yield	Nil	Nil
Expected volatility	82.73%	72.11%
Risk-free interest rate	4.12%	4.04%
Expected life (years)	5.00	4.78
Number of stock options granted	97,000	1,096,400
Weighted average fair value of options granted (\$)	0.91	0.49
<b>Compensation costs</b>	<b>\$73,524</b>	<b>\$57,239</b>

# Medicago Inc.

Notes to Interim Consolidated Financial Statements (Unaudited)

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(c) Unit options

The following table summarizes information about unit options outstanding and exercisable as at September 30, 2007:

	Number	Carrying value \$	Weighted average exercise price \$	Weighted average remaining contractual life (years)
Outstanding and exercisable – Beginning and end of period	420,268	122,135	0.67	1.42

(d) Warrants

The following table summarizes the information relating to warrants outstanding as at September 30, 2007:

	Number	Weighted average exercise price \$	Weighted average remaining contractual life (years)
Outstanding and exercisable – Beginning and end of period	7,872,321	0.93	1.78

## 7 Additional information on cash flows

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007 \$	2006 \$	2007 \$	2006 \$
Accounts receivable, financing and grants receivable	141,880	41,393	68,683	78,388
Investment tax credits receivable	(468,347)	409,454	(204,030)	513,223
Prepaid expenses	(30,275)	266,804	(61,643)	(17,176)
Accounts payable and accrued liabilities	64,206	(189,866)	(229,956)	(298,215)
Deferred revenues on research agreements	-	-	-	(20,993)
	(292,536)	527,785	(426,946)	255,227

# Medicago Inc.

Notes to Interim Consolidated Financial Statements (Unaudited)

September 30, 2007

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## 8 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:

	<b>Nine Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>
Basic and diluted weighted average number of shares outstanding	18,890,218	8,657,136

For the nine-month periods ended September 30, 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.

## 9 Comparative figures

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