



**YEAR ENDED DECEMBER 31, 2008**

## **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 years ended December 31, 2008 and 2007. 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, 2008 and 2007, appearing in the annual report of the Company, which are prepared in accordance with generally accepted accounting principles ("GAAP") in Canada.

The 2008 Annual Report of the Company and additional information regarding the business of the Company are available on SEDAR at [www.sedar.com](http://www.sedar.com).

### **COMPANY OVERVIEW**

Medicago is committed to providing highly effective and affordable vaccines based on 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 promises to deliver a vaccine for testing rapidly 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.

### **MARKET AND ECONOMIC SITUATION OVERVIEW**

The influenza vaccine market is expected to expand over \$3.7 billion by 2010. We are developing products for a growing market, with a first product (H5N1 pandemic influenza VLP vaccine) expected to be on the market in 2012 or 2013, if all clinical phases are successfully completed and market approval is granted by the regulatory authorities.

We did not incur any losses on asset-backed commercial paper as we have never invested in such securities. Our main credit facility (Biolevier) runs until 2014 and we have met all related requirements. In 2009, we have the financial resources required to work towards the attainment of our objectives (See *Products in development*) for the year, despite current economic conditions.

### **KEY DEVELOPMENTS FOR THE YEAR ENDED DECEMBER 31, 2008**

#### ***CORPORATE***

The most significant event of the year for the Company was the completion of a private placement with Philip Morris International Inc. On November 10<sup>th</sup>, 2008, following the approval by the shareholders of the Company, Medicago completed a private placement with an indirect subsidiary of PMI of 45,000,000 units (the "Units") at a price of \$0.355 per Unit for net proceeds of \$15,975,000. These funds will be used to further support the development of Medicago's pandemic and seasonal influenza vaccines programs. Following this placement, PMI holds an interest of 49.8% of the issued and outstanding common shares of Medicago.

Each Unit consists of one common share in the share capital of Medicago (a "Common Share") and one common share purchase warrant (a "Warrant"). Each Warrant entitles its holder to purchase one Common Share until October 20, 2010, at a price equal to \$0.375 for the first year following the date of the issuance of the Warrants and \$0.405 for the second year following the date of the issuance of the Warrants.

As part of the private placement, Medicago and PMI entered into:

- a Research and License Agreement granting Medicago ownership of intellectual property rights developed under the joint pandemic and seasonal influenza program and granting Philip Morris Products, S.A. (“PMP”), a subsidiary of PMI, among other rights, a license on such intellectual property rights;
- a Master Research Services Agreement providing the framework under which Medicago could conduct additional future research on PMP’s behalf and on a fee-for-service basis. PMP will be granted ownership of intellectual property rights developed under each of these projects and Medicago will be granted a license on such intellectual property rights allowing Medicago to conduct influenza research and;
- a representation right and preemptive right agreement whereby Medicago has undertaken, as long as PMI and its affiliates holds, jointly, directly or indirectly, a 10% equity interest in Medicago, calculated on a fully diluted basis, to propose for election at each annual shareholders’ meeting of Medicago at least one representative on the board of directors selected by PMI (or its affiliates) and has granted a preemptive right to PMI to maintain or increase its equity participation in Medicago.

Other key corporate developments are:

- In February, 2008, Medicago signed a \$2.0 million non-exclusive licensing agreement with PMI for the development and commercialization of the company's proprietary plant-based production technology.
- In March 2008, completion of a non-brokered private placement of 13 million units at a price of 20 cents per unit for gross proceeds of \$2.6 million.
- In April, 2008, the company completed the cGMP (current good manufacturing practices) qualification of its manufacturing facility.
- In May 2008, the Company appointed two key members of the executive management team
  - Pierre Labbé CA, Vice-president and Chief Financial Officer
  - Brigitte Barbeau, Vice-president Manufacturing
- In August 2008, completion of a non-brokered private placement of 11.05 million units at a price of 20 cents per unit for gross proceeds of \$2.21 million.

## ***PRODUCTS IN DEVELOPMENT***

### **H5N1 PANDEMIC INFLUENZA VLP VACCINE**

In 2008, the company continued the preclinical development of its H5N1 pandemic influenza VLP vaccine.

In March 2008, a lethal challenge of live H5N1 viruses in mice demonstrated that the Company's H5N1 Avian Influenza VLP vaccine provided 100% protection against the virus. In addition, it has the potential to protect against three of the deadliest strains of pandemic influenza. A major hurdle with development of pandemic flu vaccines has been the mutation of the H5N1 virus over time. As a result, cross-protection, rapid development and production are key components in the successful development of these vaccines. This is the first demonstration that the Company's VLP vaccine can protect against infection with a live deadly virus and provide cross-protection among different strains of H5N1 in circulation, increasing the chances of broader spectrum coverage.

Ferrets are the most predictive animal model for the effectiveness of influenza vaccines in humans. In June, 2008, the Company announced that its VLP vaccine was one of the first pandemic influenza vaccines to demonstrate it may provide significant immune protection in ferrets after a single dose, in addition to providing cross-reactivity against three of the deadliest strains of H5N1, after two doses. If the results in ferrets replicate in humans, Medicago’s H5N1 VLP vaccine will have the potential to generate significant protection levels (up to 100%) after just a single dose of five micrograms. Current FDA approved H5N1 vaccines in the United States require two 90-microgram doses.

In 2009, the Company intends to complete the preclinical work (lethal challenge in ferrets and toxicity study in rats) in the first half of the year and in the second half, will start and should complete the Phase 1 clinical study for its H5N1 pandemic influenza VLP vaccine.

## SEASONAL VACCINE

In the second half of 2008, the Company started a research program to develop a seasonal vaccine.

In 2009, the Company will continue its research program and should start preclinical work in the second half of the year.

## SELECTED ANNUAL CONSOLIDATED INFORMATION

	2008 \$	2007 \$	2006 \$
<b>CONSOLIDATED STATEMENTS OF EARNINGS SUMMARY</b>			
<b>Revenues</b>	<b>2,248,000</b>	74,000	156,000
<b>Loss for the year</b>			
\$	<b>7,649,000</b>	6,273,000	7,758,000
Basic and diluted loss per share	<b>0.17</b>	0.32	0.68

<b>CONSOLIDATED BALANCE SHEET DATA</b>			
<b>Cash, cash equivalents and short-term investments</b>	<b>14,028,000</b>	224,000	1,673,000
<b>Total assets</b>	<b>20,603,000</b>	6,662,000	9,551,000
<b>Total long-term liabilities</b> <sup>(1)</sup>	<b>15,283,000</b>	14,464,000	14,018,000

(1) Total long-term liabilities include long term-debt and current portion

## COMPARISON OF THE YEAR ENDED DECEMBER 31, 2008 AND 2007

### *Consolidated statements of earnings*

For the year ended December 31, 2008, revenues were \$2,248,000 compared to \$74,000 for the year ended December 31, 2007. This increase is due to revenues generated by two agreements signed with PMI. The first agreement signed in 2007, a research service agreement of \$500,000 generated \$444,000 in 2008 and revenues from the second one, a non-exclusive license agreement signed in February 2008, were \$2,000,000. Revenues from the non-exclusive license agreement were diminished by \$196,000 representing the value of the 2,000,000 common share purchase warrants granted to PMI at the signing of the agreement. Each warrant entitles PMI to purchase one common share at a price of \$0.23 for the first year, \$0.25 for the second year and \$0.28 for the third year ending February 7, 2011. Both agreements were completed in 2008.

Research and development (R&D) expenses increased by \$1,658,000 to \$4,699,000 for 2008 compared to 2007. The increase in R&D expenses for the year ended December 31, 2008 compared to 2007 is mainly related to the shift in the stage of development of the company from R&D to preclinical development for its H5N1 Avian Influenza VLP vaccine and the development of the cGMP process for the production of clinical materials for the upcoming Phase I. Wage and salaries were higher (\$908,000) in 2008 compared to 2007 explained by the hiring of new employees required for preclinical work and the upcoming Phase I (\$580,000), and payment of bonuses (\$321,000), when no bonuses were paid in 2007. More laboratory supplies and analysis (\$404,000) and a higher level of outsourced contract work (\$207,000) were also required to perform these activities.

Research grants and contribution increased by \$80,000 to \$84,000 for the year ended December 31, 2008, compared to the year ended December 31, 2007. The increase is mainly explained by the grant obtained in 2008 from Canada's National Research Council industrial research assistance program to support the development of the Company's seasonal influenza VLP vaccine program. This grant totaled \$280,000 of which \$232,000 is still available as at December 31, 2008.

Investment tax credits were \$921,000 for the year ended December 31, 2008, \$10,000 lower than the year ended December 31, 2007. Although R&D expenses increased by 55 % in 2008, the investment tax credits stayed at the same level, explained by the an amendment to the 2006 provincial tax return where the Company claimed an additional \$195,000 of tax credits for 2006. Also, following the completion of the private placement with PMI, the Company is now associated with PMI for tax purposes and this has resulted in a decrease of the tax credit rate at the provincial level from 37.5% to 17.5% and is no longer entitled to a Federal tax credit. On April 1 2007, the Company completed a corporate reorganization resulting in the creation of new entities to perform all of its R&D activities and thus maximizing its R&D tax credits. This transaction is currently under review and the Company decided to take a provision for the Federal tax credits of 2007 (\$138,000) and did not account any Federal tax credits in 2008.

General and administrative, business development and intellectual property (G&A) expenses increased by \$893,000 to \$3,322,000 for the year ended December 31, 2008 compared to 2007. The main increase was due to an increase in salaries (\$636,000) and

consultant fees (\$201,000). The increase in salaries is related to the payment of bonuses in 2008 when no bonuses were paid in 2007, the hiring of a CFO in May 2008 when it was outsourced in 2007 and the return of two maternity leaves. The increase in consultant fees is mainly related to fees paid for the recovery of new tax credits from previous years and represent 50% of the tax credits received.

Depreciation of property, plant and equipment amounted to \$475,000 for the year ended December 31, 2008, \$92,000 lower than the year ended December 31, 2007. Lesser acquisitions in 2007 and 2008 compared to preceding years explained this decrease.

Amortization of intangible assets amounted to \$99,000 for the year ended December 31, 2008, \$26,000 lower than the year ended December 31, 2007. Lesser acquisitions in 2007 and 2008 compared to preceding years explained this decrease.

A write-off of intangible assets of \$572,000 occurred in 2008 and corresponds to the carrying value of a license acquired in 2001 in relation with molecular farming in alfalfa no longer used by the Company.

Net financial expenses amounted to \$1,715,000 for the year ended December 31, 2008, \$627,000 higher compared to the year ended December 31, 2007. This increase is mainly the result of higher amortization of deferred financing expenses for \$258,000 and no grants in 2008 compared to \$393,000 in 2007. The increase in amortization of deferred financing expenses is related to the agreement that the Company reached with Investissement Québec (IQ), where IQ agreed to capitalize 50% of the interests of 2008. In consideration for this agreement, in May 2008, Medicago granted IQ 643,877 warrants to purchase an equivalent number of common shares, at a price of \$0.70 per share, for a period of three years. The fair value of these warrants amounts to \$258,000 and was amortized in 2008. For the year December 31, 2008, \$601,000 was capitalized to the principal compared to \$1,276,000 in 2007 when 100% of the interests were capitalized.

Consolidated loss for the year ended December 31, 2008 was \$7,649,000, or \$0.17 per basic and diluted share compared to a loss of \$6,273,000, or \$0.32 per basic and diluted share for the year ended December 31, 2007.

#### *Consolidated Balance sheet*

Cash, cash equivalents and short-term investments were \$14 million as at December 31, 2008, an increase of \$13.8 million from \$0.2 million as at December 31, 2007. This increase is mainly the result of the private placement completed in October 2008 with PMI for a gross amount of \$16.0 million.

Total consolidated assets were \$20.6 million as at December 31, 2008, an increase of \$13.9 million from \$6.7 million as at December 31, 2007. The variation is mainly due to an increase in the total of cash, cash equivalents and short term investments of \$13.8 million.

Long-term debt increased by \$0.8 million to \$15.3 million, mainly the result of the capitalized interest on the Bio-Levier loan for \$0.6 million.

## **QUARTERLY FINANCIAL DATA**

	<b>Quarters ended</b>			
	<b>December 31, 2008</b>	<b>September 30, 2008</b>	<b>June 30, 2008</b>	<b>March 31, 2008</b>
Revenues	-	-	\$583,000	\$1,665,000
Total expenses	(\$3,007,000)	(\$2,739,000)	(\$2,160,000)	(\$1,991,000)
Loss	(\$3,007,000)	(\$2,739,000)	(\$1,577,000)	(\$326,000)
Basic and diluted net loss per share	(\$0.04)	(\$0.07)	(\$0.05)	(\$0.01)

	December 31, 2007	September 30, 2007	June 30, 2007	March 31, 2007
Revenues	\$55,000	-	-	\$19,000
Total expenses	(\$2,109,000)	(\$1,023,000)	(\$1,550,000)	(\$1,665,000)
Loss	(\$2,053,000)	(\$1,023,000)	(\$1,550,000)	(\$1,647,000)
Basic and diluted net loss per share	(\$0.07)	(\$0.06)	(\$0.09)	(\$0.10)

Revenues from quarter to quarter may vary significantly. They are non-recurring by nature and are generated from licenses agreement as well as contract research agreement. It is also important to note that historical patterns of expenses cannot be taken as an indication of future expenses. The amount and timing of expenses and availability of capital resources vary substantially from quarter to quarter, depending on the level of R&D activity being undertaken at any one time and the availability of funding from investors and/or partners.

As described earlier, revenues for Q1 and Q2 of 2008 were generated by two agreements signed with PMI. The first agreement, a research service agreement of \$500,000, signed in 2007 and completed in 2008, generated \$444,000 in 2008 and revenues from the second one, a non-exclusive license agreement signed in February 2008 and completed in 2008, were \$2,000,000. Revenues from the non-exclusive license agreement were diminished by \$196,000 representing the value of the 2,000,000 common share purchase warrants granted to PMI at the signing of the agreement.

Expenses for the first three quarters of 2007 were kept at the minimum level due to the financial condition of the Company at that time. The improvement of the financial condition but mainly the shift in the stage of development of the company from R&D to preclinical development for its H5N1 Avian Influenza VLP vaccine and the development of the cGMP process for the production of clinical materials for the upcoming Phase I explained the increase in expenses from the fourth quarter of 2007 through the end of 2008. Wage and salaries increased in 2008 compared to 2007 explained by the hiring of new employees in the second half of 2008 required by preclinical work and by the upcoming Phase I and also by payment of bonuses when no bonuses were paid in 2007. More laboratory supplies and analysis and a higher level of outsourced contract work were also required to perform those activities.

#### **FOURTH QUARTER RESULTS**

The most important event for the Company in the fourth quarter of 2008 was the completion of a private placement with an indirect subsidiary of PMI of 45,000,000 units (the "Units") at a price of \$0.355 per Unit for a gross proceeds of \$15,975,000. These funds will be used to further fund the development of Medicago's pandemic and seasonal influenza vaccines.

Each Unit consists of one common share in the share capital of Medicago (a "Common Share") and one common share purchase warrant (a "Warrant"). Each Warrant entitles its holder to purchase one Common Share until October 20, 2010, at a price equal to \$0.375 for the first year following the date of the issuance of the Warrants and \$0.405 for the second year following the date of the issuance of the Warrants.

For the fourth quarter ended December 31, 2008, the loss increased by \$954,000 to \$3,007,000 compared to \$2,053,000 for the fourth quarter of 2007. The increase is mainly explained by an increase in R&D expenses of \$500,000, the \$177,000 decrease of investment tax credits and the \$324,000 increase in G&A expenses.

The increase in R&D expenses of \$504,000 for the quarter ended December 31, 2008 compared to 2007 is mainly related to the shift in the stage of development of the Company from R&D to preclinical development, including the development of the cGMP process for the production of clinical materials for the upcoming Phase I. Wage and salaries were higher (\$371,000) in the fourth quarter of 2008 compared to 2007 explained by the hiring of new employees required by preclinical work and by the upcoming Phase I and payment of bonuses when no bonuses were paid in 2007. More laboratory supplies and analysis (\$62,000) were also required to perform these activities.

Investment tax credits decreases by \$177,000 for the quarter ended December 31, 2008, despite the 60 % increase in R&D expenses during the fourth quarter of 2008. Following the completion of the private placement with PMI, the Company is now associated with PMI for tax purposes. An impact of this is a decrease of the tax credit rate at the provincial level from 37.5% to 17.5% and no eligibility for a Federal tax credit. On April 1 2007, the Company completed a corporate reorganization resulting in the creation of new entities to perform all of its R&D activities and thus maximizing its R&D tax credits. This transaction is

currently under review and the Company decided to take a provision for the Federal tax credits of 2007 (\$138,000) and did not account any Federal tax credits in 2008.

G&A expenses increased by \$324,000 in the fourth quarter ended December 31, 2008 compared to 2007. The main increase is in salaries (\$341,000) and is related to the payment of bonuses in the fourth quarter of 2008 when no bonuses were paid in 2007, the hiring of a CFO in May 2008 when it was outsourced in 2007 and the return of two maternity leaves.

## LIQUIDITY, CASH FLOWS AND CAPITAL RESOURCES

The Company had cash, cash equivalents and short-term investments totaling \$14.0 million as at December 31, 2008, an increase of \$13.8 million from December 31, 2007. The Company had working capital of \$13.6 million as at December 31, 2008 compared to a negative working capital of 730,000 as at December 31, 2007. The short-term investments do not include asset-backed commercial papers which are affected by liquidity issues. As at December 31, 2008, the Company's long-term debt amounted to \$15.3 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 December 31, 2008 this ratio stood at 7.45:1.

The Company's primary capital needs are the funds required to support its scientific research and development activities including preclinical and clinical trials, capital expenditures for the expansion of its pilot plant facilities and working capital. We expect our expenditures to increase in 2009 as we continue to advance our programs. We believe our existing capital resources are adequate to fund our plans for 2009.

Since its inception, the Company has financed its cash requirements primarily through issuances of securities, investment tax credits, government funding, cost recoveries, license agreement, contract research agreements, long-term debt and short-term debt guaranteed by its investment tax credits. The strategy of the Company for future funding is to find additional capital after a successful completion of the Phase I trial for its H5N1 pandemic influenza VLP vaccine. The amount of additional capital needed will depend on the cash on hand at that time and funds necessary to conduct a Phase II clinical for this vaccine. We anticipate funding additional capital requirements primarily through additional issuance of securities and/or the potential monetization of our products. (See section *RISK AND UNCERTAINTIES- Additional Financing Requirements and Access to Capital*)

The variation of our liquidity by activities is explained below.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

<i>Cash flows</i>	<b>Year ended December 31, 2008</b>	<b>Year ended December 31, 2007</b>
Operating activities	<b>(\$5,710,000)</b>	(\$4,154,000)
Financing activities	<b>\$20,155,000</b>	\$2,811,000
Investing activities <sup>(1)</sup>	<b>(\$13,577,000)</b>	\$1,124,000
Net change in cash	<b>\$868,000</b>	(\$219,000)

(1) Cash flows used in investing activities net of acquisitions of short-term investments and term deposit cashed were (\$592,000) in 2008 and (\$106,000) in 2007.

### *Operating Activities*

Cash used in operating activities increased by \$1,556,000 to \$5,710,000 for the year ended December 31, 2008 compared to 2007. This increase is explained by the increase in loss, net of items not affecting cash and cash equivalents (or burn rate) for \$638,000 and the change in non-working capital for \$918,000.

We expect net cash used in operating activities to increase in 2009, as we will begin our Phase I clinical program with our H5N1 pandemic influenza vaccine and will further advance our seasonal influenza vaccine in preclinical program (see *Outlook for 2010*).

### *Financing Activities*

For 2008, cash from financing activities increased by \$17.3 million to \$20.2 million compared to 2007. The increase is mainly the result of three private placements completed in 2008, for total gross proceeds of \$20,785,000. The first private placement of 13,000,000 units at a price of \$0.20 per unit for total gross proceeds of \$2,600,000 was completed in March, the second for 11,050,000 units at a price of \$0.20 per unit for total gross proceeds of \$2,210,000 was completed in August and the third one, completed in October, with PMI for 45,000,000 units at a price of \$0.355 for total gross proceeds of \$15,975,000. In 2007, one private placement of 4,000,000 units at a price of \$0.50 per Unit for gross proceeds of \$2,000,000 was completed.

For the first private placement of 2008, each unit consists of one common share of the Company and one-half common share purchase warrant. Each whole warrant entitles the holder thereof to purchase one of common share at a price of \$0.25 for two years. For the second private placement of 2008, each unit consists of one common share of the company and one-half common share purchase warrant. Each whole warrant entitles the holder thereof to purchase one of common share at a price of \$0.30 for 12 months. For the private placement with PMI each unit consists of one common share and one common share purchase warrant. Each warrant entitles the holder thereof to purchase one common share until October 20, 2010, at a price equal to \$0.375 for the first year following the date of the issuance of the warrants and \$0.405 for the second year following the date of the issuance of the Warrants.

As a result of these above mentioned private placements the Company issued a total of 69,050,000 common shares and 57,025,000 warrants in 2008.

### *Investing Activities*

Cash used in investing activities (excluding acquisitions of short-term investments and term deposit cashed) increased by \$486,000 to \$592,000 in 2008 related to more additions of property, plant and equipment for \$380,000. In 2008, the Company acquired a land adjacent to its pilot plant for \$215,000 for potential future expansions.

The Company plans to invest \$1.25 million in 2009 to expand its manufacturing facility to optimize manufacturing activities and provide additional space to produce clinical-grade material for human clinical trials.

## **CONTRACTUAL OBLIGATIONS**

The Company has certain contractual obligations and commercial commitments. The following table indicates the Company's cash requirements to comply with these obligations:

Minimum payments under the Company's contractual obligations are as follows as at December 31, 2008:

\$	2009	2010	2011	2012	2013	Thereafter	Total
Accounts payable	1,314,089	-	-	-	-	-	1,314,089
Bank loans	727,950	-	-	-	-	-	727,950
Long-term debt	73,071	60,000	60,000	60,000	60,000	16,153,280	16,466,351
Operating leases	216,574	154,241	205,002	203,535	84,603	-	863,955
Licenses	102,000	122,000	147,000	147,000	147,000	205,000	870,000

## **OUTLOOK FOR 2009**

We expect R&D expenses to increase in 2009, primarily due to the beginning of the Phase 1 clinical program with our H5N1 pandemic influenza vaccine and we will further advance our seasonal influenza vaccine in preclinical program.

Based on our current estimates, net cash outflow for 2009 is projected to be around \$10.5 million. Our expectations are that the cash outflow will not proceed linearly through the year but will be higher in the second half of the year due to cost associated with clinical studies and the cost of the expansion of our manufacturing facility.

## **RELATED PARTY TRANSACTIONS AND OFF-BALANCE SHEET AGREEMENTS**

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

## **OUTSTANDING SHARE DATA**

As at March 24, 2009, there were 90,324,940 common shares issued and outstanding, 5,817,245 stock options outstanding, 64,933,196 warrants outstanding, and 280,000 unit options outstanding.

## **CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

These financial statements have been prepared in accordance with Canadian generally accepted accounting principles. The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts of assets and liabilities reported in the financial statements. Those estimates and assumptions also affect the disclosure of contingencies at the date of the financial statements and the reported amounts of revenues and expenses during the year. Significant estimates are generally made in connection with the calculation of revenues, research and development expenses, stock-based compensation expense, as well as in determining future income tax assets and liabilities, the useful lives of property, plant and equipment and intangible assets with finite lives and the valuation of intangible assets, the fair value of stock options granted, and certain accrued liabilities. Estimates are based on historical experience, where relevant, and on various other assumptions that we believe to be reasonable under the circumstances. Actual results could differ from those estimates.

The following summarizes our critical accounting policies and other policies that require the most significant judgment and estimates in the preparation of our consolidated financial statements.

### **Impairment of long-lived assets**

Long-lived assets are reviewed for impairment when events or circumstances indicate that costs may not be recoverable. Impairment exists when the carrying value of the asset is greater than the pre-tax undiscounted future cash flows expected to be provided by the asset. The amount of impairment loss, if any, is the excess of the carrying value of the asset over its fair value.

### **Income taxes**

The Company follows the liability method of accounting for income taxes. Under this method, future income tax assets and liabilities are determined based on deductible or taxable temporary differences between the carrying amounts and tax bases of the assets and liabilities. Changes in the future income tax assets or liabilities are included in the statements of earnings. Future income tax assets and liabilities are measured using enacted or substantively enacted tax rates expected to be in effect for the year in which the differences are expected to reverse.

The Company establishes a valuation allowance against future income tax assets if, based on available information, it is more likely than not that some or all of the future income tax assets will not be realized.

### **Research and development costs**

All expenses related to development activities, which do not meet generally accepted criteria for deferral, and research activities are expensed as incurred. Development expenses which meet generally accepted criteria for deferral are capitalized and amortized against earnings over the estimated period of benefit. As at December 31, 2008 and 2007, no development costs have been deferred.

### **Revenue recognition**

Revenues related to research agreements are bound to milestone agreements and are recorded as the milestones are reached and upon customer acceptance. Under these agreements, the payments received in advance are recognized as deferred revenue in the balance sheet and then, as revenue when milestone are reached and upon customer acceptance. Revenue from research agreements are recognized using the percentage-of-completion method.

The existing licensing agreement usually foresees one-time payment (upfront payment) and milestone payments. Revenues associated with those multiple-element arrangements are allocated to the various elements based on their relative fair value. Agreements containing multiple elements are divided into separate units of accounting if certain criteria are met, including whether the delivered element has stand-alone value to the customer and whether there is objective and reliable evidence of the fair value of the undelivered obligation(s). The consideration received is allocated among the separate units based on each unit's fair value or using the residual method, and the applicable revenue recognition criteria are applied to each of the separate units.

License fees representing non-refundable payments received upon the execution of license agreements are recognized as revenue upon execution of the license agreements when the Company has no significant future performance obligations and collectability of the fees is assured. Upfront payments received at the beginning of licensing agreements are not recorded as revenue when received but are amortized based on the progress to the related research and development work. This progress is based on estimates of total expected time or duration to complete the work which is compared to the period of time incurred to date in order to arrive at an estimate of the percentage of revenue earned to date.

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

The company has a stock option plan which is described in note 12 of the financial statements. As regards stock options granted to non-employees, the company uses the fair value-based method of accounting. The fair value of stock options is determined using the Black-Scholes option pricing model and stock-based compensation costs are recognized over the vesting period of the options and are recorded in Shareholders' Equity under caption "Other equity components". Any consideration received by the company on the exercise of stock options and the carrying value of those stock options are recorded in Shareholders' Equity under caption "Share capital" upon the issuance of shares.

## **NEW ACCOUNTING STANDARDS AND FUTURE ACCOUNTING CHANGES**

### **New accounting standards adopted in 2008**

On January 1, 2008 the company adopted the following section of the CICA Handbook:

(a) Section 3862, "Financial Instruments – Disclosures". This section describes the required disclosures to evaluate the significance of financial instruments for the entity's financial position and performance as well as the nature and extent of risks arising from financial instruments to which the entity is exposed and how the entity manages those risks, see note 19 of the financial statements.

(b) Section 3863, "Financial Instruments – Presentation". This section establishes standards for presentation of financial instruments and non-financial derivatives. It details the presentation of standards described in Section 3861, "Financial Instruments – Disclosure and Presentation", see note 19 of the financial statements.

(c) Section 1535, "Capital Disclosures". This section establishes standards for disclosing information about an entity's capital and how it is managed. It describes the disclosure of the entity's objectives, policies and processes for managing capital as well as summary quantitative data on the elements included in the management of capital. The section seeks to determine if the entity has complied with capital requirements and if not, the consequences of such non-compliance, see note 18 of the financial statements.

(d) Section 3031, "Inventories". This section prescribes the accounting treatment for inventories. It provides guidance on the determination of cost and its subsequent recognition as an expense, including any writedown to net realizable value. It also provides guidance on the cost formulas that are used to assign costs to inventories.

(e) Section 1400, "General Standards of Financial Statement Presentation" to include requirements to assess and disclose an entity's ability to continue as a going concern (going concern assumption).

The company has adopted these standards and there has been no impact on the financial statements except for additional disclosures mentioned above (notes 18 and 19 of the financial statements).

### **Future accounting changes**

The CICA issued Section 3064, "Goodwill and Intangible Assets", which will apply to interim and annual financial statements relating to fiscal years beginning on or after October 1, 2008. This section establishes standards for the recognition, measurement

and disclosure applicable to intangible assets. It replaces Section 3062, "Goodwill and Other Intangible Assets", and Section 3450, "Research and Development Costs". Upon consideration of this new standard, the Company has concluded that it will not impact significantly on its financial position and results of operations. On January 1, 2009, the company adopted Section 3064 of the CICA Handbook.

The CICA published the following sections of the CICA Handbook that apply to interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011.

(a) Section 1582, "Business Combinations", which replaces the former Section 1581 with the same title, establishes accounting standards for a business combination. It provides the Canadian equivalent to International Financial Reporting Standard IFRS3, "Business Combinations".

(b) Section 1601, "Consolidated Financial Statements", which replaces the former Section 1600 with the same title, establishes standards for the preparation of consolidated financial statements.

(c) Section 1602, "Non-Controlling Interests". This new section establishes standards on accounting for non-controlling interests in a subsidiary in consolidated financial statements prepared subsequent to a business combination. It is equivalent to the corresponding provisions of International Accounting Standard IAS 27, "Consolidated and Separate Financial Statements".

The company is currently evaluating the impact of these new standards on its financial statements.

In January 2009, the CICA's Emerging Issue Committee ("EIC") issued Abstract EIC-173, *Credit Risk and the Fair Value of Financial Assets and Liabilities*, which requires entities to take both counterparty credit risk and their own credit risk into account when measuring the fair value of financial assets and liabilities, including derivatives. EIC-173 will be effective for interim and annual periods beginning on or after January 1, 2009. The Company does not expect that adoption of this guidance will have a significant impact on its consolidated financial statements.

### **International Financial Reporting Standards**

In February 2008, the Accounting Standards Board ("AcSB") confirmed that Canadian GAAP for publicly accountable enterprises will be converged with IFRS effective in calendar year 2011, with early adoption allowed starting in calendar year 2009. The conversion to IFRS will be required, for the Company, for interim and annual financial statements beginning on January 1, 2011. IFRS uses a conceptual framework similar to Canadian GAAP, but there are significant differences on recognition, measurement, presentation and disclosures. In the period leading up to the conversion, the AcSB will continue to issue accounting standards that are converged with IFRS such as IAS 2 "Inventories" and IAS 38 "Intangible Assets", thus mitigating the impact of adopting IFRS at the mandatory transition date.

During 2008, the Company proceeded with the assistance of external experts to establish a stage 1 diagnosis for the adoption of IFRS. This diagnosis has identified the main differences between the accounting treatments applied by the Company under Canadian GAAP and the IFRS as well as the practical implications related to the measure. The differences were further classified according to their degree of complexity and by the amount of work to implement with respect to the measure.

The Company has decided to switch to IFRS on January 1, 2011. Some options permitted under IFRS are currently under analysis. A summary analysis indicates that in most cases, the Company would opt for a prospective application when the choice is available. The changeover to IFRS will result in changes to our accounting systems, our internal control systems and our management and evaluation systems. Therefore, we are currently analyzing the potential of our systems and the possibility to integrate all our subsidiaries on the same information system. The Company is currently evaluating the impact of the adoption of IFRS on its consolidated financial statements.

### **CAPITAL MANAGEMENT**

The Company views capital as the sum of Long-term debt and Shareholders' Equity.

The Company's objectives when managing capital is to safeguard the Company's ability to continue as a going concern in order to provide an adequate return to shareholders and maintain a sufficient level of funds to finance its research and development activities, general and administrative expenses, working capital and overall capital expenditures, including those associated with patents and trademarks.

To maintain or adjust the capital structure, the Company may attempt to issue new shares, issue new debt, acquire or dispose of assets all subject to market conditions and the terms of the underlying third party agreements.

The Company is not subject to any capital requirements imposed by a regulator.

The total capital as at December 31, 2008 and 2007 is calculated as follows:

	<b>2008</b>	<b>2007</b>
	\$	\$
Long-term debt	15,160,628	14,451,147
Current portion of long-term debt	121,959	13,072
	<hr/>	<hr/>
	15,282,587	14,464,219
Share capital	37,182,667	23,465,147
Contributed surplus	1,087,608	802,219
Other equity components		
Stock options	500,081	263,821
Unit options	66,640	122,135
Warrants	8,410,742	1,787,553
Deficit	(43,920,364)	(36,271,760)
Accumulated other comprehensive loss	(48,384)	-
	<hr/>	<hr/>
	3,278,991	(9,830,885)
Total capital	<hr/>	<hr/>
	18,561,580	4,663,334

## FINANCIAL INSTRUMENTS RISK FACTORS

### *Financial risk*

The Company is exposed to various types of risks owing the nature of the business activities it carries on, including those related to the use of financial instruments. The Company does not use financial derivatives.

### *Market risk*

Market risk corresponds to the financial losses that the Company could incur because of unfavourable fluctuations in the value of financial instruments, following variations in the parameters underlying their evaluation, such as interest rates and exchange rates. The exposure to variation to interest rates is described hereunder.

### *Foreign Currency Risk*

Regarding the exposure to foreign exchange rates, the Company operate internationally and a portion of our expenses are incurred in US dollars and Euros but these exposures are not material.

### *Interest rate risk*

As at December 31, 2008, the company's exposure to interest rate risk is summarized as follows:

Cash and cash equivalents	Variable interest rate
Short term investments	Fixed interest rate
Accounts receivable	Non-interest bearing
Financing receivable	Non-interest bearing
Grants receivable	Non-interest bearing
Bank loans	Variable interest rate
Accounts payable and accrued liabilities	Non-interest bearing
Long-term debt	As described in note 10

Bank loans (note 8) bear interest at variable rate and as at December 31, 2008, everything else being equal a 1% increase in interest rate on the bank loans would have had an unfavourable impact of \$7,280 on loss and comprehensive loss. A 1% decrease in interest rate would have had the opposite impact on loss and comprehensive loss.

The Biolevier loan (note 10) bears interest at variable rate and as at December 31, 2008, everything else being equal a 1% increase in interest rate on the debt would have had an unfavourable impact of \$153,186 on loss and comprehensive loss. A 1% decrease in interest rate would have had the opposite impact on loss and comprehensive loss.

#### *Credit risk*

Financial instruments which potentially subject the Company to concentrations of credit risk consist primarily of cash and cash equivalents, short-term investments and accounts receivable. Cash and cash equivalents are maintained with high-credit quality financial institutions. Short-term investments consist primarily of term deposits, bonds and residuals issued by high-credit quality institutions. Consequently, management considers the risk of non-performance related to cash and cash equivalents and short-term investments to be minimal.

#### *Liquidity risk*

Liquidity risk represents the possibility that the Company may not be able to gather sufficient cash resources, when required and under reasonable conditions, to meet its financial obligations.

The Company believes that, with the financial resources currently at its disposal, it has sufficient cash and cash equivalents to meet its contractual liabilities for at least the next 12 months. To meet all its contractual liabilities, the Company will need to raise additional funds in the future and will seek additional forms of debt or equity financing, but cannot provide assurance that we will be successful in doing so. See 'Risk Factors' hereunder.

## **RISK FACTORS AND UNCERTAINTIES**

#### *Additional Financing Requirements and Access to Capital*

The Company will require significant additional funds for further research and development, planned clinical trials, regulatory approvals, establishment of commercial manufacturing capabilities and the marketing of its products and product candidates. An attempt may be made to raise additional funds for the aforementioned purposes through public or private equity or debt financing, and collaborations with other companies, or financing from other sources may be undertaken. There can be no assurance that additional funding will be available.

#### *Stage of Development*

Medicago is still in development and still has a short operating history. The Company's product candidates will require additional investments to move through commercialization and it is not certain that these products will be produced at reasonable cost and quality or be successfully marketed. It is not known whether the Company's investment in such products or product candidates will be recovered through sales or royalties.

Since the Company's more advanced products are in preclinical development, the Company still has not demonstrated efficacy in humans for any of the Company's products or received any regulatory authorization for clinical trials. It is not known whether the Company will meet applicable health regulatory standards and obtain the required regulatory approvals for its actual products or product candidates.

Currently, the Company's ability to produce a commercial quantity of its products and product candidates has not been tested and the Company still does not have the manufacturing capacity to produce at such a commercial level. Additional investments will be required to build the manufacturing capacity to meet the market needs and these scale-up operations may change the Company's cost structure that may affect some of its platform benefits or lower capital costs and lower the cost of goods sold.

The Company is still several years away from commercialization and it may encounter unforeseen difficulties or delays in its operations and it is possible that competitors may develop alternative production methods which could reduce the Company's competitive advantages.

### *History of Operating Losses*

As at the present date, the Company has not recorded any revenues from the sale of products or product candidates. The Company has an accumulated deficit, since its inception through December 31, 2008 of \$43,920,364. Losses could increase in the near term as the Company continues its product development and, in the case of pharmaceutical proteins, seeks regulatory approval for the sale of its product candidates. Operating losses are expected to be incurred until such time as product sales and royalty payments are sufficient to generate revenues to fund its continuing operations. Quarter-to-quarter fluctuations in revenues, expenses and losses are also expected.

### *Regulation of Drug and Product Approval*

Potential investors should be aware of the risks, problems, delays, expenses and difficulties which the Company may encounter in light of the extensive regulatory environment in which its business is carried on.

Numerous statutes and regulations govern the manufacture and sale of human therapeutic products in Canada, the United States and other countries, the intended markets for the Company's products and product candidates. Such legislation and regulation bears upon the approval of manufacturing facilities, testing procedures and controlled research, preclinical and clinical data prior to marketing approval, including adherence to cGMP standards during production and storage, as well as regulation of marketing activities, including advertising and labelling.

Product candidates and processes that the Company is currently developing require significant development, testing and the investment of significant funds prior to their commercialization. There can be no assurance that any of such products, product candidates or processes will actually be developed to a commercial level.

Before obtaining regulatory clearance for the commercial sale of any of the Company's pharmaceutical product candidates, the Company must demonstrate through preclinical studies and clinical trials that the potential product candidate is safe and efficacious for use in humans for each target indication. The results from preclinical studies and early clinical trials may not be predictive of results that will be obtained in large-scale testing, and there can be no assurance that the Company's clinical trials will demonstrate sufficient safety for an IND or subsequent phases or steps in human trials even after preclinical testing and/or human data is submitted. The failure to adequately demonstrate the safety and efficacy of a product candidate under development could delay or prevent regulatory clearance of the potential product candidate and would have a material adverse effect on the Company's success.

Any drug is likely to produce some toxicity or undesirable side effects in animals and in humans when administered as a monotherapy or in combination with other drugs. There can be no assurance that unacceptable toxicity, adverse events or side effects will not occur at any dose level at any time in the course of toxicological studies or of human clinical trials of the Company's potential product candidates as a monotherapy or in combination with other drugs. The appearance of any such unacceptable toxicity, adverse events or side effects in toxicology studies or in clinical trials could cause the Company or regulatory authorities to interrupt, limit, delay or abort the development of any of the Company's product candidates and could ultimately prevent their clearance by Health Canada, the FDA or other regulatory authorities, for any or all targeted indications. There can be no assurance that a phase, component or step of a trial will be successful or safely completed allowing a subsequent phase, step or component of a trial or a trial's design to commence. There is no assurance that Health Canada, the FDA or other regulatory authorities will accept a specific protocol or protocol design regardless of phase, steps or components of a phase. Furthermore, after a trial or phase of a trial has commenced, Health Canada, the FDA or other regulatory authorities could place the trial on clinical hold if Health Canada, the FDA or other regulatory authorities determine a trial or its design may be unsafe or require clarifications regarding protocol design. If the Company is placed on clinical hold, there is no assurance the objections or issues will be overcome or resolved and such trial could be postponed and/or terminated. Even after being cleared by Health Canada, FDA or other regulatory authorities, a product candidate may later be shown to be unsafe or not to have its purported effect, thereby preventing its widespread use or requiring withdrawal from the market. There can be no assurance that any product candidates the Company has developed or will develop will be safe when administered to patients.

The rate of completion of clinical trials in relation to the Company's products will be dependent upon, among other factors, the rate of patient enrolment. Patient enrolment is a function of many factors, including the size of the patient population, the nature of the protocol, competing trials for the same patient population, the proximity of parties to clinical sites, the eligibility criteria for the study and interest of clinical investigators. Delays in planned patient enrolment may result in increased costs, delays or termination of clinical trials, which could have a material adverse effect on the Company's success. In addition, the Company's staff has limited clinical experience and, as a result, will rely on third parties to assist the Company in overseeing and monitoring the clinical trials, which may result in delays in completing clinical trials, or them not being completed at all, if such third parties fail

to perform under their agreements with the Company or fail to meet regulatory standards in the performance of their obligations under such agreements. There can be no assurance that the Company will be able to submit a new drug application as scheduled if clinical trials are completed or that any such applications will be reviewed and cleared by Health Canada or FDA in a timely manner or at all.

#### *Regulation of Genetically Engineered Plants*

The Company must comply with regulations of the United States Department of Agriculture (“USDA”), the CFIA and other regulatory authorities for outdoor releases of genetically engineered organisms as well as other products designed for use on or with agricultural products. The USDA and the CFIA prohibit growing and transporting genetically modified plants except pursuant to an exemption or under special permits. In order to obtain the required permits, the Company will be required to demonstrate that the Company has satisfactory procedures for the growth of its genetically modified plants and for the control of seed stocks, harvested material, processing facilities, and waste material from such plants. There can be no assurance that permits will be granted to the Company in a timely fashion, if at all. In addition, the conditions to the grant of such permits may be time consuming or expensive for the Company to fulfill. Furthermore, changes in regulations or policies of the USDA, the CFIA and other regulatory authorities regarding the growth and movement or field release of genetically modified plant hosts could adversely affect the Company’s business by increasing the cost of its products and technologies or decreasing consumer demand for those products and technologies or causing governments to prohibit their sale or use. If the Company fails to comply with such rules or policies, it may be subject to financial loss or be liable for costs incurred as a result of non-compliance. To the knowledge of the Company, no regulatory requirement for the outdoor commercial growth of transgenic plants producing pharmaceutical proteins has been promulgated in Canada, the United States or elsewhere.

#### *Rapid Technological Change*

Considering the rapid evolution and the substantial technological change of the industry, there can be no assurance that developments by others will not render the Company’s technologies non-competitive or that the Company will be able to keep pace with technological developments. The Company’s competitors may also have developed or may be developing technologies which could become the basis for competitive products and product candidates. Some of these products and product candidates may prove to be more effective and less costly than the products and product candidates developed or that are being developed by the Company.

#### *Dependence on Key Personnel*

The Company depends on certain members of its management and scientific staff and the loss of services of one or more of said persons could adversely affect the Company. It is necessary for the Company to continue to implement and improve its management systems and to continue to recruit and train new employees in order to manage its growth effectively. In particular, the Company will need to recruit personnel with experience in cGMP manufacturing, drug development and quality control. While the Company has been able to attract and retain skilled and experienced personnel in the past, no assurance can be given that it will be able to do so in the future.

#### *Competition*

Technological competition is intense in the industry in which the Company operates. Competition comes from pharmaceutical companies, biotechnology companies and universities as well as companies that participate in each of the non-pharmaceuticals markets the Company is attempting to address with its products and product candidates. Many of the Company’s competitors have substantially more financial and technical resources, more extensive research and development capabilities and greater marketing, distribution, production and human resources than the Company. Moreover, competitors may develop products before the Company develops its own products and product candidates and may obtain regulatory approval for such products and product candidates more rapidly than the Company. Products and product candidates and processes which are more effective than those that the Company intends to develop may be developed by the Company’s competitors. Research and development by others may render the Company’s technology, products and product candidates or processes non-competitive or obsolete.

#### *Negative Public Reaction to Genetically Engineered Technology*

Future commercial success of some of the Company’s products and product candidates and of the products of some of its partners will depend in part on public acceptance of the use of genetically engineered products and product candidates, including drugs, plants and plant products. Claims that genetically engineered products and product candidates are unsafe for consumption or pose a danger to the environment may influence public attitudes, regardless of their veracity. Negative public reaction to genetically

modified organisms and products and product candidates could result in greater government regulation of genetic research and resultant products and product candidates, including stricter labelling requirements, and could cause a decrease in the demand for the Company's products and product candidates, even if such products and product candidates do not result from genetically modified organisms.

#### *Patents and Proprietary Rights*

The Company's success depends, in part, on its ability to secure and protect its intellectual property rights and to operate without infringing on the proprietary rights of others or having third parties circumvent the rights owned or licensed by the Company. Applications for patents in Canada, the United States and in other jurisdictions have been filed and the Company is actively pursuing them. The patent positions of pharmaceutical and biotechnology firms, including the Company, are uncertain and involve complex questions of law and fact for which important legal issues remain unresolved. Therefore, it is not clear whether the Company's pending patent applications will result in the issuance of patents or whether the Company will develop additional proprietary products and product candidates which are patentable. Part of the Company's strategy resides on its ability to secure a patent position around the production of a recombinant protein using its Proficia™ technology platform. There is no assurance that the Company will be successful in this approach and failure to secure patent protection may have a material adverse effect upon the Company and its financial condition. Also, the Company may fail in its attempt to commercialize products and product candidates without having to license additional patents, such as patents relating to plant transformation or the use of certain plant specific genetic elements. Moreover, it is not clear whether the patents issued or to be issued to the Company will provide it with any competitive advantages or if any such patents will be the target of challenges by third parties, whether the patents of others will interfere with its ability to market its products and product candidates or whether third parties will circumvent its patents by means of alternate processes. Furthermore, it is possible for others to develop products and product candidates which have the same effect as the Company's products and product candidates or production technologies on an independent basis or to design around technologies patented by the Company.

Patent applications relating to or affecting the Company's business have been filed by a number of pharmaceutical and biotechnology companies and academic institutions. A number of these technologies, applications or patents may conflict with the Company's technologies or patent applications and such conflict could reduce the scope of patent protection which the Company could otherwise obtain or even lead to refusal of its patent applications.

If third parties engage in activities that infringe the Company's proprietary rights, management's focus will be diverted and the Company may incur significant costs in asserting its rights. The Company may not be successful in asserting its proprietary rights, which could result in its patents being held invalid or a court holding that the third party is not infringing the Company's proprietary rights, either or which would harm the Company's competitive position. In addition, there is no assurance that others will not design around the Company's patented technology. Moreover, the Company may have to participate in interference proceedings declared by the U.S. Patent and Trademark Office, European opposition proceedings, or other analogous proceedings in other parts of the world to determine priority of invention and the validity of patent rights granted or applied for, which could result in substantial cost and delay, even if the eventual outcome is favourable to the Company.

There is no assurance that the Company will be able to enter into licensing arrangements on reasonable commercial terms, or develop or obtain alternative technology in respect of patents issued to third parties that incidentally cover its products or production technologies. Any inability to secure licenses or alternative technology could result in delays in the introduction of some of the Company's products or product candidates or even lead to prohibition of the development, manufacture or sale of certain products by the Company. Moreover, the Company could potentially incur substantial legal costs in defending legal actions which allege patent infringement, or by instituting patent infringement suits against others.

It is not possible for the Company to be certain that it is the creator of inventions covered by pending patent applications or that the Company was the first to file patent applications for any such inventions. No assurance can be given that the Company's patents, once issued, would be upheld by a court, or that a competitor's technology or product would be found to infringe on the Company's patents.

Moreover, much of the Company's know-how technology which is not patentable may constitute trade secrets. Therefore, the Company requires its employees, consultants, advisors and collaborators to enter into confidentiality agreements. However, no assurance can be given that such agreements will provide for a meaningful protection of the Company's trade secrets, know-how or other proprietary information in the event of any unauthorized use or disclosure of information.

### *Potential Product Liability*

A risk of product liability claims and related negative publicity is inherent in the development of human therapeutic and other products. Product liability insurance is expensive, its availability is limited, and may not be on terms acceptable to the Company, if at all. The commercialization of the Company's potential products and product candidates could be inhibited or prevented by an inability to maintain sufficient insurance coverage on reasonable terms or to otherwise protect against potential product liability claims. A product liability claim against the Company or the withdrawal of a product or product candidates from the market could have a material adverse effect upon the Company and its financial condition.

### *Unproven Market*

Much of the Company's strategy is based on the belief that the application of its technologies to develop products and product candidates for the markets it is addressing will result in the creation of new, commercially viable products. Notwithstanding the Company's estimated market potential for its products and product candidates, no assurance can be given that these beliefs will prove to be correct owing to, in particular, competition from existing or new products and the yet to be established commercial viability of its products and product candidates.

### *Market Acceptance*

Even if the Company develops safe and effective products and obtains the necessary regulatory approvals, the process will take years, and by the time this occurs, because of the competitive and dynamic nature of the drug development industry, there is a risk that at such time, any such product:

- will not be economical to market, reimbursable by third party payers, or marketable at prices that will allow the Company to achieve profitability;
- will not be successfully marketed or achieve market acceptance;
- will not be preferable to existing or newly developed products marketed by third parties; or,
- will infringe proprietary rights held by third parties now or in the future that would preclude Medicago from marketing any such product.

The degree of market acceptance of products developed by Medicago, if any, will depend on a number of factors, including the establishment and demonstration in the medical community of the clinical efficacy and safety of the Company's products and their potential advantage over alternative treatment methods. There is no assurance that physicians, patients or the medical community in general will accept and utilize any products that may be developed by the Company.

In addition, by the time the Company's products, if any, are ready to be commercialized, what the Company believes to be the market for these products may have changed. Any estimates referenced herein of the number of patients who have received or might have been candidates to use a specific product may not accurately reflect the true market or market prices for such products or the extent to which such products, if successfully developed, will actually be used by patients.

The Company's failure to successfully introduce and market its products that are under development would have a material adverse effect on its business, financial condition and results of operations.

### *Sales, Marketing and Distribution Capabilities*

The Company currently has no sales, marketing or distribution capability. The Company intends to rely primarily on its partners to market its product candidates, if and when approved; however, there can be no assurance that such partners or collaborators have effective marketing, sales and distribution capabilities.

If the Company or its partners are unable to establish or maintain relationships with partners with sales, marketing or distribution capabilities and the Company or its partners are required to market any of the Company's products directly, the Company or its partners will have to develop a marketing and sales force with technical expertise and with supporting distribution capabilities. There can be no assurance that the Company or its partners will be able to establish or maintain such relationships with third parties or develop in-house marketing, sales and distribution capabilities.

### *Commercial Manufacturing*

The Company has no experience manufacturing commercial quantities of products and does not currently have the resources to commercially manufacture any products that the Company may develop. Accordingly, if the Company becomes successful in developing any product with commercial potential, the Company would either be required to develop the facilities to manufacture independently or secure a contract manufacturer or enter into another arrangement with third parties to manufacture such products. If the Company is unable to develop such capabilities or enter into any such arrangement on favourable terms, the Company may be unable to compete effectively in the marketplace. If the Company is unable to manufacture or contract for a sufficient supply of product on acceptable terms, or if the Company encounters delays or difficulties in its relationships with manufacturers or collaborators, its preclinical, clinical testing and/or product sales could be delayed, thereby delaying the submission of products for regulatory approval and/or market introduction and subsequent sales of such products.

### *Dependence on Collaborative Partners*

The Company's strategy is to enter into various arrangements for clinical testing, and eventual manufacturing, marketing and commercialization of its products and product candidates. The Company also expects to enter into collaborations for the potential development and commercialization of its products and product candidates with other firms, pursuant to which the Company may receive additional funding, including milestone payments. The Company also intends to enter into additional corporate partnership agreements to develop and commercialize products and product candidates based upon its core technology. There can be no assurance, however, that the Company will be able to establish such additional collaborations on favourable terms, if at all, or that its current or future collaborative arrangements will be successful.

Should any collaborative partner fail to successfully develop or commercialize any product or product candidate to which it has rights, or any of the partners' products or product candidates to which the Company has rights, its business may be adversely affected. In addition, while the Company believes that its actual and eventual collaborative partners will have sufficient economic motivation to continue their funding, there can be no assurance that any of these collaborations will be continued or will result in successfully commercialized products or product candidates. Failure of a collaborative partner to continue funding any particular program could delay or halt the development or commercialization of any products or product candidates arising out of such program. In addition, there can be no assurance that the collaborative partners will not pursue alternative technologies or develop alternative products or product candidates either on their own or in collaboration with others, including the Company's competitors.

### *Hazardous Materials: Environmental Matters*

The Company's discovery and development processes involve the controlled use of hazardous and radioactive materials. The Company is subject to federal, provincial and local laws and regulations governing the use, manufacture, storage, handling and disposal of such materials and certain waste products. Although the Company believes that its safety procedures for handling and disposing of such materials comply with the standards prescribed by such laws and regulations, the risk of accidental contamination or injury from these materials cannot be completely eliminated. In the event of such an accident, the Company could be held liable for any damages that result and any such liability could exceed its financial capabilities. The Company is not specifically insured with respect to this liability. Although the Company believes that it is in compliance with applicable environmental laws and regulations in all material respects and currently does not expect to make material capital expenditures for environmental control facilities in the near-term, there can be no assurance that the Company will not be required to incur significant costs to comply with environmental laws and regulations in the future, or that current or future environmental laws or regulations will not have a material adverse affect on its operations, business or assets.

### *Income Tax Matters*

The Company has determined that it was eligible for investment tax credits on expenditures incurred on scientific research and experimental development. There is a risk that the governmental agency could conclude that some or all of the expenditures were not incurred on scientific research and experimental development activities and, therefore, could reduce or disallow claims for such credits, including refundable credits.

### *Management of Growth*

Rapid growth in any area of the Company's business could place a significant strain on its managerial, operational and technical resources. The Company expects operating expenses and staffing levels to increase in the future. To manage its growth, the Company must expand its operational and technical capabilities and manage its employee base while effectively administering

multiple relationships with various third parties. There can be no assurance that the Company will be able to manage its expanding operations effectively. Any failure to implement cohesive management and operating systems, add resources on a cost-effective basis or properly manage the Company's expansion could have a material adverse effect on its business and results of operations.

## **FORWARD-LOOKING STATEMENTS**

This report contains certain forward-looking statements with respect to the Company. These forward-looking statements, by their nature, necessarily involve risks and uncertainties that could cause actual results to differ materially from those contemplated by these forward-looking statements. We consider the assumptions on which these forward-looking statements are based to be reasonable, but caution the reader that these assumptions regarding future events, many of which are beyond our control, may ultimately prove to be incorrect since they are subject to risks and uncertainties that affect us. The information contained herein is dated as of March 24, 2009, date of the Board's approval for the MD&A and the Consolidated Financial Statements.

On behalf of management,

*(signed) Pierre Labbé*

Pierre Labbé, CA

Vice-president and Chief Financial Officer

March 24, 2009

# **Medicago Inc.**

Consolidated Financial Statements  
**December 31, 2008 and 2007**

## Auditors' Report

### To the Shareholders of Medicago Inc.

We have audited the consolidated balance sheets of **Medicago Inc.** as at December 31, 2008 and 2007 and the consolidated statements of earnings and comprehensive loss, deficit, accumulated other comprehensive loss and contributed surplus and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2008 and 2007 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

*PricewaterhouseCoopers LLP*<sup>1</sup>

March 23, 2009

<sup>1</sup> Chartered accountant auditor permit No. 7451

"PricewaterhouseCoopers" refers to PricewaterhouseCoopers LLP/s.r.l./s.e.n.c.r.l., an Ontario limited liability partnership, or, as the context requires, the PricewaterhouseCoopers global network or other member firms of the network, each of which is a separate and independent legal entity. (1)

# Medicago Inc.

## Consolidated Balance Sheets

As at December 31, 2008 and 2007

	2008 \$	2007 \$
<b>Assets</b>		
<b>Current assets</b>		
Cash and cash equivalents (note 14c)	1,091,347	223,711
Short-term investments (note 4)	12,936,773	-
Accounts receivable (note 5)	181,587	69,745
Financing receivable	-	71,641
Investment tax credits receivable (note 8)	1,428,289	844,245
Grants receivable	44,750	9,308
Prepaid expenses	76,962	92,963
	15,759,708	1,311,613
<b>Property, plant and equipment</b> (notes 6, 8 and 10)	4,065,399	4,060,918
<b>Intangible assets</b> (note 7)	778,512	1,289,052
	20,603,619	6,661,583
<b>Liabilities</b>		
<b>Current liabilities</b>		
Bank loans (note 8)	727,950	750,000
Accounts payable and accrued liabilities (note 9)	1,314,089	983,849
Deferred revenues on research agreements	-	294,400
Current portion of long-term debt	73,071	13,072
	2,115,110	2,041,321
<b>Long-term debt</b> (note 10)	15,209,518	14,451,147
	17,324,628	16,492,468
<b>Shareholders' Equity (Deficiency)</b>		
<b>Share capital</b> (note 11)	37,182,667	23,465,147
<b>Contributed surplus</b>	1,087,608	802,219
<b>Other equity components</b> (note 12)		
Stock options plan (note 12a)	500,081	263,821
Unit options (note 12b)	66,640	122,135
Warrants (note 12c)	8,410,743	1,787,553
<b>Deficit</b>	(43,920,364)	(36,271,760)
<b>Accumulated other comprehensive loss</b>	(48,384)	-
	3,278,991	(9,830,885)
	20,603,619	6,661,583
<b>Commitments</b> (note 18)		
<b>Subsequent events</b> (note 22)		

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

Approved by the Board of Directors

(signed) RANDAL CHASE, PH.D. \_\_\_\_\_ Director

(signed) ANDREW J. SHELDON \_\_\_\_\_ Director

(2)

# Medicago Inc.

## Consolidated Statements of Deficit, Accumulated Other Comprehensive Loss and Contributed Surplus

For the years ended December 31, 2008 and 2007

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<b>Deficit</b>	<b>2008</b>	<b>2007</b>
	<b>\$</b>	<b>\$</b>
<b>Balance – Beginning of year</b>	36,271,760	30,269,947
Adjustment related to the implementation of the new accounting standard on financial instruments	-	(271,368)
Loss for the year	7,648,604	6,273,181
<b>Balance – End of year</b>	<u>43,920,364</u>	<u>36,271,760</u>
<b>Accumulated Other Comprehensive Loss</b>	<b>2008</b>	<b>2007</b>
	<b>\$</b>	<b>\$</b>
<b>Balance – Beginning of year</b>	-	-
Unrealized losses on available-for-sale investments	48,384	-
<b>Balance – End of year</b>	<u>48,384</u>	<u>-</u>
<b>Total deficit and accumulated other comprehensive loss</b>	<u>43,968,748</u>	<u>36,271,760</u>
<b>Contributed Surplus</b>	<b>2008</b>	<b>2007</b>
	<b>\$</b>	<b>\$</b>
<b>Balance – Beginning of year</b>	802,219	798,034
Stock options forfeited	9,452	4,185
Unit options forfeited	55,495	-
Warrants forfeited	220,442	-
<b>Balance – End of year</b>	<u>1,087,608</u>	<u>802,219</u>

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

# Medicago Inc.

## Consolidated Statements of Earnings and Comprehensive Loss For the years ended December 31, 2008 and 2007

<b>Statements of Earnings</b>	<b>2008</b>	<b>2007</b>
	<b>\$</b>	<b>\$</b>
<b>Revenues</b>		
Revenues from license agreement	2,000,000	-
Revenues from research agreements	444,400	74,100
Less: Warrants issued under a licensing agreement	(196,136)	-
	<u>2,248,264</u>	<u>74,100</u>
<b>Expenses</b>		
Research and development	4,699,188	3,040,750
Research grants and contributions	(83,691)	(4,375)
Research and development tax credits	(920,567)	(930,876)
General and administrative, business development and intellectual property	3,321,845	2,429,281
Exchange (gain) loss	7,942	(3,310)
Depreciation of property, plant and equipment	475,408	567,478
Amortization of intangible assets	99,198	125,307
Gain on disposal of property, plant and equipment	-	(14,135)
Writeoff of intangible assets (note 7)	572,439	48,838
Writeoff of property, plant and equipment (note 6)	9,897	-
Financial expenses, net (note 13)	1,715,210	1,088,323
	<u>9,896,869</u>	<u>6,347,281</u>
<b>Loss for the year</b>	<u>(7,648,605)</u>	<u>(6,273,181)</u>
<b>Basic and diluted loss per share</b> (note 21)	<u>(0.17)</u>	<u>(0.32)</u>
<b>Comprehensive Loss</b>	<b>2008</b>	<b>2007</b>
	<b>\$</b>	<b>\$</b>
<b>Loss for the year</b>	(7,648,604)	(6,273,181)
Unrealized losses on available-for-sale investments	(48,384)	-
<b>Comprehensive loss for the year</b>	<u>(7,696,988)</u>	<u>(6,273,181)</u>

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

# Medicago Inc.

## Consolidated Statements of Cash Flows

For the years ended December 31, 2008 and 2007

	2008 \$	2007 \$
<b>Cash flows from operating activities</b>		
Loss for the year	(7,648,605)	(6,273,181)
Items not affecting cash and cash equivalents		
Warrants issued pursuant to licensing agreement and as financing fees	454,396	-
Stock-based compensation costs	245,712	157,080
Depreciation and amortization	574,606	692,785
Amortization of deferred charges	117,500	117,498
Gain on disposal of property, plant and equipment	-	(14,135)
Interest capitalized on long-term debt	713,942	1,341,309
Writeoff of intangible assets	572,439	48,838
Writeoff of property, plant and equipment	9,897	-
Grants	-	(392,582)
	(4,960,113)	(4,322,388)
Change in non-cash working capital items (note 14a)	(749,801)	168,141
	(5,709,914)	(4,154,247)
<b>Cash flows from financing activities</b>		
Bank loans contracted (reimbursed)	(22,050)	450,000
Non-interest-bearing long-term debt contracted	-	602,241
Payments on long-term debt	(13,072)	(13,072)
Issuance of units	20,785,000	2,000,000
Exercise of warrants	40,625	-
Issue expenses	(635,579)	(228,510)
	20,154,924	2,810,659
<b>Cash flows from investing activities</b>		
Acquisitions of short-term investments	(12,985,157)	-
Term deposit cashed	-	1,230,188
Decrease in security deposit on a lease agreement	-	40,000
Additions to property, plant and equipment	(482,698)	(102,893)
Proceeds from disposal of property, plant and equipment	-	18,500
Additions to intangible assets	(109,519)	(61,425)
	(13,577,374)	1,124,370
<b>Net change in cash and cash equivalents</b>	867,636	(219,218)
<b>Cash and cash equivalents – Beginning of year</b>	223,711	442,929
<b>Cash and cash equivalents – End of year</b>	1,091,347	223,711
<b>Additional information</b> (note 14b)		
Interest paid	702,569	87,438

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

# Medicago Inc.

## Notes to Consolidated Financial Statements December 31, 2008 and 2007

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### 1 Statutes and nature of activities

The Company was incorporated under Part 1A of the *Companies Act* (Québec) on July 17, 1997. Since the beginning of its operations, most of the Company's activities have been devoted to research and development. Medicago is a biotechnology company focused on the development and production of vaccines in order to commercialize them in the future using its unique and proprietary manufacturing systems.

### 2 Changes in accounting policies

#### Adopted in 2008

On January 1, 2008, the Company adopted the following sections of the CICA Handbook:

- (a) Section 3862, "Financial Instruments – Disclosures". This section describes the required disclosures to evaluate the significance of financial instruments for the entity's financial position and performance as well as the nature and extent of risks arising from financial instruments to which the entity is exposed and how the entity manages those risks (note 19).
- (b) Section 3863, "Financial Instruments – Presentation". This section establishes standards for presentation of financial instruments and non-financial derivatives. It details the presentation of standards described in Section 3861, "Financial Instruments – Disclosure and Presentation" (note 19).
- (c) Section 1535, "Capital Disclosures". This section establishes standards for disclosing information about an entity's capital and how it is managed. It describes the disclosure of the entity's objectives, policies and processes for managing capital as well as summary quantitative data on the elements included in the management of capital. The section seeks to determine if the entity has complied with capital requirements and if not, the consequences of such non-compliance (note 18).
- (d) Section 3031, "Inventories". This section prescribes the accounting treatment for inventories. It provides guidance on the determination of cost and its subsequent recognition as an expense, including any writedown to net realizable value. It also provides guidance on the cost formulas that are used to assign costs to inventories.
- (e) Section 1400, "General Standards of Financial Statement Presentation". This section includes requirements to assess and disclose an entity's ability to continue as a going concern (going concern assumption).

The Company has adopted these standards and there has been no impact on the financial statements except for additional disclosures mentioned-above (notes 18 and 19).

# Medicago Inc.

## Notes to Consolidated Financial Statements December 31, 2008 and 2007

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### Future accounting changes

The CICA issued Section 3064, "Goodwill and Intangible Assets", which will apply to interim and annual financial statements relating to fiscal years beginning on or after October 1, 2008. This section establishes standards for the recognition, measurement and disclosure applicable to intangible assets. It replaces Section 3062, "Goodwill and Other Intangible Assets", and Section 3450, "Research and Development Costs". Upon consideration of this new standard, the Company has concluded that it will not impact significantly its financial position and results of operations. On January 1, 2009, the Company adopted Section 3064 of the CICA Handbook.

In January 2009, the CICA published the following sections of the CICA Handbook that apply to interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011.

- (a) Section 1582, "Business Combinations", which replaces the former Section 1581 with the same title, establishes accounting standards for a business combination. It provides the Canadian equivalent to International Financial Reporting Standard IFRS3, "Business Combinations".
- (b) Section 1601, "Consolidated Financial Statements", which replaces the former Section 1600 with the same title, establishes standards for the preparation of consolidated financial statements.
- (c) Section 1602, "Non-Controlling Interests". This new section establishes standards on accounting for non-controlling interests in a subsidiary in consolidated financial statements prepared subsequent to a business combination. It is equivalent to the corresponding provisions of International Accounting Standard IAS 27, "Consolidated and Separate Financial Statements".

The Company is currently evaluating the impact of these new standards on its financial statements.

In January 2009, the CICA's Emerging Issue Committee ("EIC") issued Abstract EIC-173, *Credit Risk and the Fair Value of Financial Assets and Liabilities*, which requires entities to take both counterparty credit risk and their own credit risk into account when measuring the fair value of financial assets and liabilities, including derivatives. EIC-173 will be effective for interim and annual periods beginning on or after January 1, 2009. The Company does not expect that adoption of this guidance will have a significant impact on its consolidated financial statements.

On February 13, 2008, the Accounting Standards Board confirmed the date of changeover from Canadian GAAP to International Financial Reporting Standards ("IFRS"). Canadian publicly accountable enterprises must adopt IFRS for their interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. The Company has developed a plan for the conversion of its consolidated financial statements to IFRS. An analysis of the differences between IFRS and the Company's accounting standards is underway. This analysis is being conducted by taking into account the potential impacts, among others, on accounting policies, financial reporting and information technologies.

# Medicago Inc.

## Notes to Consolidated Financial Statements December 31, 2008 and 2007

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### 3 Summary of significant accounting policies

#### **Basis of presentation**

These financial statements have been prepared in accordance with Canadian generally accepted accounting principles. The Company's significant accounting policies are summarized as follows:

#### **Basis of consolidation**

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., Fiducie Financière Medicago and Medicago Europa SAS.

#### **Use of estimates**

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts of assets and liabilities reported in the financial statements. Those estimates and assumptions also affect the disclosure of contingencies at the date of the financial statements and the reported amounts of revenues and expenses during the year. Actual results could differ from those estimates.

#### **Foreign currency translation**

##### *Foreign subsidiary*

Medicago Europa SAS, the Company's subsidiary, is considered to be an integrated foreign entity. As a result, this foreign subsidiary's accounts are translated into Canadian dollars using the temporal method. Under this method, monetary assets and liabilities denominated in foreign currencies are translated at the exchange rates in effect at the balance sheet date. Non-monetary assets and liabilities are translated at historical rates. Revenues and expenses are translated at the average exchange rate for the year. Exchange gains or losses resulting from translation are reflected in the statements of earnings.

##### *Foreign currency transactions*

Transactions denominated in foreign currencies are translated into Canadian dollars as follows: monetary assets and liabilities are translated at the exchange rate in effect at the balance sheet date and revenues and expenses are translated at the average exchange rate for the year. Non-monetary assets and liabilities are translated at historical rates. Exchange gains or losses resulting from translation are reflected in the statements of earnings.

# Medicago Inc.

## Notes to Consolidated Financial Statements

December 31, 2008 and 2007

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### Financial instruments

The impact of the use of the effective interest rate method was recognized as an adjustment of \$271,368 to the opening balance of the 2007 deficit, a \$938,189 reduction in deferred financing expenses and a \$1,209,557 reduction in long-term debt.

### Financial assets and liabilities

Financial assets and liabilities are initially recognized at fair value and subsequently recognized according to their classification as described below. The classification depends on the intention with which the financial instruments were acquired and their characteristics and designation by the Company. Unless in the presence of specific circumstances, the classification is not modified following the initial recognition.

Cash	Held-for-trading
Cash equivalents	Available for sale
Short-term investments	Available for sale
Other receivables	Loans and receivables
Financing receivable	Loans and receivables
Bank loans	Other financial liabilities
Accounts payable and accrued liabilities	Other financial liabilities
Long-term debt	Other financial liabilities

### Assets and liabilities held for trading

Financial instruments classified as assets or liabilities held for trading are recognized at fair value at each balance sheet date, and any change in the fair value is reflected in net earnings in the period during which these changes take place.

### Loans and receivables and other financial liabilities

Financial instruments classified as loans and receivables, and other financial liabilities are accounted for at amortized cost using the effective interest rate method. Interest income or expense is included in net earnings over the expected life of the financial instrument.

### Available-for-sale assets

Financial instruments classified as available for sale are recorded at fair value, and the gains/losses resulting from the revaluation at the end of each period are recognized as comprehensive income. Securities classified as available for sale that do not have a readily available price quoted on an active market are recognized at cost. Available-for-sale securities are reduced to fair value (recognition of a loss in earnings) when it is necessary to reflect a permanent decline in value. Upon derecognition, all gains or losses cumulated in accumulated other comprehensive income are reflected in net earnings.

# Medicago Inc.

## Notes to Consolidated Financial Statements

December 31, 2008 and 2007

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### Transaction costs

Transaction costs related to financial instruments that are not classified as held for trading are recognized on the balance sheet as an adjustment to the cost of the financial instrument upon initial recognition and amortized using the effective interest rate method.

### Cash and cash equivalents

Cash and cash equivalents consist of cash on hand and balances with banks and as well as all highly liquid short-term investments having a term of less than three months at the acquisition date.

### Short-term investments

Short-term investments consist primarily of term deposits, bonds and discount notes that do not meet the definition of cash and cash equivalents.

Transactions are recorded on settlement date, and investments are recognized at fair value.

### Property, plant and equipment

Property, plant and equipment are recorded at cost, net of related tax credits and accumulated depreciation. Depreciation is calculated using the following methods, period and annual rates:

	<b>Methods</b>	<b>Period and rates</b>
Production unit	Straight-line	5%
Leasehold improvements	Straight-line	Lease term
Computer equipment	Declining balance	30%
Laboratory equipment	Declining balance	30%
Office furniture	Declining balance	20%

### Intangible assets

Intangible assets consist of a license, patents and software. The license and patents represent the costs, including professional fees, incurred for the registration of trademarks for product marketing and manufacturing purposes, net of related government grants and accumulated amortization. The license and patents are amortized using the straight-line method over their estimative useful lives of twenty years. Software is recorded at cost, net of related tax credits. Amortization is calculated using the straight-line method at an annual rate of 33%.

# Medicago Inc.

## Notes to Consolidated Financial Statements December 31, 2008 and 2007

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### **Impairment of long-lived assets**

Long-lived assets are reviewed for impairment when events or circumstances indicate that costs may not be recoverable. Impairment exists when the carrying value of the asset is greater than the pre-tax undiscounted future cash flows expected to be provided by the asset. The amount of impairment loss, if any, is the excess of the carrying value of the asset over its fair value.

### **Share issue expenses**

Share issue expenses are applied against share capital.

### **Income taxes**

The Company follows the liability method of accounting for income taxes. Under this method, future income tax assets and liabilities are determined based on deductible or taxable temporary differences between the carrying amounts and tax bases of the assets and liabilities. Changes in the future income tax assets or liabilities are included in the statements of earnings. Future income tax assets and liabilities are measured using enacted or substantively enacted tax rates expected to be in effect for the year in which the differences are expected to reverse.

The Company establishes a valuation allowance against future income tax assets if, based on available information, it is more likely than not that some or all of the future income tax assets will not be realized.

### **Research and development costs**

All expenses related to development activities, which do not meet generally accepted criteria for deferral, and research activities are expensed as incurred. Development expenses which meet generally accepted criteria for deferral are capitalized and amortized against earnings over the estimated period of benefit. As at December 31, 2008 and 2007, no development costs have been deferred.

### **Research and development tax credits and grants**

The Company is entitled to scientific research and experimental development ("SR&ED") tax credits granted by the Canadian federal government and the government of the Province of Québec.

SR&ED tax credits and grants are accounted for using the cost reduction method. Accordingly, tax credits and grants are recorded as a reduction of the related expenses or capital expenditures in the year in which those expenses are incurred, provided there is reasonable assurance that the credits and grants will be realized.

# Medicago Inc.

## Notes to Consolidated Financial Statements

December 31, 2008 and 2007

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### **Revenue recognition**

Revenues related to research agreements are bound to milestone agreements and are recorded as the milestones are reached and upon customer acceptance. Under these agreements, the payments received in advance are recognized as deferred revenue in the balance sheet and then, as revenue when milestones are reached and upon customer acceptance. Revenue from research agreements are recognized using the percentage-of-completion method.

The existing licensing agreements usually foresee one-time payment (upfront payment) and milestone payments. Revenues associated with those multiple-element arrangements are allocated to the various elements based on their relative fair value. Agreements containing multiple elements are divided into separate units of accounting if certain criteria are met, including whether the delivered element has stand-alone value to the customer and whether there is objective and reliable evidence of the fair value of the undelivered obligation(s). The consideration received is allocated among the separate units based on each unit's fair value or using the residual method, and the applicable revenue recognition criteria are applied to each of the separate units.

License fees representing non-refundable payments received upon the execution of license agreements are recognized as revenue upon execution of the license agreements when the Company has no significant future performance obligations and collectability of the fees is assured. Upfront payments received at the beginning of licensing agreements are not recorded as revenue when received but are amortized based on the progress of the related research and development work. This progress is based on estimates of total expected time or duration to complete the work which is compared to the period of time incurred to date in order to arrive at an estimate of the percentage of revenue earned to date.

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

The Company has a stock option plan which is described in note 12. The fair value of stock options is determined using the Black-Scholes option pricing model and stock-based compensation costs are recognized over the vesting period of the options and are recorded in Shareholders' Deficiency under caption "Other equity components". Any consideration received by the Company on the exercise of stock options and the carrying value of those stock options are recorded in Shareholders' Equity under caption "Share capital" upon the issuance of shares.

### **Basic and diluted earnings per share**

Basic earnings per share are determined using the weighted average number of participating shares outstanding during the year.

Diluted earnings per share are determined using the weighted average number of participating shares outstanding during the year, plus the effects of dilutive potential participating shares outstanding during the year. The calculation of diluted earnings per share is made using the treasury stock method, as if all dilutive potential shares had been exercised at the later of the beginning of the year or the issuance date, as the case may be, and that the funds obtained thereby be used to purchase participating shares of the Company at the average market value of the participating shares during the year.

# Medicago Inc.

## Notes to Consolidated Financial Statements December 31, 2008 and 2007

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### Comparative figures

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

#### 4 Short-term investments

	2008 \$	2007 \$
Term deposits bearing interest at annual rates ranging from 2.75% to 3.55%, maturing in November and December 2009	6,000,000	-
Bonds and discount notes, bearing interest at effective annual rates ranging from 2.50% to 4.91%, maturing from December 2009 to January 2016	6,557,575	-
Money market funds	379,198	-
	<hr/> 12,936,773	<hr/> -

#### 5 Accounts receivable

	2008 \$	2007 \$
Commodity taxes receivable	98,266	51,694
Interest receivable	67,346	-
Other receivables	15,975	18,051
	<hr/> 181,587	<hr/> 69,745

# Medicago Inc.

## Notes to Consolidated Financial Statements December 31, 2008 and 2007

### 6 Property, plant and equipment

	2008		2007	
	Cost \$	Accumulated depreciation \$	Cost \$	Accumulated depreciation \$
Land	491,840	-	276,612	-
Production unit	3,490,335	653,047	3,490,335	478,530
Leasehold improvements	302,506	302,506	302,506	266,566
Computer equipment	102,395	58,246	363,469	291,472
Laboratory equipment	2,315,003	1,654,690	2,064,024	1,413,794
Office furniture	174,280	126,388	165,800	115,651
	6,876,359	2,794,877	6,662,746	2,566,013
Research and development tax credits	(123,038)	(106,955)	(227,512)	(191,697)
	6,753,321	<u>2,687,922</u>	6,435,234	<u>2,374,316</u>
Less: Accumulated depreciation	<u>2,687,922</u>		<u>2,374,316</u>	
Net amount	<u>4,065,399</u>		<u>4,060,918</u>	

In 2008, computer equipment with a carrying value of \$9,897 (nil in 2007) was written off since it was no longer in use.

# Medicago Inc.

## Notes to Consolidated Financial Statements December 31, 2008 and 2007

### 7 Intangible assets

	2008		2007	
	Cost \$	Accumulated amortization \$	Cost \$	Accumulated amortization \$
License	68,966	8,423	1,136,982	460,501
Patents	965,826	249,716	804,728	205,452
Software	57,659	55,800	57,660	44,365
	1,092,451	313,939	1,999,370	710,318
Research and development tax credits	-	-	(15,106)	(15,106)
	1,092,451	<u>313,939</u>	1,984,264	<u>695,212</u>
Less: Accumulated amortization	<u>313,939</u>		<u>695,212</u>	
Net amount	<u>778,512</u>		<u>1,289,052</u>	

In 2008, a license with a net carrying value of \$572,439 was written off since it was no longer in use. In 2007, the writeoff included a licence and two patents that were no longer in use for a total amount of \$48,838.

### 8 Bank loans

	2008 \$	2007 \$
Bearing interest at prime rate plus 3.5% annually, repayable at the earlier of the following: upon receipt of tax credits or on June 30, 2009, secured by investment tax credits	385,000	200,000
Bearing interest at prime rate plus 0.75% annually, repayable at the earlier of the following: upon receipt of tax credits or on June 30, 2010, secured by a senior charge over investment tax credits and by a junior charge over other property, plant and equipment and intellectual property of the Company and also guaranteed by the chief executive officer	342,950	-
Reimbursed during the year	-	550,000
	<u>727,950</u>	<u>750,000</u>

# Medicago Inc.

## Notes to Consolidated Financial Statements December 31, 2008 and 2007

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### 9 Accounts payable and accrued liabilities

	2008 \$	2007 \$
Accounts payable	586,628	624,594
Salaries and fringe benefits	395,301	210,802
Accrued liabilities	174,404	148,453
Tax credit payable	157,756	-
	<hr/>	<hr/>
	1,314,089	983,849
	<hr/>	<hr/>

### 10 Long-term debt

	2008 \$	2007 \$
Loan from Investissement Québec ("IQ"), bearing interest at prime rate plus 3%, payable annually 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 (note 21) (a)	15,318,648	14,717,187
Deferred financing expenses	(703,191)	(820,691)
Discounted at a rate of 20%, refundable contribution granted under the Technology Partnerships Canada program (b)	461,542	384,618
Discounted at a rate of 20%, contribution under an innovation program, payable in annual instalments of \$60,000 until September 2013	193,742	161,452
Discounted at a rate of 20%, contribution under an innovation program, payable in semi-annual instalments of \$6,536 until October 2009	11,848	21,653
	<hr/>	<hr/>
	15,282,589	14,464,219
Less: Current portion	<hr/>	<hr/>
	73,071	13,072
	<hr/>	<hr/>
	15,209,518	14,451,147
	<hr/>	<hr/>

- (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, 2008, the Company has used \$12,000,000 plus capitalized interest of \$3,318,648.

# Medicago Inc.

## Notes to Consolidated Financial Statements

December 31, 2008 and 2007

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

- (i) For the first three years, the Company deferred the principal instalments and capitalized interest. Interest is payable on a monthly basis. In March 2008, IQ agreed to capitalize 50% of the interest payable for 2008. In consideration for this, Medicago issued 643,877 warrants to purchase an equivalent number of common shares, at a price of \$0.70 per share, for a period of three years. The fair value of \$258,260 has been recorded as financial expenses in 2008.
  - (ii) The interest rate may be converted into a fixed rate.
  - (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.
  - (iv) Under the terms of the agreement in 2004, the Company has granted IQ 1,426,819 warrants for the purchase of common shares at a price of \$1.12 each expiring on August 30, 2011.
  - (v) Under the terms of the agreement, the Company undertook to meet a current ratio exceeding 1.3:1. As at December 31, 2008, the current ratio was 7.45:1.
- (b) Under the federal contribution program called Technology Partnerships Canada ("TPC"), the Company received a refundable contribution equivalent to 33% of the eligible expenses incurred by the Company in the optimization and scale-up of its production unit for a total amount of \$834,635 as at December 31, 2008 (\$834,635 as at December 31, 2007). Royalties of 2% on gross cash proceeds of any kind will be payable from January 1, 2010 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.

The principal instalments for each of the next five years, excluding IQ loan, are as follows:

	\$
2009	73,071
2010	60,000
2011	60,000
2012	60,000
2013	60,000

# Medicago Inc.

## Notes to Consolidated Financial Statements December 31, 2008 and 2007

### 11 Share capital

The authorized share capital of the Company is 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

The share capital issued has varied as follows:

	For the years ended December 31,			
	2008		2007	
	Number	\$	Number	\$
<b>Common shares</b>				
Balance – Beginning of year	21,112,440	23,465,147	17,112,440	22,152,413
Issued pursuant to private placements (i), (ii), (iii), (iv)	69,050,000	14,207,918	4,000,000	1,540,000
Issued pursuant to the exercise of warrants	162,500	50,586	-	-
Issue expenses *	-	(540,984)	-	(227,266)
Balance – End of year	90,324,940	37,182,667	21,112,440	23,465,147

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

- (i) On October 21, 2008, the Company issued 45,000,000 units at a price of \$0.355 per unit for total gross proceeds of \$15,975,000 ("the October 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 \$0.375 for the first year following the issuance of the warrant and \$0.405 for the second year.

The gross proceeds of the October Private Placement of \$15,975,000 are shared out between the 45,000,000 common shares for a gross amount of \$10,183,385 and the 45,000,000 warrants attached to each unit for a gross amount of \$5,791,615 (note 12c). The issue expense for the Company regarding this investment totalled \$301,138.

- (ii) On August 29, 2008, the Company issued 11,050,000 units at a price of \$0.20 per unit for total gross proceeds of \$2,210,000 ("the August Private Placement"). Each unit consists of one common share of the Company and one-half common share purchase warrant. Each warrant entitles the holder thereof to purchase one common share at a price of \$0.30 for a period of twelve months.

# Medicago Inc.

## Notes to Consolidated Financial Statements

December 31, 2008 and 2007

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The gross proceeds of the August Private Placement of \$2,210,000 are shared out between the 11,050,000 common shares for a gross amount of \$1,866,533 and the 5,525,000 warrants attached to each unit for a gross amount of \$343,467 (note 12c). The issue expense for the Company regarding this investment totalled \$162,817.

- (iii) On March 14, 2008, the Company issued 13,000,000 units at a price of \$0.20 per unit for total gross proceeds of \$2,600,000 ("the March Private Placement"). Each unit consists of one common share of the Company and one-half common share purchase warrant. Each warrant entitles the holder thereof to purchase one common share at a price of \$0.25 for a period of twenty-four months.

The gross proceeds of the March Private Placement of \$2,600,000 are shared out between the 13,000,000 common shares for a gross amount of \$2,158,000 and the 6,500,000 warrants attached to each unit for a gross amount of \$442,000 (note 12c). The issue expense for the Company regarding this investment totalled \$254,913.

- (iv) 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 2007 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.

The gross proceeds of the May 2007 Private Placement of \$2,000,000 are shared out between the 4,000,000 common shares for a gross amount of \$1,540,000 and the 4,000,000 warrants attached to each unit for a gross amount of \$460,000. In connection with this financing, the Company paid a cash compensation equivalent to 7% of the gross proceeds from the financing, 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. Each option entitles the holder thereof to purchase one common share at a price of \$0.50.

## 12 Other equity components

- (a) Stock option plan

Under the Company's stock option plan (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"). On April 22, 2008, the Company's Board of Directors approved an increase of 2,790,000 shares issuable under the plan, thus increasing the maximum number issuable to 4,500,000 shares.

# Medicago Inc.

## Notes to Consolidated Financial Statements

December 31, 2008 and 2007

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, 2007:

	For the years ended December 31,					
	2008			2007		
	Number	Carrying value \$	Weighted average exercise price \$	Number	Carrying value \$	Weighted average exercise price \$
Outstanding – Beginning of year	1,415,958	263,821	1.10	1,628,978	110,926	1.12
Granted	965,968	-	0.59	97,000	-	0.91
Exercised	-	-	-	-	-	-
Forfeited	(37,331)	(9,452) *	1.00	(310,020)	(4,185) *	1.17
Compensation costs for the year	-	245,712	-	-	157,080	-
Outstanding – End of year	2,344,595	500,081	0.89	1,415,958	263,821	1.10
Options exercisable – End of year	1,046,954	-	1.12	751,258	-	1.13

\* During fiscal 2008, 37,331 stock options were forfeited (310,020 in 2007). The corresponding credit amounting to \$9,452 (\$4,185 in 2007) has been recorded as contributed surplus.

# Medicago Inc.

## Notes to Consolidated Financial Statements

December 31, 2008 and 2007

The following table summarizes information about outstanding and exercisable stock options as at December 31, 2008:

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 \$
\$0.37	223,674	56	0.37	-	-
\$0.62 to 0.66	767,294	51	0.65	8,333	0.65
\$1.00 to 1.11	1,201,539	29	1.03	903,540	1.05
\$1.68	152,088	30	1.68	135,081	1.68
	<u>2,344,595</u>	<u>39</u>	<u>0.89</u>	<u>1,046,954</u>	<u>1.12</u>

### Assumptions used in determining stock-based compensation costs

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

	2008	2007
Dividend yield	Nil	Nil
Expected volatility	95%	82.73%
Risk-free interest rate	3.06%	4.12%
Expected life (years)	5.00	5.00
Weighted average fair value of stock options granted at market price at the date of the grant (\$)	0.40	0.35
Weighted average fair value of stock options granted at a price higher than the market price at the date of the grant (\$)	0.42	0.66
Stock-based compensation costs	245,712	157,080

# Medicago Inc.

## Notes to Consolidated Financial Statements December 31, 2008 and 2007

(b) Unit options

The following table summarizes the unit option activity since January 1, 2007:

	For the years ended December 31,					
	2008			2007		
	Number	Carrying value \$	Weighted average exercise price \$	Number	Carrying value \$	Weighted average exercise price \$
Outstanding and exercisable						
– Beginning of year	420,268	122,135	0.67	140,268	55,495	1.00
Granted to the agent pursuant to a private placement	-	-	-	280,000	66,640	0.50
Forfeited	(140,268)	(55,495) *	1.00	-	-	-
Outstanding and exercisable						
– End of year	280,000	66,640	0.50	420,268	122,135	0.67

\* During fiscal 2008, 140,268 unit options were forfeited. The corresponding credit amounting to \$55,495 has been recorded as contributed surplus.

The following table summarizes information about unit options outstanding and exercisable as at December 31, 2008:

Exercise price	Number	Weighted average remaining contractual life (years)
\$0.50	280,000	0.41

The fair value of unit options was estimated using the Black-Scholes valuation model with the following assumptions:

	2007
Dividend yield	Nil
Expected volatility	85%
Risk-free interest rate	4.53%
Expected life (years)	2
Fair value of unit options granted (\$)	0.238

# Medicago Inc.

## Notes to Consolidated Financial Statements

December 31, 2008 and 2007

(c) Warrants

The following table summarizes the warrant activity since January 1, 2007:

	2008			2007		
	Number	Carrying value \$	Weighted average exercise price \$	Number	Carrying value \$	Weighted average exercise price \$
Outstanding and exercisable – Beginning of year	7,430,653	1,787,553	1.05	3,872,321	1,395,437	1.11
Granted at the signing of a non-exclusive license agreement	2,000,000	196,136	0.23	-	-	-
Granted to the subscribers in connection with private placements	57,025,000	6,577,082	0.35	4,000,000	460,000	0.75
Granted to IQ (see note 10(a) (i))	643,877	258,260	0.70	-	-	-
Exercised	(162,500)	(9,961)	0.25	-	-	-
Forfeited	(2,003,834)	(220,442)	1.10	-	-	-
Cancelled *	-	-	-	(441,668)	-	-
Warrant issue expenses	-	(177,885)	-	-	(67,884)	-
Outstanding and exercisable – End of year	64,933,196	8,410,743	0.39	7,430,653	1,787,553	1.05

\* No carrying value has been allocated to these warrants since they were granted before January 1, 2003.

The following table summarizes the information relating to warrants outstanding and exercisable as at December 31, 2008:

Exercise price	Number	Weighted average remaining contractual life (years)
\$0.230	2,000,000	2.10
\$0.250	6,337,500	1.20
\$0.300	5,525,000	0.66
\$0.375	45,000,000	1.81
\$0.700	643,877	2.34
\$0.750	4,000,000	0.41
\$1.120	1,426,819	2.66
	64,933,196	1.60

# Medicago Inc.

## Notes to Consolidated Financial Statements December 31, 2008 and 2007

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The fair value of warrants was estimated using the Black-Scholes valuation model with the following weighted average assumptions:

	<b>2008</b>	<b>2007</b>
Dividend yield	Nil	Nil
Expected volatility	129%	85%
Risk-free interest rate	2.31%	4.53%
Expected life (years)	1.95	2
Fair value of warrants granted (\$)	0.118	0.115

### 13 Financial expenses, net

	<b>2008</b>	<b>2007</b>
	\$	\$
Interest on long-term debt	1,292,356	1,341,309
Interest and bank charges	114,016	50,786
Amortization of deferred financing expenses	117,500	117,498
Warrants issued as financing fees	258,260	-
Interest income	(66,922)	(28,688)
Grants	-	(392,582)
	<hr/>	<hr/>
	1,715,210	1,088,323
	<hr/>	<hr/>

### 14 Additional information on cash flows

(a) Change in non-cash working capital items

	<b>2008</b>	<b>2007</b>
	\$	\$
Accounts receivable, grants and financing receivable	(75,643)	123,487
Investment tax credits receivable	(584,044)	(263,078)
Prepaid expenses	16,001	(18,651)
Accounts payable and accrued liabilities	188,285	31,983
Deferred revenues on research agreements	(294,400)	294,400
	<hr/>	<hr/>
	(749,801)	168,141
	<hr/>	<hr/>

# Medicago Inc.

## Notes to Consolidated Financial Statements December 31, 2008 and 2007

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(b) Items not affecting cash related to financing and investing activities

	<b>2008</b>	<b>2007</b>
	\$	\$
Warrants transferred to share capital upon exercise	9,961	-
Share issue expenses included in accounts payable and accrued liabilities	83,290	-
Acquisition of property, plant and equipment in accounts payable and accrued liabilities	10,475	3,387
Acquisition of intangible assets in accounts payable and accrued liabilities	51,578	-

(c) Cash and cash equivalents

	<b>2008</b>	<b>2007</b>
	\$	\$
Cash	41,347	223,711
Cash equivalents	1,050,000	-
	<u>1,091,347</u>	<u>223,711</u>

## 15 Income taxes

The reconciliation of the income tax recovery, calculated using the statutory income tax rates of the Company, with the income tax recovery per the financial statements is as follows:

	<b>2008</b>	<b>2007</b>
Combined Canadian federal and provincial statutory tax rate	<u>30.90%</u>	<u>32.02%</u>
Income tax recovery based on statutory income tax rates	\$ (2,359,717)	\$ (1,902,415)
Non-deductible expenses	164,599	56,103
Non-taxable items	(133,510)	(96,060)
Difference between statutory and future tax rate	322,429	1,387,863
Change in valuation allowance	1,822,376	246,065
Items not affecting earnings	(222,130)	(71,715)
Expiry of loss carry-forward	512,463	390,508
Prior years' adjustments	(100,934)	-
Other	(5,576)	(10,349)
	<u>\$ -</u>	<u>\$ -</u>

# Medicago Inc.

## Notes to Consolidated Financial Statements December 31, 2008 and 2007

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The significant components of the Company's future income tax assets and liabilities are as follows:

	2008 \$	2007 \$
<b>Future income tax assets</b>		
Current future income tax assets		
Other	-	5,361
Long-term future income tax assets		
Property, plant and equipment	65,043	45,654
Intangible assets	289,406	146,989
Research and development expenses	4,060,763	2,987,331
Non-capital losses	6,917,029	6,495,070
Financing expenses	142,091	71,109
Federal contribution	225,915	224,129
Other	3,303	3,106
	<u>11,703,550</u>	<u>9,973,388</u>
	11,703,550	9,978,749
Valuation allowance	<u>(11,572,878)</u>	<u>(9,750,502)</u>
Total future income tax assets	<u>130,672</u>	<u>228,247</u>
<b>Future income tax liabilities</b>		
Current future income tax liabilities		
Investment tax credit	-	(67,318)
Long-term future income tax liabilities		
Property, plant and equipment		-
Long-term debt	<u>(130,672)</u>	<u>(160,929)</u>
Total future income tax liabilities	<u>(130,672)</u>	<u>(228,247)</u>
Future income taxes, net	<u>-</u>	<u>-</u>

# Medicago Inc.

## Notes to Consolidated Financial Statements

December 31, 2008 and 2007

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As at December 31, 2008, the Company has accumulated, for federal and provincial income tax purposes, non-capital losses totalling approximately \$27,771,000 (\$27,878,000 in 2007) and \$22,954,000 (\$22,353,000 in 2007), respectively. These losses can be carried forward against future years' taxable income and will expire as follows:

	<b>Federal</b> \$	<b>Provincial</b> \$
2009	2,566,000	1,733,000
2014	4,522,000	3,847,000
2015	5,450,000	3,943,000
2026	6,966,000	5,788,000
2027	3,784,000	3,199,000
2028	4,483,000	4,444,000
	<hr/> 27,771,000	<hr/> 22,954,000

The Company is entitled to a non-refundable federal tax credit of approximately \$1,192,000. This credit can be applied against future years' taxable income and will expire at the latest in 2028.

### 16 Segment information

The Company is organized under one single business segment, being the research and development of vaccines. Substantially all of the Company's property, plant and equipment and intangible assets are located in Canada.

All revenues for the year have been allocated based on the location in which the sale originated. All of them have been generated in Canada.

### 17 Economic dependence

Customers who represent more than 10% of revenues are as follows:

	<b>2008</b> %	<b>2007</b> %
Customer A	100	75
Customer B	-	25
	<hr/> 100	<hr/> 100

# Medicago Inc.

## Notes to Consolidated Financial Statements

December 31, 2008 and 2007

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### 18 Commitments

As at December 31, 2008, the balance of commitments on lease agreements for premises amounts to \$863,955. Minimum rental amounts for each of the next five fiscal years are as follows: \$216,574 in 2009, \$154,241 in 2010, \$205,002 in 2011, \$203,535 in 2012 and \$84,603 in 2013. The main lease for premises expires in May 2013 with a renewal option of five years.

Under a license obtained from Agriculture and Agri-Food Canada, the Company is committed to paying royalties. The minimum royalties for the next 8 years amount to \$50,000 per year from 2009 to 2017.

Under a license from the University of Guelph, the Company is committed to paying royalties. The minimum royalties for the next six years amount to \$5,000 per year from 2009 to 2014.

Under a license, the Company is committed to paying royalties. Minimum royalties for each of the next five fiscal years are as follows: \$47,000 in 2009, \$67,000 in 2010, and \$92,000 in 2011, 2012 and 2013.

### 19 Capital management

The Company views capital as the sum of long-term debt and Shareholders' Equity.

The Company's objectives when managing capital is to safeguard the Company's ability to continue as a going concern in order to provide an adequate return to shareholders and maintain a sufficient level of funds to finance its research and development activities, general and administrative expenses, working capital and overall capital expenditures, including those associated with patents and trademarks.

To maintain or adjust the capital structure, the Company may attempt to issue new shares, issue new debt, acquire or dispose of assets, all of which are subject to market conditions and the terms of the underlying third party agreements.

The Company is not subject to any capital requirements imposed by a regulator.

# Medicago Inc.

## Notes to Consolidated Financial Statements December 31, 2008 and 2007

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The total capital as at December 31, 2008 and 2007 is calculated as follows:

	2008 \$	2007 \$
Long-term debt	15,209,518	14,451,147
Current portion of long-term debt	73,071	13,072
	<hr/> 15,282,589	<hr/> 14,464,219
Share capital	37,182,667	23,465,147
Contributed surplus	1,087,608	802,219
Other equity components		
Stock options	500,081	263,821
Unit options	66,640	122,135
Warrants	8,410,743	1,787,553
Deficit	(43,920,364)	(36,271,760)
Accumulated other comprehensive loss	(48,384)	-
	<hr/> 3,278,991	<hr/> (9,830,885)
Total capital	<hr/> 18,561,580	<hr/> 4,633,334

# Medicago Inc.

## Notes to Consolidated Financial Statements

December 31, 2008 and 2007

### 20 Financial instruments

#### *Fair value*

The following table summarizes the fair value of financial instruments as at December 31, 2008 and 2007:

	Held for trading	Available for sale	Loans and receivables	Other financial liabilities	As at December 31, 2008	
					Carrying value	Fair value
	\$	\$	\$	\$	Total	Total
					\$	\$
Financial assets						
Cash	18,574	22,773	-	-	41,347	41,347
Cash equivalents	-	1,050,000	-	-	1,050,000	1,050,000
Short-term investments	-	12,936,773	-	-	12,936,773	12,936,773
Accounts receivable	-	-	83,321	-	83,321	83,321
Grants receivable	-	-	44,750	-	44,750	44,750
	18,574	14,009,546	128,071	-	14,156,191	14,156,191
Financial liabilities						
Bank loans	-	-	-	727,950	727,950	727,950
Accounts payable and accrued liabilities	-	-	-	1,156,333	1,156,333	1,156,333
Long-term debt	-	-	-	15,282,589	15,282,589	15,985,780
	-	-	-	17,166,872	17,166,872	17,870,063

# Medicago Inc.

## Notes to Consolidated Financial Statements December 31, 2008 and 2007

	<b>As at December 31, 2007</b>					
	<b>Held for trading \$</b>	<b>Available for sale \$</b>	<b>Loans and receivables \$</b>	<b>Other financial liabilities \$</b>	<b>Carrying value</b>	<b>Fair value</b>
					<b>Total \$</b>	<b>Total \$</b>
<b>Financial assets</b>						
Cash and cash equivalents	223,711	-	-	-	223,711	223,711
Accounts receivable	-	-	18,051	-	18,051	18,051
Financing receivable	-	-	71,641	-	71,641	71,641
Grants receivable	-	-	9,308	-	9,308	9,308
	<u>223,711</u>	<u>-</u>	<u>99,000</u>	<u>-</u>	<u>322,711</u>	<u>322,711</u>
<b>Financial liabilities</b>						
Bank loans	-	-	-	750,000	750,000	750,000
Accounts payable and accrued liabilities	-	-	-	983,849	983,849	983,849
Long-term debt	-	-	-	14,464,219	14,464,219	15,284,910
	<u>-</u>	<u>-</u>	<u>-</u>	<u>16,198,068</u>	<u>16,198,068</u>	<u>17,018,759</u>

Cash and cash equivalents and short-term investments are recorded at fair value. The fair value of other financial instruments, except long-term, debt approximates their carrying value due to their short-term maturity or to current market rates.

The fair value of long-term debt approximates its carrying value due to the current market rate for the Bio-Levier loan and due to the use of the effective interest rate method for the other loans comprised in the long-term debt.

### *Financial risk*

The Company is exposed to various types of risks due to the nature of the business activities it carries on, including those related to the use of financial instruments. The Company does not use financial derivatives.

### *Market risk*

Market risk corresponds to the financial losses that the Company could incur because of unfavourable fluctuations in the value of financial instruments, following variations in the parameters underlying their evaluation, such as interest rates and exchange rates.

# Medicago Inc.

## Notes to Consolidated Financial Statements December 31, 2008 and 2007

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### *Foreign exchange risk*

The exposure to variation of interest rates is described hereunder. Regarding the exposure to foreign exchange rates, the Company operates internationally and a portion of its expenses are incurred in US dollars and Euros but these exposures are not material.

### *Interest rate risk*

As at December 31, 2008, the Company's exposure to interest rate risk is summarized as follows:

Cash and cash equivalents	Variable interest rate
Short-term investments	Fixed interest rate
Accounts receivable	Non-interest bearing
Financing receivable	Non-interest bearing
Grants receivable	Non-interest bearing
Bank loans	Variable interest rate
Accounts payable and accrued liabilities	Non-interest bearing
Long-term debt	As described in note 10

Bank loans (note 8) bear interest at variable rate. As at December 31, 2008, fluctuations of 1% in bank loans' interest rate would have a positive or negative impact of \$7,280 on loss and comprehensive loss.

The Bio-Levier loan (note 10) bears interest at variable rate. As at December 31, 2008, fluctuations of 1% in debt interest rate would have a positive or negative impact of \$153,186 on loss and comprehensive loss.

### *Credit risk*

Financial instruments which potentially subject the Company to concentrations of credit risk consist primarily of cash and cash equivalents, short-term investments (note 4) and accounts receivable (note 5). Cash and cash equivalents are maintained with high-credit quality financial institutions. Short-term investments consist primarily of term deposits, bonds and residuals issued by high-credit quality institutions. Consequently, management considers the risk of non-performance related to cash and cash equivalents and short-term investments to be minimal.

### *Liquidity risk*

Liquidity risk represents the possibility that the Company may not be able to gather sufficient cash resources, when required and under reasonable conditions, to meet its financial obligations.

# Medicago Inc.

## Notes to Consolidated Financial Statements

December 31, 2008 and 2007

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The Company believes that, with the financial resources currently at its disposal, it has sufficient cash and cash equivalents to meet its contractual liabilities for at least the next 12 months. To meet all its contractual liabilities, the Company will need to raise additional funds in the future and will seek additional forms of debt or equity financing, but cannot provide assurance that it will be successful in doing so. The following table summarizes contractual obligations as at December 31, 2008:

	Net value \$	Cash flows \$	0-12 months \$	12-24 months \$	Thereafter \$
Bank loans	727,950	727,950	727,950	-	-
Accounts payable	1,314,089	1,314,089	1,314,089	-	-
Long-term debt	15,985,780	16,466,354	73,071	60,000	16,333,283
	<u>18,027,819</u>	<u>18,508,393</u>	<u>2,115,110</u>	<u>60,000</u>	<u>16,333,283</u>

## 21 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:

	2008	2007
Basic and diluted weighted average number of shares outstanding	44,024,223	19,445,773
Dilutive effect of stock options	2,343	-
Dilutive effect of warrants	3,034,456	-
Diluted weighted average number of shares outstanding	<u>47,061,022</u>	<u>19,445,773</u>

For the years ended December 31, 2008 and 2007, the diluted loss per share was the same as the basic net loss per share since the dilutive effect of stock options and warrants was not included in the calculation; otherwise the effect would have been anti-dilutive. Accordingly, the diluted loss per share for those periods was calculated using the basic weighted average number of shares outstanding.

Excluded from the 2008 calculation of diluted earnings per share were 2,120,921 stock options (1,415,958 in 2007) and 6,076,696 warrants (7,430,653 in 2007) where the exercise prices were greater than the average market price of the common shares for the year.

## 22 Subsequent events

On January 14, 2009, the Company granted 3,472,650 stock options to employees, directors and a consultant. The Company issued 1,420,000 options at an exercise price of \$0.355 and 2,052,650 at a price of \$0.20. They expire after a five-year period from the date of grant.