

27 MILLION
AMERICANS ARE
LIVING WITH
OSTEOARTHRITIS



Message to Shareholders:

Our first quarter was an exceptional period of progress for Nuvo Research.

In January, we announced the successful completion of the studies that we conducted to support the resubmission of our Pennsaid® application to the United States Food and Drug Administration (FDA). In early February, we resubmitted our application for marketing approval to the FDA.

Two weeks later, the FDA accepted our resubmission as a complete response and confirmed that it expected to advise us of Pennsaid's approvability by August 5, 2009 (the PDUFA date). This milestone is one that we have been working towards since we received an approvable letter for Pennsaid from the FDA in December, 2006. We remain confident that we have provided the FDA with the information that it requires to grant Nuvo final, unconditional approval to market Pennsaid in the U.S.

We believe Pennsaid will be the best-in-class topical NSAID treatment for knee osteoarthritis available in the U.S. While we will be the second entry into the U.S. topical NSAID market, the strong performance of the first entry has established that physicians and patients are accepting of topical NSAIDs as an effective treatment. We believe that once physicians understand Pennsaid's superior clinical profile, it will rapidly become the leader in a market predicted to grow to approximately \$2 billion by 2014.

It is a testament to the determination and commitment of our staff, Board of Directors and management that we have reached this critical and pivotal point in Nuvo's history. However, we are acutely aware that approval of Pennsaid is just the beginning in our mission to make Nuvo the leading global transdermal drug delivery company.

To support that vision, we are working diligently on executing the clinical development plan for our Pennsaid Plus program. We expect to commence two Phase 3 clinical trials for Pennsaid Plus shortly after Pennsaid is approved. Pennsaid Plus' twice daily dosing regimen - Pennsaid is four times a day - together with its gel format will offer improved patient compliance and ease of use while providing the same symptom relief as Pennsaid.

At our fqubed Inc. research and development subsidiary in San Diego, we are expanding our early stage pipeline of topical and transdermal drug product candidates. Products in development include four topical formulations for treating various pain conditions, and our anti-fungal drug for treating onychomycosis.

We have always believed that our research and development efforts have been industry leading. Our transdermal delivery platform received external validation during the first quarter from an institution with an impressive pedigree.

In February, INSIGHT, our high throughput experimentation platform that evaluates how compounds penetrate the skin, was nominated as one of four finalists in the Science and Medical category for the prestigious 2009 Edison Best New Product Awards™. The Edison Awards honour excellence in new product development, marketing, and innovation. Other 2009 nominees included the Apple iPhone and Procter & Gamble's Olay Regenerist®. Subsequent to quarter end, we learned that INSIGHT was awarded the bronze medal. We extend congratulations to our focused team who are continuing to develop and expand our transdermal research and development capabilities and platforms.

We continued discussions with potential U.S. licensing partners for Pennsaid and Pennsaid Plus. While our preference is to complete a licensing agreement before FDA approval, we have taken steps to ensure that we have the cash resources to extend our financial runway beyond the anticipated FDA approval date. If licensing negotiations extend beyond the Pennsaid PDUFA date, we want to be in a strong position to negotiate the best terms possible with a capable partner that can help us fully realize Pennsaid's potential.

To that end, in the first quarter, we launched our second Warrant Incentive Program to encourage the early exercise of approximately 73.9 million outstanding warrants that were "out of the money". The program was successful as 42% of the warrants were exercised, generating net cash proceeds of \$3.7 million. We believe that these proceeds, coupled with our current cash balances, provide us with the financial resources required to fund our operations through the end of 2009 and, if necessary, into 2010.

Looking ahead, we are truly excited about Nuvo's future. We have a post Phase 3 asset that has the potential to be a best-in-class product in a lucrative therapeutic area; our research and development subsidiary is emerging as a world leader in the development of transdermal drug delivery technology and has developed promising early stage drug candidates; and we have the financial resources to see Pennsaid through to a licensing transaction with a strong partner.

As always, we are extremely grateful for the support and dedication of our employees and our Board of Directors. They have persevered through some challenging times to take Nuvo to the brink of success. We would also like to thank all of you, our shareholders. We know that many of you have been supporters of Nuvo for years. We appreciate your patience and your support and are working hard to bring the success to Nuvo that you envisioned when you became shareholders.

Dan Chicoine, Chairman
John London, Vice Chairman
Henrich Guntermann, President and CEO

Management's Discussion and Analysis ("MD&A")

April 30, 2009 / The following information should be read in conjunction with the Nuvo Research Inc. ("Nuvo" or the "Company") interim financial statements and notes and should also be read in conjunction with the audited consolidated financial statements, notes and management's discussion and analysis contained in the Company's annual report for the year ended December 31, 2008. Additional information relating to the Company, including its Annual Information Form, can be found on SEDAR at www.sedar.com

All amounts in the MD&A, financial statements and related notes are expressed in Canadian dollars, unless otherwise noted.

Forward-looking Statements

This MD&A contains forward-looking statements that are subject to risks and uncertainties beyond management's control. Actual results could differ materially from those expressed here. Risk factors are discussed more fully in the Company's Annual Information Form filed with the securities commissions in each Canadian province. Nuvo undertakes no obligation to revise forward-looking statements in light of future events.

Overview

Background

Nuvo is a publicly traded, Canadian drug development company, focused on the research and development of drug products that are delivered to and through the skin. Nuvo is also involved in research and development activities involving WF10, a chlorite-based, immunomodulating drug through its 60% interest in Dimethaid AG. The Company refers to and manages these activities as two distinct business and research segments: (i) topical and transdermal drug delivery; and (ii) immune system regulation.

Topical and Transdermal Drug Delivery ("TTDD")

Nuvo believes it is uniquely positioned to research and develop new drug product candidates for delivery to and through the skin. First, Nuvo has developed several penetration enhancer formulations, multiplexed molecular penetration enhancers ("MMPE™s"), that interact with the skin so as to modify its permeability; thereby allowing certain drug molecules to pass to and through the skin to proximate tissues. Second, Nuvo operates high throughput experimentation ("HTE") systems that allow its scientists to rapidly screen combinations of existing molecular penetration enhancers ("MPE™s") and large numbers of potential drug formulations to measure their ability to permeabilize and permeate the skin. Third, the Company has assembled a team of scientists who have and continue to develop expertise in TTDD.

Nuvo's topical and transdermal drug product focus is primarily on the treatment of pain, particularly in cases where changing the dosage form of proven active drugs from oral to topical provides the possibility of clinical benefit, with reduced systemic exposure and fewer systemic side effects. The Company is also using its technology to pursue drugs to treat dermatological indications. The Company's HTE platforms also have practical utility for diverse use in pharmaceutical, cosmetic, personal care, diagnostic and medical device applications, where formulations suitable for modulating one or more properties

of the skin, such as permeability, need to be developed. The Company intends to continue collaborations with third parties, directed towards either developing prospective products outside of its focus on pain and dermatology or advancing its HTE capabilities.

Pennsaid

The Company's lead product, Pennsaid, is used to treat the pain and symptoms associated with knee osteoarthritis ("OA") a condition that afflicts 27 million Americans. The drug combines the transdermal carrier DMSO with diclofenac sodium, a leading non-steroidal anti-inflammatory drug ("NSAID"), and delivers the active drug through the skin directly to the site of pain. Pennsaid is approved for sale and marketed under license and distribution agreements in Canada and several European countries.

In December 2006, the United States ("U.S.") Food and Drug Administration ("FDA") issued an approvable letter ("Approvable Letter") that indicated Pennsaid is approvable subject to Nuvo satisfying certain conditions including the provision of additional nonclinical dermal safety and packaging data. None of the conditions in the Approvable Letter related to the clinical efficacy or the clinical safety of Pennsaid, which were evidenced in Nuvo's Phase 3 trials.

During 2007, the Company engaged in communications with the FDA to clarify the Agency's expectations regarding certain of its requirements in the Approvable Letter for additional information relating to Pennsaid. Based on the contents of the Approvable Letter and these clarifications, the Company completed several short-term studies (the "Short-Term Studies"). In addition, the Company concluded it must complete three (3) longer-term animal studies (the "Long-Term Studies") to confirm the dermal and systemic safety of Pennsaid. The three Long-Term Studies are as follows:

- a six (6) month repeat dose dermal toxicity study (the "Six-Month Tox Study");
- a twelve (12) month repeat dose dermal toxicity study (the "Twelve-Month Tox Study"); and,
- a two (2) year dermal carcinogenicity study (the "Carc Study") preceded by a dose finding trial (the "Carc Dosing Trial").

The FDA confirmed in written minutes of a telephone meeting with the Company, that the Carc Study can be completed post approval, provided no safety concerns are identified in the Six-Month Tox Study or the Twelve-Month Tox Study (together the "Tox Studies"). The Company completed the Tox Studies and based upon its interpretation of the data believes there are no safety concerns such that, as per the Company's agreement with the FDA, the Carc Study may be completed post approval.

On February 4, 2009, the Company filed a complete response amendment to address all of the FDA's concerns raised in the Approvable Letter and subsequently, the FDA set August 5, 2009 as the date pursuant to the Prescription Drug User Fee Act (the "PDUFA Date") by which they will advise Nuvo of their decision regarding Pennsaid's approvability; however, there is no guarantee that the FDA will complete its review in this timeframe. If approved by the FDA, Pennsaid will be permitted to be sold and marketed in the U.S. However, there can be no assurance, if or when, the FDA will approve the sale or marketing of Pennsaid in the U.S.

Pennsaid Plus

To improve upon Pennsaid the Company has completed preliminary testing of a new, improved version of Pennsaid, currently referred to as Pennsaid Plus. The Company has had meetings with the FDA at which the FDA's information requirements for the approval of Pennsaid Plus were discussed. Based on the feedback from the FDA, the Company intends to conduct two pivotal phase 3 clinical trials to demonstrate the clinical efficacy of Pennsaid Plus. The Company does not anticipate that it will commence these phase 3 clinical trials until certain goals are achieved including receipt of sufficient funds to complete the trials. Furthermore, additional clinical and non-clinical studies may be required to support applications for the regulatory approval of Pennsaid Plus in the U.S. and other jurisdictions in which the Company would wish to market the product. There can be no assurance that such trials will be sufficient for regulatory authorities or that the studies will yield successful results or that the required regulatory approvals will be obtained. If approved for sale and marketing, the Company believes that Pennsaid Plus will be more desirable than Pennsaid as it is anticipated that less frequent dosing will offer improved patient compliance and ease of use while providing the same OA symptom relief as Pennsaid.

Early Stage Drug Development

In addition to Pennsaid and Pennsaid Plus, the Company is actively conducting research on formulations utilizing its MPE™ systems to build its topical and transdermal drug candidate pipeline. The Company is focusing its research in the areas of pain and selected indications in the field of dermatology. A number of formulations are under research or in early stage pre-clinical development.

In the field of pain, in addition to Pennsaid and Pennsaid Plus, Nuvo is developing topical medications for a variety of pain conditions including acute and chronic pain of inflammatory, nociceptive and neuropathic origin. All of these pain medications will be designed to treat the pain locally while limiting systemic exposure to the active drug thereby reducing the potential for negative side effects, adverse events and potential drug-drug interactions. The drug product candidates under development are at various stages of formulation and pre-clinical development. Development of these topical drug candidates is being aided by fqubed's screening technology.

Immune System Regulation (“ISR”)

The immune system provides an essential defence to micro organisms, cancer and substances it sees as foreign and potentially harmful. The Company's ISR platform, WF10, a solution of OXO-K993, focuses on supporting the immune system and returning it to normal immune function. All ISR research is carried out through Dimethaid AG in which the Company has a 60% interest.

WF10

In December 2008, the Company terminated its Phase 2 clinical trial using WF10 as an adjuvant treatment for inoperable pancreatic cancer. Preliminary results of an interim analysis indicate that the primary end point, greater than six months survival, was successfully achieved. However, it is unclear, based on the open-label study design and the data reviewed whether the positive results could be confirmed in a placebo controlled study. The Company will continue to analyze the interim study results,

including a more detailed analysis of the Quality of Life data collected during the study. In addition, discussions between the Company and both the University of Heidelberg and the National Centre for Tumor Diseases are ongoing as the data is analyzed and the best path forward determined.

Oxoferin™

The Company markets a diluted form of WF10 through a European subsidiary in parts of Europe, Asia and South America as a topical wound healing agent under several trade names including Oxoferin™ and Oxovasin®. In 2008, the Company signed a distribution and license agreement with a regional pharmaceutical company for Russia and some of the former Soviet republics including all of the Baltic States. The Company and its licensee are currently working to gain marketing authorizations in these territories, but do not expect to receive such authorizations until 2010 at the earliest.

Key Developments

During the first quarter and prior to the release of its first quarter results the Company:

- Successfully completed all of the studies required to support Nuvo's resubmission of its Pennsaid application to the FDA;
- Filed its complete response amendment to address all of the FDA's concerns raised in the Approvable Letter. The resubmission was accepted by the FDA and August 5, 2009 was set as the PDUFA date, the date by which the FDA will advise the Company of its decision respecting Pennsaid's approvability;
- Raised \$3.7 million from the exercise of 30.7 million warrants under the warrant incentive program which was designed to encourage the early exercise of June 2006 Warrants, July 2007 Warrants, and November 2004 Warrants (the "2009 Warrant Incentive Program") during the period from January 21, 2009 to April 3, 2009; and,
- Won a bronze medal at the 2009 Edison Awards recognizing the excellence and innovativeness of the Company's High Throughput Experimentation Platform, INSIGHT™.

Liquidity

The Company has incurred substantial losses since its inception as it has invested significantly in drug development activities and other legacy ventures. At March 31, 2009, the Company had an accumulated deficit of \$202.5 million including a loss of approximately \$2.9 million for the three months ended March 31, 2009. At March 31, 2009, the Company had cash and cash equivalents of \$14.2 million.

The Company expects that it will continue to incur losses as it expands research and development activities, its pipeline and works toward the approval of Pennsaid in the U.S. The Company currently anticipates that its cash and cash equivalents together with revenues it expects to generate from product sales, interest it expects to earn on invested funds and proceeds from the 2009 Warrant Incentive Program that were received subsequent to March 31, 2009 will be sufficient to execute its plan and fund

operations through the end of 2009 and into 2010. Nonetheless, as is typical in this industry, the Company will require additional funding in the future in order to continue developing its early stage drug candidates and to continue as a going concern. The Company's success in doing so will depend upon its ability to secure additional licensing fees, secure co-development agreements, obtain additional capital and ultimately achieve profitable operations.

Given this inevitability the Company monitors on a regular basis its liquidity position, the status of its drug development programs, including cost estimates for completing various stages of development, the scientific progress on each drug candidate, the potential to license or co-develop each drug candidate and continues to actively pursue fund-raising possibilities through various means, including the sale of its equity securities. However, there can be no assurance, especially considering the current economic environment, that additional financing will be available on acceptable terms, or at all. If adequate funds are not available, the Company will have to substantially reduce or eliminate planned expenditures, delay clinical trials for its product candidates and curtail product development programs designed to expand the product pipeline. If the Company is unable to obtain additional financing when and if required, the Company may be unable to continue operations.

The consolidated financial statements do not include adjustments to the amounts and classification of assets and liabilities that would be necessary should the Company be unable to continue as a going concern.

Change in Accounting Policies

Goodwill, Intangible Assets and Financial Statement Concepts

On January 1, 2009 the Company adopted new *Handbook Section 3064, Goodwill and intangible assets*, replacing *Handbook Section 3062, Goodwill and other intangible assets* and *Handbook Section 3450, Research and development costs*. The CICA also amended *Handbook Section 1000 Financial Statement Concepts* to provide consistency with this new standard. Section 3064 establishes standards for the recognition, measurement, presentation and disclosure of goodwill subsequent to its initial recognition and intangible assets by profit-oriented enterprises. This section clarifies that costs can be deferred only when they relate to an item that meets the definition of an asset and as a result start-up costs must be expensed as incurred. The provisions relating to the definition and initial recognition of intangible assets, including internally generated intangible assets, are equivalent to the corresponding provisions of International Financial Reporting Standards ("IFRS") *IAS 38 Intangible Assets*. Upon adoption, there was no impact on the Company's consolidated financial statements.

Credit Risk and the Fair Value of Financial Assets and Liabilities

In January 2009, the CICA's Emerging Issue Committee ("EIC") issued abstract *EIC-173, Credit 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. Upon adoption, there was no impact on the financial statements.

Selected Financial Information

in thousands (except per share and share information)

	Three-months ended March 31, 2009	Three-months ended March 31, 2008
<i>Operations</i>		
Product sales	\$ 2,383	\$ 1,975
Cost of goods sold	1,134	1,084
Gross margin on product sales	1,249	891
License fees	560	250
Research and other contract revenue	104	11
	1,913	1,152
Operating expenses	4,781	3,423
Net loss	\$ (2,868)	\$ (2,271)

Share Information

Net loss per share	\$ (0.01)	\$ (0.01)
Average number of common shares outstanding – basic and diluted (in millions)	319.6	299.5

	As at March 31, 2009	As at December 31, 2008
<i>Financial Position</i>		
Cash and cash equivalents	\$ 14,176	\$ 15,219
Total assets	20,306	21,435
Deferred revenue, including current portion	5,025	5,562
Long-term debt, debentures and capital lease obligations, including current portions	5,363	5,275
Total liabilities	12,905	13,573
Total shareholders' equity	7,401	7,862

Fluctuations in Operating Results

The Company's results of operations have fluctuated significantly from period-to-period in the past and are likely to do so in the future. The Company anticipates that its quarterly and annual results of operations will be impacted for the foreseeable future by several factors, including the timing and amount of payments received pursuant to current and future collaborations, and the progress and timing of expenditures related to research, development and commercialization efforts. Due to these fluctuations, the Company believes that the period-to-period comparisons of its operating results are not necessarily a good indication of its future performance.

Results of Operations

Product Sales and Gross Margin

in thousands (except gross profit percentage)

	Three-months ended March 31, 2009	Three-months ended March 31, 2008
Pennsaid sales	\$ 2,051	\$ 1,731
WF10 sales	299	216
Contract manufacturing sales	33	28
Total product sales	2,383	1,975
Cost of goods sold	1,134	1,084
Gross margin on product sales	1,249	891
Gross margin percentage	52%	45%

Product sales for the three months ended March 31, 2009 were \$2.4 million compared with \$2.0 million for the period ended March 31, 2008, an increase of 21%. Sales of Pennsaid products were the Company's largest revenue source accounting for 86% and 88% of total revenue for the three months ending March 31, 2009 and 2008, respectively.

Pennsaid sales

Sales of Pennsaid, increased 18% to \$2.1 million for the three months ended March 31, 2009 from \$1.7 million for the three months ended March 31, 2008. Pennsaid sales increased in all markets where Pennsaid is sold, with the most significant increases attributable to the Greek and Canadian markets. Sales to our Greek distributor increased 17% to \$1.3 million from \$1.1 million a year ago. Pennsaid has been the market leader by revenue in Greece's topical anti-rheumatics market for over a year. Sales to our Canadian partner, Paladin increased by 41% to \$0.4 million compared to the three months ended March 31, 2008.

WF10 sales

Sales of WF10 based products for the three months ended March 31, 2009 were \$299,000 an increase of 38% compared with \$216,000 for the period ended March 31, 2008. For the three months, higher sales to the Company's distributor in Venezuela and the impact of a stronger Euro (which increased the translated value of these sales) were only partially offset by decreases in sales to the Company's distributors in Pakistan and Thailand and to customers in Germany.

Contract manufacturing sales

Contract manufacturing sales for the three months ended March 31, 2009 were \$33,000 compared to \$28,000 for the three months ended March 31, 2008. Contract manufacturing sales were earned through third party contract manufacturing opportunities fulfilled by the Varennes manufacturing facility. While not core to the Company's business, contract manufacturing provides additional revenue and absorbs excess manufacturing capacity and costs without affecting the Company's ability to supply Pennsaid.

Significant customers

As the Company sells product in a limited number of markets through exclusive agreements, it receives most of its revenue from a limited number of customers. Sales to the Company's three largest customers were \$2.0 million, 84% of total product sales in the latest three-month period, versus \$1.7 million (86%) in the comparable three months ended March 31, 2008. Sales to the Company's largest customer represented 54% of total product sales for the three months ended March 31, 2009 versus 56% for the same period in 2008.

Gross margin

For the three months ended March 31, 2009, gross margin on product sales was \$1.2 million compared to \$0.9 million for the three months ended March 31, 2008. The increase in gross margin is primarily attributable to the 18% increase in Pennsaid sales, the 38% increase in WF10 based product sales and improvements and efficiencies achieved in the Pennsaid manufacturing process. The additional volume combined with the process changes allowed the Company to better utilize capacity at its Canadian and German manufacturing facilities. The increase was partially offset by significant price increases in many of the raw materials used to compound and package Pennsaid and the strengthening U.S. dollar as, under the terms of its various supply agreements, the Company is not always able to pass these increases on to customers as they occur. The overall gross margin percentage was 52% for the three months ended March 31, 2009 versus 45% for the same period in 2008. The gross margin percentage for the quarter was higher than expected as the Pennsaid manufacturing facilities operated near full capacity to increase first quarter production levels ahead of the Company's planned shutdown to prepare for the U.S. launch. The Company expects the gross margin percentage to return to normal levels in the second quarter on a year-to-date basis.

Licensing Fees

During the three months ended March 31, 2009, the Company recorded \$560,000 in licensing fee revenue compared to \$250,000 for the three months ended March 31, 2008. This represents the recognition of a portion of the upfront fees received from Paladin in 2005 and 2006 for the Canadian marketing rights to Pennsaid and the recognition of the portion of the prepaid Pennsaid royalties received in July 2008 that relate to the current quarter.

Research and Other Contract Revenue

Research and other contract revenue for the three months ended March 31, 2009 was \$104,000 compared with \$11,000 for the three months ended March 31, 2008. This revenue was generated by the Company's San Diego based research and development facility through third party collaborations.

Operating Expenses

in thousands

	Three-months ended March 31, 2009	Three-months ended March 31, 2008
Research and development	\$ 2,934	\$ 2,104
Selling, general and administrative	1,363	1,124
Stock-based compensation	132	150
Amortization of property, plant and equipment and intangibles	149	205
Interest, net	212	119
	4,790	3,702
Foreign currency gain	(9)	(279)
Total operating expenses	\$ 4,781	\$ 3,423

Total operating expenses, excluding foreign currency gains, for the three months ended March 31, 2009 were \$4.8 million, an increase of 29% compared to \$3.7 million for the three months ended March 31, 2008. The increase from 2008 relates to higher research and development spending, SG&A costs, and net interest expense. During the first quarter of 2009, research and development expenditures represented 61% of operating expenses (before currency gains) versus 57% in the first quarter of 2008.

Research and Development

Research and development expenses were \$2.9 million for the three months ended March 31, 2009, an increase of 39% compared with \$2.1 million for the three months ended March 31, 2008. Approximately, half of the spending related to the completion of the studies and preparation of all data and documents necessary for filing the Company's Complete Response to the Pennsaid Approvable Letter that occurred on February 4, 2009. The FDA accepted our resubmission for review and set August 5, 2009 as the PDUFA Date, the date by which they will advise Nuvo of their decision regarding Pennsaid's approvability. The Company has spent an aggregate of approximately \$9.4 million in external costs to respond to the Approvable Letter.

The balance of the research and development spending for the three months ended March 31, 2009 included:

- The costs associated with the recently expanded research and formulation development activities at fqubed which increased by approximately 60% to \$0.9 million. During the quarter, this group was focused on formulation development activities aimed at expanding the early stage drug candidate pipeline and advancing the Company's HTE capabilities through a third party collaboration agreement with a Fortune 500 Company;
- The ongoing costs associated with the Company's laboratory in Varennes, Québec and its clinical, pre-clinical and regulatory group in Mississauga that designed and co-ordinated most of the Company's pre-clinical and clinical studies for the Complete Response and reviewed and prepared the NDA; and
- Chemistry, manufacturing and controls ("CMC"), pre-clinical and formulation development work on Pennsaid Plus and other early stage pain and dermatologic drug candidates.

In the comparable period ending March 31, 2008, of the Company's \$2.1 million in research and development expenditures, about half were focused on activities surrounding the Pennsaid Approvable Letter. The balance related to costs of hiring additional scientists and key managers to support the development of the Company's topical and transdermal drug candidate pipeline at fqubed and the laboratory in Québec.

Research and development expenditures vary depending upon the stage of development of drug products and candidates in the Company's pipeline and management's allocation of the Company's limited resources to these activities in general and to each drug specifically. As the Company awaits the FDA's decision on Pennsaid's approval in August 2009, its research and development activities will focus on utilizing internal resources to conduct research, formulation development, CMC and pre-clinical activities to expand and move the early stage drug candidate pipeline and Pennsaid Plus forward while limiting external spending.

Selling, General and Administrative ("SG&A")

SG&A expenses increased to \$1.4 million for the three months ended March 31, 2009, compared to \$1.1 million for the three months ended March 31, 2008. The increase in the quarter was attributable to costs incurred from the ongoing licensing activities in the U.S and \$0.1 million recognized under the new Deferred Share Unit Plan ("DSU Plan"). As part of its regular review of Board compensation the Company implemented a DSU Plan which is a share-based compensation plan for non-employee directors under which directors are allotted a portion of and can elect to receive a portion of their cash compensation in deferred share units ("DSUs"). During the quarter the Company issued 693,519 DSUs to the directors. Each DSU has a cash value equal to the market price of one of the Company's Common Shares. At March 31, 2009, the 693,519 DSUs had a fair value of \$94,000.

Stock-Based Compensation

Total compensation expense related to shares issued and options granted under the Company's three stock-based compensation plans decreased to \$132,000 for the three months ended March 31, 2009 from \$150,000 for the three months ended March 31, 2008.

Compensation expense related to the stock option plan decreased slightly for the three months ended March 31, 2009 to \$132,000 compared to \$137,000 for the three months ended March 31, 2008 as the compensation cost attributable to share options granted in the past two years was more than offset by a significant number of options issued prior to 2007 that became fully amortized during 2008 such that no or reduced compensation expense was recorded in the three-months ended March 31, 2009 for these options.

Compensation expense for the share bonus plan was \$nil for the three months ended March 31, 2009 compared to \$13,000 for the three months ended March 31, 2008.

Amortization of Property, Plant and Equipment and Intangibles

Amortization charges for the three months ended March 31, 2009 were \$149,000, a 27% decrease from \$205,000 for the three months ended March 31, 2008. The decrease in amortization relates primarily to assets acquired upon the 2005 purchase of the Company's research and development centre in San Diego that became fully amortized at the end 2008.

Interest

Interest expense was \$246,000 for the three months ended March 31, 2009 compared to \$303,000 for the three months ended March 31, 2008. The decrease in the quarter is due to lower non-cash accretion charges recorded on the convertible debentures and the elimination of interest expense on the short-term loan, partially offset by the interest expense related to the convertible debentures issued in July 2008.

Interest income decreased to \$34,000 from \$184,000 for the three months ended March 31, 2009 from a year ago. The decrease in interest income relates primarily to lower average cash and cash equivalent balances during the current year and rates of interest earned on the Company's cash and cash equivalents that have declined by more than 50% versus the prior year. Interest rates received on cash and cash equivalents continued their decline during the quarter and the Company expects this to continue given the current economic climate and the Company's desire to preserve capital rather than maximize return through additional risk.

The aggregate result was an increase in net interest expense to \$212,000 in 2009 compared to \$119,000 in 2008.

Foreign Currency Gains and Losses

The Company incurred net foreign currency gains of \$9,000 in the three months ended March 31, 2009 compared to \$279,000 for the three months ended March 31, 2008. During the quarter, the negative impact of the strengthening U.S. dollar on the Company's accounts payable in U.S. dollars was almost entirely offset by the positive impact of the strengthening Euro on the Company's Euro denominated accounts receivable and cash and cash equivalent balances and the translation of the Company's net investment in its foreign subsidiaries.

Net Loss and Total Comprehensive Loss

For the three months ended March 31, 2009, net loss was \$2.9 million, an increase over the \$2.3 million net loss for the three months ended March 31, 2008. For the period, higher research and development costs to complete the Pennsaid resubmission, a reduced foreign exchange gain, higher SG&A costs and higher net interest expense more than offset the increased gross margin generated from higher product sales and operating efficiencies. There were no comprehensive income or loss components in the three months ended March 31, 2009 or 2008.

On a segmented basis, TTDD which includes all Pennsaid activities incurred a loss of \$2.6 million in the first quarter of 2009 and ISR, which includes all WF10 activities, incurred a loss of \$270,000. In the quarter ended March 31, 2008 TTDD and ISR incurred losses of \$2.1 million and \$132,000 respectively. The losses incurred on ISR are small relative to TTDD as the level of research and development activity conducted over the past two years has been confined to the pancreatic cancer trial and other small projects that can be funded primarily through the cash flow generated from sales of Oxoferin.

Net Loss per Common Share

Net loss per common share on both a basic and diluted basis was \$0.01 for the three months ended March 31, 2009 and 2008.

The weighted average number of common shares outstanding on both a basic and diluted basis was 319.6 million for the three months ended March 31, 2009 versus 299.5 million for the three months ended March 31, 2008. The majority of the 20.1 million share increase is attributable to the 9 million common shares issued through a private placement equity financing in May 2008, 3 million common shares issued as part of the Employee Share Purchase Plan in December 2008 and common shares issued upon the conversion of warrants under the 2009 Warrant Incentive Program during the first quarter of 2009.

Liquidity and Capital Resources

in thousands

	Three-months ended March 31, 2009	Three-months ended March 31, 2008
Net loss	\$ (2,868)	\$ (2,271)
Items not involving current cash flows	(21)	(51)
Cash used in operations	(2,889)	(2,322)
Net change in non-cash working capital	(300)	(626)
Advances on research contracts	23	-
Cash used in operating activities	(3,166)	(2,948)
Cash provided by (used in) investing activities	(55)	1
Cash provided by (used in) financing activities	2,134	(44)
	(1,087)	(2,991)
Effect of exchange rates on cash and cash equivalents	44	261
Net decrease in cash and cash equivalents	(1,043)	(2,730)
Cash and cash equivalents, beginning of period	15,219	21,791
Cash and cash equivalents, end of period	\$ 14,176	\$ 19,061

Cash and Cash Equivalents

Cash and cash equivalents were \$14.2 million as at March 31, 2009, compared to \$15.2 million as at December 31, 2008. At March 31, 2009, cash and cash equivalents include \$76,000 in term deposits that are posted as collateral against the current portion of long-term debt.

Operating Activities

Cash used in operations increased to \$2.9 million for the quarter ended March 31, 2009 compared to \$2.3 million for the quarter ended March 31, 2008, a 24% increase. This was primarily attributable to the higher net loss.

Overall cash used in operating activities increased a more modest 7% to \$3.2 million for the three months ended March 31, 2009 versus \$2.9 million for the three months ended March 31, 2008. The \$0.6 million increase in cash used in operations was reduced by a lower investment in non-cash working capital and the receipt of advances on research contracts during the current quarter. For the three months ended March 31, 2009, the investment in non-cash working capital of \$0.3 million related to an increase in inventory levels as the manufacturing operations increased first quarter production levels ahead of our planned shutdown to prepare for the U.S. launch and the payment of year end

accruals offset somewhat by the collection of accounts receivable relating to record sales that were recognized in the final two months of 2008.

Investing Activities

Net cash used in investing activities totaled \$55,000 for the three months ended March 31, 2009 compared to net cash provided by investing activities of \$1,000 in the three months ended March 31, 2008. The additions in the quarter primarily represent deposits on new production equipment as the Company began the process of expanding capacity at its Québec manufacturing facility in preparation for the anticipated launch of Pennsaid in the U.S. later this year. During the comparative period, proceeds received on the sale of excess lab equipment were almost entirely offset by purchases of new lab equipment in Varennes and computer software for the Mississauga office.

Financing Activities

Net cash provided by financing activities totaled \$2.1 million for the three months ended March 31, 2009, compared with net cash used in financing activities of \$44,000 for the three months ended March 31, 2008. During the quarter, the Company announced the commencement of its second warrant incentive program, the 2009 Warrant Incentive Program, that was designed to encourage the early exercise of June 2006 Warrants, July 2007 Warrants, and November 2004 Warrants. In order to encourage the early exercise of these warrants, Nuvo amended the terms of such warrants so that upon payment of a reduced exercise price of \$0.125 and surrender of the holder's warrant certificate in accordance with applicable procedures, the holder was entitled to receive one common share of the Company. The exercise period commenced on January 21, 2009 and ended on April 3, 2009. As of March 31, 2009 warrant holders exercised 18.9 million warrants for net proceeds of \$2.2 million. Subsequent to March 31, 2009 and prior to the expiry of the 2009 Warrant Incentive Program, the Company received an additional \$1.5 million in proceeds from the exercise of 11.8 million warrants. The Company also made scheduled debt repayments of \$62,000 during the quarter versus \$44,000 in 2008.

Selected Quarterly Information (unaudited)

The following is selected quarterly financial information for the last eight quarterly reporting periods:

(in thousands, except per share data)

	June 30, 2008	September 30, 2008	December 31, 2008	March 31, 2009
Revenue	\$ 2,085	\$ 3,289 ⁽²⁾	\$ 3,117	\$ 3,047
Net loss	(2,864)	(3,004) ⁽³⁾	(2,413) ⁽¹⁾	(2,868)
Loss per share	\$(0.01)	\$(0.01)	\$(0.01)	\$(0.01)

	June 30, 2007	September 30, 2007	December 31, 2007	March 31, 2008
Revenue	\$ 1,435	\$ 2,558	\$ 2,207	\$ 2,236
Net loss	(3,034)	(2,523) ⁽⁴⁾	(3,332)	(2,271)
Loss per share	\$(0.01)	\$(0.01)	\$(0.01)	\$(0.01)

(1) The quarter ended December 31, 2008 includes a \$0.9 million gain on the change in estimate in the Leadenhall contingency.

(2) The quarter ended September 30, 2008 includes \$0.9 million in licensing revenue recognized upon the completion of the Amended and Restated Canadian Licensing Arrangements with Paladin.

(3) The quarter ended September 30, 2008 includes a \$0.3 million loss on the extinguishment of a convertible debenture.

(4) The quarter ended September 30, 2007 includes a \$0.5 million gain on the sale of assets.

The significant increase in year-over-year quarterly sales is due to the launch of Pennsaid in Greece.

Financial Instruments

The fair value of a financial instrument is the amount of consideration that would be agreed upon in an arm's length transaction between willing parties.

The Company has determined the estimated fair values of its financial instruments based on appropriate valuation methodologies. However, considerable judgment is required to develop these estimates. Accordingly, these estimated values are not necessarily indicative of the amounts the Company could realize in a current market exchange. The estimated fair value amounts can be materially affected by the use of different assumptions or methodologies. The methods and assumptions used to estimate the fair value of each class of financial instruments are discussed below.

The fair values of short-term financial assets and liabilities, including cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities as presented in the consolidated balance sheets approximate their carrying amounts due to the short period to maturity of these financial instruments.

Rates currently available to the Company for long-term debt, with similar terms and remaining maturities have been used to estimate the fair value of the debentures, long-

term debt and capital lease obligations. These fair values approximate the carrying values for all instruments.

FINANCIAL RISK MANAGEMENT

Risk factors

The following is a discussion of market, credit and liquidity risks and related mitigation strategies that have been identified. This is not an exhaustive list of all risks, nor will the mitigation strategies eliminate all risks listed.

Credit risk

The Company's cash and cash equivalents subject the Company to a significant concentration of credit risk. At March 31, 2009, the Company had \$11.5 million on deposit in a high interest savings account held by a single financial institution, as per its practice of protecting its capital rather than maximizing investment yield through additional risk. The financial institution is a major Canadian bank which the Company believes lessens the degree of credit risk. The Company has EURO 100,000 (CDN\$168,000) in term deposits that are posted as collateral against long-term debt. The remaining cash and cash equivalent balances are held in bank accounts and money market funds in various geographic regions.

The Company, in the normal course of business, is exposed to credit risk from its global customers most of whom are in the pharmaceutical industry. The accounts receivable are subject to normal industry risks in each geographic region in which the Company operates. In addition, the Company is exposed to credit related losses on sales to its customers outside North America and the European Union due to potentially higher risks of enforceability and collectability. The Company attempts to manage these risks prior signing of distribution or licensing agreements by dealing with creditworthy customers; however, due to the limited number of potential customers in each market this is not always possible. In addition, a customer's creditworthiness may change subsequent to becoming a licensee or distributor and the terms and conditions in the agreement may prevent the Company from seeking new customers during the term of the agreement. At March 31, 2009, the Company's three largest customers located in Canada and Europe represent 74% [March 31, 2008 – 86%] of accounts receivable and our accounts receivable from customers located outside of North America and the European Union represent 20% [March 31, 2008 – 6%] of accounts receivable.

Pursuant to their collective terms, accounts receivable are aged as follows at March 31, 2009:

<u>(in thousands)</u>	<u>\$</u>
Current	1,256
0-31 days past due	209
61-90 days past due	84
<u>Over 90 days past due</u>	<u>124</u>
	<u>1,673</u>

Liquidity risk

The Company has an ongoing need for substantial capital resources to research and develop, commercialize and manufacture its products and technologies. The Company only has limited participation in Pennsaid sales revenues in those markets where it has currently been approved and is marketed. Until the Company receives FDA approval for the sale and marketing of Pennsaid in the U.S., and has signed a licensing agreement with a U.S. marketing partner, the Company's Pennsaid revenues are not expected to be sufficient to provide the capital required for the Company to be self-sustaining without the need for future financings. There can be no assurance that the Company will have sufficient capital to fund its ongoing operations, satisfy all of the FDA requirements for the approval of Pennsaid, consummate a licensing agreement for Pennsaid with a U.S. marketing partner, develop or commercialize any further products based on its TTDD or ISR platforms without future financings. There can be no assurance that additional financing will be available on acceptable terms, or at all. If adequate funds are not available, the Company will have to substantially reduce or eliminate planned expenditures, terminate or delay clinical trials for its product candidates and curtail drug development programs designed to expand the product pipeline. If the Company is unable to obtain additional financings to address its cash requirements, the Company may be unable to continue operations.

Interest rate risk

All debentures, long-term debt and capital lease obligations are at fixed interest rates.

Currency risk

The Company operates globally, which gives rise to a risk that earnings and cash flows may be adversely affected by fluctuations in foreign currency exchange rates. The Company is primarily exposed to the U.S. dollar and Euro, but also transacts in other foreign currencies. The Company currently does not use financial instruments to hedge these risks. The significant balances in foreign currencies as at March 31 are as follows:

	Euros		U.S. Dollars	
	2009	2008	2009	2008
(in thousands)	€	€	\$	\$
Cash and cash equivalents	443	1,416	835	325
Accounts receivable	610	1,154	-	-
Other current assets	9	12	35	20
Restricted cash	100	100	-	-
Accounts payable and accrued liabilities	(124)	(173)	(657)	(1,005)
Short-term loan	-	-	-	(621)
Long-term debt and capital lease obligations	(113)	(159)	(192)	(24)
	925	2,350	21	(1,305)

The translation impact to the Company of a 1 cent increase in the Canadian dollar versus the Euro and the U.S. dollar would have been an increase to the net loss by \$26,000 and \$nil respectively for the three months ended March 31, 2009. A 1 cent decrease in the Canadian dollar versus the Euro and the U.S. dollar would have decreased the net loss by \$26,000 and \$nil respectively for the three months ended March 31, 2009.

The Company manages its foreign currency exposures where practical and cost effective. In terms of the Euro, the Company has three significant exposures: its net investment and net cash flows in its European operations and sales of Pennsaid by the Canadian operations to European distributors. In terms of the U.S. dollar, the Company has three significant exposures: its net investment and net cash flows in its U.S. operations and the cost of running trials and other studies at U.S. sites.

The Company does not actively hedge any of its foreign currency exposures given the relative risk of currency versus other risks the Company faces and the cost of establishing the necessary credit facilities and purchasing hedging instruments. As a result, the Company does not attempt to hedge its net investment in foreign subsidiaries. The Company does not currently hedge the cash flows of its European operations as outflows are managed to closely approximate inflows in these operations. The U.S. operations have net cash outflows and these are funded monthly.

Sales to European distributors are substantially contracted in Euros. The Company receives payments from the distributors in its Euro bank accounts and uses these funds to pay Euro expenditures and to fund European operations as necessary. In addition, these funds are converted into U.S. funds as needed to fund our U.S. dollar outflows and U.S. based operations. The Company reviews the amount of Euros held periodically and if they are excessive compared to the Company's projected future Euro cash flows they may be converted into U.S. or Canadian dollars.

Commodity risk

The Company is exposed to commodity risk related to purchases of key raw materials necessary for the manufacture of its bulk product from a limited number of suppliers around the world. The Company attempts to mitigate this risk by entering into long-term supply contracts at fixed pricing with capped annual increases. DMSO (one of the key ingredients in Pennsaid) is the Company's most significant cost subject to commodity risk. The Company has attempted to mitigate this risk by entering into a supply agreement with a U.S. supplier for its pharmaceutical grade DMSO until October 31, 2012 using the supplier's patented process at a fixed base price with capped annual increases. There is commodity risk for all other ingredients in each of the Company's products including the active pharmaceutical ingredient. The Company attempts to mitigate these risks through the use of multiple suppliers and fixed price contracts but due to the nature of the some of the chemicals required and the regulatory paths to approving new suppliers, this is not always possible.

Contractual Obligations

The following table lists the Company's contractual obligations as at March 31, 2009.

<i>in thousands</i>	Total	Payments due by year end			
		April 1 – December 31, 2009	2010	2011	2012
Long-term debt	\$ 190	\$ 57	\$ 76	\$ 57	\$ -
Capital lease obligations	280	93	106	81	-
Debentures	5,986	-	5,986	-	-
Operating leases	1,034	348	466	202	18
Research and other contracts	428	417	10	1	-
	\$ 7,918	\$ 915	\$ 6,644	\$ 341	\$ 18

Off Balance Sheet Arrangements

The Company does not have any off-balance sheet arrangements.

Outstanding Share Data

The number of common shares outstanding as at March 31, 2009 was 333.3 million, an increase of 6% from 314.4 million at December 31, 2008. The increase was entirely due to the issuance of 18.9 million shares upon the exercise of warrants under the 2009 Warrant Incentive Program.

As at March 31, 2009, there were 60,772,673 warrants and 33,794,568 options outstanding and 43,376,812 common shares potentially issuable on the conversion of the outstanding debentures.

Litigation

From time to time, during the ordinary course of business, the Company is threatened with, or is named as a defendant in various legal proceedings including lawsuits based upon product liability, personal injury, breach of contract and lost profits or other consequential damage claims.

Leadenhall

The Company's former head office property was subject to a \$2.0 million mortgage (the "Mortgage"). As previously disclosed, the Mortgage balance due is in dispute with Leadenhall Bank & Trust Company Limited ("the Mortgagee"). The Mortgage dispute centers on the calculation and amount of interest owing and was the subject of an Ontario court action (the "Ontario Action") commenced by the Mortgagee in April 2005. The Mortgagee's position is that interest should be calculated at a rate of 2% per month calculated monthly; including interest on late payments; and costs. The Company's position is that the Mortgage is null and void and should be discharged, or alternatively, that the interest payable is limited to 5% per annum pursuant to the provisions of the Interest Act (Canada). The Ontario Action was subsequently dismissed by the courts for delay. Subsequent to the filing by the Mortgagee of its Statement of Claim and the

Company of its Statement of Defense and Counterclaim, a liquidator (the "Liquidator") of the Mortgagee was appointed by the courts of the Bahamas, where the Mortgagee is situated.

In November of 2005, the Company negotiated a written agreement (the "Settlement Agreement") with the Liquidator to settle all claims pursuant to the Ontario Action for US\$1.1 million (CDN\$1.2 million) (the "Settlement Amount") payable out of closing funds received on the sale of the Company's former head office. The Settlement Agreement is subject to the approval of the Bahamian court that appointed the Liquidator. The Liquidator agreed to seek court approval as soon as possible after signing the Settlement Agreement. The Liquidator did not seek court approval prior to the completion of the head office sale, and in order to allow the sale to proceed, the Liquidator and the Company entered into an escrow arrangement (the "Escrow Agreement"). Pursuant to the Escrow Agreement the Liquidator agreed that upon payment of US\$1.4 million (CDN\$1.6 million) to the Liquidator, to be held in escrow pending court approval of the Settlement Agreement, the Liquidator would deliver a discharge of the Mortgage. It was further agreed that upon approval of the Settlement Agreement by the Bahamian Court \$US1.1 million would be released from escrow and paid to the Liquidator and the balance, US\$303,000 (CDN\$382,000), would be released to the Company. In January 2006, the Liquidator discharged the mortgage, the Company completed the sale of its head office and it paid US\$1.4 million (CDN\$1.6 million) into escrow with the Liquidator's Bahamian counsel.

The Liquidator has continually delayed seeking court approval of the Settlement Agreement and has not yet presented it to the Bahamian court for approval. Since April 2006, the Liquidator has indicated that while still intending to present the Settlement Agreement to the court for its consideration, it will not recommend that the court approve it. In addition, in its February 2007 Affidavit, the Liquidator indicates that if the Court does not approve the Settlement Agreement, it will request that the Bahamian court order that all escrowed funds, including the US\$303,000 (CDN\$382,000) be released to it and not to the Company. The Liquidator further states that the full amount in escrow is insufficient to retire the mortgage principal plus interest at the alleged interest rate of 2% per month and that it may pursue the Company for the deficiency. The Company has retained legal counsel in the Bahamas to assist it in securing court approval of the Settlement Agreement and to ensure that if the Settlement Agreement is not approved, that the escrow continues in accordance with the terms of the Escrow Agreement.

A hearing in the Bahamian court was held on March 20, 2007. At this hearing, the Liquidator submitted additional arguments to the Bahamian court requesting that all matters, including those that form the basis of the Ontario Action, be decided by the Bahamian court. While this request was not ruled upon, the judge issued an order that the escrow funds continue to be held in escrow for at least 90 days to provide the Company an opportunity to bring an action in the Bahamian courts for the release of the funds based upon the non-ratification of the Settlement Agreement. The judge retired shortly thereafter and to this date no new judge has been assigned to hear the matter.

In June 2007, as the Company was not able to bring its action to release the escrow funds to it before the Bahamian courts its Bahamian legal counsel filed a summons in the Leadenhall liquidation proceedings requesting that the Company be granted leave to join the liquidation as an interested party. The Summons was served on the Liquidator in June 2007 and requires that the Company be notified if the Liquidator intends to make

application to have the escrow funds released to it. Since June 2007, the shortage of commercial judges available to hear the case and a lack of co-operation by the Liquidator the Company's Bahamian legal counsel has not been able to obtain a date for a hearing at which a judge will consider the Settlement Agreement. Late in 2008, the Company's Bahamian legal counsel informed the Company that a commercial court judge was assigned to handle all aspects of the Leadenhall liquidation; however, the Company still does not have a date for a hearing. In January 2009, the Company instructed its Bahamian legal counsel to reinitiate dialogue with the Liquidator's counsel for the purpose of attempting to find a mutually agreeable resolution to all outstanding matters between the Company and the Liquidator and to jointly approach the courts to seek approval for any potential resolution of matters.

Paladin Tax Reassessment

On August 16, 2005, the Company sold 100% of the common shares of its subsidiary DHCL (renamed Squire and amalgamated with Paladin) to Paladin. Under the terms of the share purchase agreement ("SPA") with Paladin, the Company provided representations and warranties with respect to the status of the Company's tax accounts and its tax assets, which consisted of noncapital losses, investment tax credits and undeducted scientific research and experimental development expenditures. If the amounts represented are incorrect, then the Company is required to indemnify Paladin for a portion of its losses.

In July and August 2008, Paladin received notices of reassessment relating to its taxation years ending August 16, 2005 and July 31, 2006 and 2007 ("the Tax Years") from the Canada Revenue Agency ("CRA") containing adjustments related to certain transactions occurring in the tax year ended August 16, 2005 that impact all of the Tax Years. Certain provincial tax authorities have also reassessed certain of the Tax Years and other provincial tax authorities may propose similar adjustments as a result of the CRA reassessments. The notices of reassessment, if they stand, could cause the Company to breach certain representations and warranties in the SPA.

The Company estimates its potential obligation under the indemnification provisions of the SPA as a result of the reassessments is in the range of \$6 million to \$8 million, including interest and penalties. In addition, the Company expects the potential obligation under the indemnity to increase as additional interest accrues and penalties are assessed on the reassessed amounts. The SPA also requires the Company to indemnify Paladin for out-of-pocket costs (including attorneys' and experts' fees) incurred by Paladin that are caused by the Company's breach of its representations and warranties contained in the SPA.

The Company disagrees with the position taken by the CRA and believes it is without merit. Paladin is contesting the reassessments through the CRA appeals process and filed a Notice of Objection with the CRA in October 2008. There has been no communication with or from the CRA regarding this matter since this Notice of Objection was filed. The Company is participating in this process. An unfavourable resolution could have a material adverse impact on the Company's cash flows.

Paladin is a "Large Corporation" under subsection 225.1(8) of the Income Tax Act and as a result the CRA took action to collect 50% of the reassessed amount, \$3.7 million, in September 2008. Paladin suggested that it may have a claim against the Company pursuant to the SPA for a portion of the \$3.7 million. However, on November 17, 2008,

the Company and Paladin signed an agreement (the “Letter Agreement”), whereby, the Company agreed to provide security (the “Indemnity Security”) for potential indemnity obligations that arise from or relates to the CRA Reassessments to Paladin and to pay half of Paladin’s ongoing out-of-pocket costs to contest the CRA Reassessments. The Indemnity Security charges the same assets as the security provided by the Company for the convertible debenture held by Paladin. In exchange, Paladin agreed not pursue any claims against the Company for reimbursement of any funds that Paladin may have paid or may be required to pay in connection with the CRA Reassessments while their contestation is continuing, except in circumstances where the Company has or is to determined to have become insolvent as defined in the Letter Agreement.

Research Capital Company (“RCC”)

On September 15, 2006, RCC commenced legal proceedings against the Company by filing a Statement of Claim with the Ontario Superior Court of Justice. The Statement of Claim claimed that RCC was entitled to: (i) damages in the amount of \$1.5 million or alternatively damages of \$1.0 million; (ii) 3 million warrants to purchase Common Shares at a price of \$0.50 and an option to purchase \$5 million of Units of the Company or alternatively to (i) and (ii), \$350,000 and in each case interest and costs. Management of the Company believed that RCC’s claim was without merit. The Company filed a Statement of Defence and Counterclaim in October 2006 and vigorously defended its position. In November 2006, RCC served its reply and defence to the counterclaim but took no further steps to advance the litigation until December 2007 when the Company received RCC’s unsworn affidavit of documents. The Company assembled its affidavit of documents which was served upon RCC and filed with the court. In November 2008, the Company and RCC signed a Full and Final Mutual Release and agreed to dismiss the Claim and Counterclaim without costs. Prior to the Minutes of Settlement and the Full and Final Mutual Release being filed by RCC’s legal counsel with the Ontario Superior Court the Registrar issued an order dismissing the Claim due to delays in proceeding with it. Legal Counsel for the Company and RCC agreed that the dismissal should be withdrawn and replaced by the Minutes of Settlement and the Full and Final Mutual Release. Subsequent to quarter end on April 13, 2009, the Ontario Superior Court issued an order setting aside the Registrar’s dismissal and dismissed the Claim and Counterclaim on consent of the parties.

Recent Accounting Pronouncements

Harmonizing Of Canadian and International Standards

In February 2008, the Accounting Standards Board (“AcSB”) of the CICA confirmed that Canadian GAAP for publically accountable enterprises will be converged with IFRS effective in the calendar year 2011. 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 and disclosures.

Management continues to develop its IFRS changeover plan and the Company’s key finance employees continue to increase their understanding of IFRS and its impact on the Company through formal training and review of current literature including interpretations of current IFRS. However, based on the work completed it continues to be very difficult to finalize a definitive work plan given the quantum of new and updated IFRS standards that are planned over the next two years leading up to adoption. The

Company's conversion plan for 2009 is primarily focused on assessing differences between Canadian GAAP and IFRS, assessing all elective choices to be made under IFRS 1 by first-time adopters of IFRS, making accounting policy choices, where necessary and determining IT and accounting system needs for 2010, when the companies will be required to run a parallel system under IFRS to facilitate 2011 comparative reporting albeit this may be difficult to accomplish given the quantum of changes that are planned to IFRS.

The IASB ("International Accounting Standards Board") has issued several exposure drafts for new or amended IFRS, including consolidation, earnings per share, financial instruments, election options under first time adoption, income taxes and share-based payments that will likely have mandatory application for the 2011 calendar year. Given the quantum of changes planned for IFRS, the Company cannot reasonably assess the financial impact that IFRS will have on its financial statements at this time and it may not be able to do so with any certainty at any time prior to conversion.

Business Combinations

In January 2009, the CICA issued new *Handbook Section 1582, Business Combinations*. Section 1582 will be converged with *IFRS 3, Business Combinations* and replaces *Handbook Section 1581, Business Combinations*. Section 1582 establishes the standards for the measurement of a business combination and states that all assets and liabilities of an acquired business will be recorded at fair value. Obligations for contingent considerations and contingencies will also be recorded at fair value at the acquisition date. The standard also states that acquisition-related costs will be expensed as incurred and that restructuring charges will be expensed in the periods after the acquisition date. This section is effective for acquisition dates on or after January 1, 2011. The Company may elect to early adopt this section and if so, will be required to early adopt *Section 1601, Consolidated Financial Statements* and *Section 1602, Non-controlling Interests*.

Consolidated Financial Statements

In January 2009, the CICA issued *Handbook Section 1601, Consolidated Financial Statements*, which replaces *Handbook Section 1600, Consolidated Financial Statements* other than the standards relating to non-controlling interests. The section establishes the standards for preparing consolidated financial statements and is effective for fiscal years beginning on or after January 1, 2011. The Company may elect to early adopt this section and if so, will be required to early adopt *Section 1582, Business Combinations* and *Section 1602, Non-controlling Interests*.

Non-controlling Interests

In January 2009, the CICA issued new *Handbook Section 1602, Non-controlling Interests*, which establishes standards for the accounting of non-controlling interests of a subsidiary in the preparation of consolidated financial statements subsequent to a business combination. This standard is effective for fiscal years beginning on or after January 1, 2011. The Company may elect to early adopt this section and if so, will be required to early adopt *Section 1582, Business Combinations* and *Section 1601, Consolidated Financial Statements*.

