

# Management's Report

The accompanying consolidated financial statements have been prepared by management and approved by the Board of Directors of the Company. Management is responsible for the information and representations contained in these financial statements and the accompanying Management's Discussion and Analysis. The financial statements have been prepared in accordance with generally accepted accounting principles ("GAAP") in Canada. The significant accounting policies followed by the Company are set out in note 2 to the consolidated financial statements.

To assist management in discharging these responsibilities, the Company maintains a system of procedures and internal controls which are designed to provide reasonable assurance that its assets are safeguarded, that transactions are executed in accordance with management's authorization, and that the financial records form a reliable base for the preparation of accurate and timely financial information.

The Company's external auditors are appointed by the shareholders. They independently perform the necessary tests of accounting records and procedures to enable them to report their opinion as to the fairness of the consolidated financial statements and their conformity with Canadian GAAP.

The Board of Directors ensures that management fulfills its responsibilities for financial reporting and internal control. The Board of Directors exercises this responsibility through an Audit Committee composed of three Directors, all of whom are not involved in the day-to-day operations of the Company. The Audit Committee meets quarterly with management, and with external auditors to review audit recommendations and any matters that the auditors believe should be brought to the attention of the Board of Directors. The Audit Committee reviews the consolidated financial statements and Management's Discussion and Analysis and recommends their approval by the Board of Directors.



Chairman and  
Co-Chief Executive Officer  
February 18, 2010



President and  
Co-Chief Executive Officer  
February 18, 2010



Executive Vice President  
and Chief Financial Officer  
February 18, 2010



**Nuvo Research Inc.**

**Fiscal 2009  
Consolidated Financial Statements  
December 31, 2009**



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## Auditors' Report

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### To the Shareholders of Nuvo Research Inc.

We have audited the consolidated balance sheets of Nuvo Research Inc. as at December 31, 2009 and 2008 and the consolidated statements of income (loss) and comprehensive income (loss), shareholders' equity and cash flows for each of 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, 2009 and 2008 and the results of its operations and its cash flows for each of the years then ended in accordance with Canadian generally accepted accounting principles.

*BDO Canada LLP*

Chartered Accountants, Licensed Public Accountants

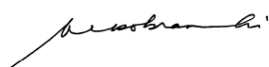
Toronto, Ontario  
February 18, 2010

**NUVO RESEARCH INC.  
CONSOLIDATED BALANCE SHEETS**

	As at December 31, 2009 \$	As at December 31, 2008 \$
(Canadian dollars in thousands)		
<b>ASSETS</b>		
<b>CURRENT</b>		
Cash and cash equivalents (note 4)	42,102	15,219
Accounts receivable	2,091	2,294
Inventories (note 5)	2,078	1,393
Prepaid expenses and other	445	446
<b>TOTAL CURRENT ASSETS</b>	<b>46,716</b>	<b>19,352</b>
Restricted cash (note 4)	-	93
Property, plant and equipment (note 6)	1,834	1,990
<b>TOTAL ASSETS</b>	<b>48,550</b>	<b>21,435</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>CURRENT</b>		
Accounts payable and accrued liabilities	4,589	2,736
Deferred revenue (note 7)	2,241	2,241
Current portion of long-term debt and capital lease obligations (note 8)	79	181
Current portion of debentures (note 9)	3,038	-
<b>TOTAL CURRENT LIABILITIES</b>	<b>9,947</b>	<b>5,158</b>
Deferred revenue (note 7)	1,080	3,321
Long-term debt and capital lease obligations (note 8)	65	320
Debentures (note 9)	-	4,774
<b>TOTAL LIABILITIES</b>	<b>11,092</b>	<b>13,573</b>
<b>SHAREHOLDERS' EQUITY</b>		
Common shares (note 10)	210,086	189,603
Warrants (note 11)	-	10,847
Contributed surplus	12,536	6,890
Accumulated other comprehensive income	114	114
Deficit	(185,278)	(199,592)
<b>TOTAL SHAREHOLDERS' EQUITY</b>	<b>37,458</b>	<b>7,862</b>
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<b>48,550</b>	<b>21,435</b>

See accompanying notes.

On behalf of the Board:



Anthony E. Dobranowski  
Director



Dr. Klaus von Lindeiner  
Director

**NUVO RESEARCH INC.**  
**CONSOLIDATED STATEMENTS OF INCOME (LOSS) AND COMPREHENSIVE INCOME (LOSS)**

	<b>Year ended</b> <b>December 31, 2009</b>	<b>Year ended</b> <b>December 31, 2008</b>
(Canadian dollars in thousands, except per share and share figures)	\$	\$
<b>REVENUE</b>		
Product sales	<b>8,795</b>	8,008
Cost of goods sold	<b>5,534</b>	4,809
<b>Gross margin on product sales</b>	<b>3,261</b>	3,199
<b>Other revenue</b>		
Licensing fees (notes 7 and 12)	<b>29,553</b>	2,514
Research and other contract revenue	<b>299</b>	205
	<b>33,113</b>	5,918
<b>EXPENSES</b>		
Research and development (note 12)	<b>8,575</b>	9,263
Selling, general and administrative expenses (note 13)	<b>6,950</b>	5,204
Stock-based compensation (note 13)	<b>598</b>	803
Amortization of property, plant, and equipment and intangibles and impairment of intangibles (notes 6 and 17)	<b>547</b>	1,068
Foreign currency (gain) loss	<b>689</b>	(93)
Interest expense (note 15)	<b>815</b>	1,283
Interest income	<b>(79)</b>	(497)
	<b>18,095</b>	17,031
<b>Income (loss) from operations</b>	<b>15,018</b>	(11,113)
Change in estimate of contingency (note 16)	-	860
Loss on extinguishment of convertible debenture (note 9)	-	(299)
<b>NET INCOME (LOSS) AND TOTAL COMPREHENSIVE INCOME (LOSS)</b>	<b>15,018</b>	(10,552)
<b>Net income (loss) per common share (note 14)</b>		
<b>basic</b>	<b>\$0.04</b>	\$(0.03)
<b>diluted</b>	<b>\$0.04</b>	\$(0.03)
<b>Average number of common shares outstanding (millions) (note 14)</b>		
<b>basic</b>	<b>363.4</b>	306.3
<b>diluted</b>	<b>400.2</b>	306.3

*See accompanying notes.*

**NUVO RESEARCH INC.**  
**CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY**

(Canadian dollars in thousands, except for number of shares)

	Common shares		Warrants	Contributed surplus	Accumulated other comprehensive income	Deficit	Shareholders' equity	
	(000s)	\$	\$	\$	\$	\$	\$	
	Note	9,10,11,13	9,10,11,13	10,11	9,11,13	9		
Balance, December 31, 2007		299,460	187,877	11,243	5,670	114	(189,040)	15,864
Issuance of shares and warrants		7,692	967	33	-	-	-	1,000
Issuance of shares to settle accounts payable		1,762	214	-	-	-	-	214
Costs related to issuance of shares and warrants		-	(55)	(1)	-	-	-	(56)
Employee contributions to Share Purchase Plan		1,566	169	-	-	-	-	169
Employer's portion of Share Purchase Plan		1,566	169	-	-	-	-	169
Debentures converted		1,087	107	-	-	-	-	107
Shares issued under the Share Bonus Plan		191	18	-	-	-	-	18
Issuance of shares to acquire intangible asset		962	125	-	-	-	-	125
Professional fees settled in shares		135	12	-	-	-	-	12
June 2006 Underwriter Warrants expired		-	-	(428)	428	-	-	-
Issuance of July 2008 Convertible Debenture		-	-	-	176	-	-	176
Stock option compensation expense		-	-	-	616	-	-	616
Net loss		-	-	-	-	-	(10,552)	(10,552)
Balance, December 31, 2008		314,421	189,603	10,847	6,890	114	(199,592)	7,862
Warrants converted		58,650	17,125	(5,483)	-	-	-	11,642
Debentures converted		18,116	3,156	-	(176)	-	(704)	2,276
Costs related to issuance of shares		-	(88)	-	-	-	-	(88)
Stock option exercise		150	50	-	(20)	-	-	30
Employee contributions to Share Purchase Plan		338	120	-	-	-	-	120
Employer's portion of Share Purchase Plan		338	120	-	-	-	-	120
June 2006 Warrants expired		-	-	(424)	424	-	-	-
July 2007 Warrants expired		-	-	(288)	288	-	-	-
November 2004 Warrants expired		-	-	(4,652)	4,652	-	-	-
Stock option compensation expense		-	-	-	478	-	-	478
Net income		-	-	-	-	-	15,018	15,018
<b>Balance, December 31, 2009</b>		<b>392,013</b>	<b>210,086</b>	<b>-</b>	<b>12,536</b>	<b>114</b>	<b>(185,278)</b>	<b>37,458</b>

See accompanying notes.

**NUVO RESEARCH INC**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

	Year ended December 31, 2009	Year ended December 31, 2008
(Canadian dollars in thousands)	\$	\$
<b>OPERATING ACTIVITIES</b>		
Net income (loss)	15,018	(10,552)
Items not involving current cash flows:		
Amortization	547	1,068
Deferred revenue recognized (note 7)	(2,241)	(1,832)
Stock-based compensation and payments (note 13)	598	815
Deferred stock unit expense (note 13)	225	-
Accretion of interest on debentures (note 9)	538	828
Loss on extinguishment of convertible debenture (note 9)	-	299
Change in estimate in contingency (note 16)	-	(860)
Unrealized foreign exchange loss (gain)	488	(214)
Other	(75)	49
Net change in non-cash working capital (note 18)	1,161	270
Deferred proceeds from licensing arrangements (note 7)	-	1,014
<b>CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES</b>	<b>16,259</b>	<b>(9,115)</b>
<b>INVESTING ACTIVITIES</b>		
Acquisition of property, plant and equipment	(391)	(151)
Proceeds from sale of assets	-	28
<b>CASH USED IN INVESTING ACTIVITIES</b>	<b>(391)</b>	<b>(123)</b>
<b>FINANCING ACTIVITIES</b>		
Issuance of common shares and warrants, net of related costs (note 11)	11,704	1,115
Issuance of debentures, net of related costs (note 9)	-	1,956
Costs related to the November 2004 Unsecured Convertible Debenture amendments (note 9)	-	(32)
Repayments of long-term debt and capital lease obligations	(243)	(630)
<b>CASH PROVIDED BY FINANCING ACTIVITIES</b>	<b>11,461</b>	<b>2,409</b>
Effect of exchange rate changes on cash and cash equivalents	(446)	257
Net change in cash and cash equivalents during the year	26,883	(6,572)
Cash and cash equivalents, beginning of year	15,219	21,791
<b>CASH AND CASH EQUIVALENTS, END OF YEAR</b>	<b>42,102</b>	<b>15,219</b>
<b>Interest paid</b>	<b>363</b>	<b>256</b>

See accompanying notes.

Significant non-cash financing activities are discussed in notes 8 & 11.

**NUVO RESEARCH INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Unless noted otherwise all amounts shown are in thousands of Canadian dollars**

**1. NATURE OF BUSINESS AND GOING CONCERN ASSUMPTION**

Nuvo Research Inc. ("Nuvo" or the "Company") is a publicly traded Canadian drug development company with manufacturing operations. Nuvo develops products internally in order to enter into strategic alliances or licensing agreements with national or international pharmaceutical companies that have the necessary resources and distribution networks to market and sell its pharmaceutical products. The Company's primary research and development is directed towards drug products that are delivered into and through the skin. Nuvo is also involved in research and development activities involving WF10, a chlorite based immunomodulating drug, through its 60% ownership in Dimethaid AG. The Company refers to and manages these activities as two distinct business and research segments: Pain, utilizing the Company's topical and transdermal drug delivery ("TTDD") platform, and Immunology, utilizing the Company's immune system regulation ("ISR") platform.

**Pain**

The Pain segment utilizes the Company's TTDD platform to develop drugs for the treatment of pain. The TTDD platform is based upon the use of molecular skin penetration enhancers and transdermal carriers, to deliver drugs into and through the skin directly to the disease site. Pennsaid®, the Company's lead product, is used to treat the pain and symptoms associated with knee osteoarthritis ("OA"). Pennsaid, combines a transdermal carrier 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 has completed the development stage and commercial activities are underway in North America and parts of Europe.

**Immunology**

The immune system provides an essential defense to micro organisms, cancer and substances it sees as foreign and potentially harmful. The Company's ISR platform, WF10, a proprietary solution of OXO-K993 focuses on supporting the immune system. Oxoferin™, a diluted form of WF10, is a topical wound healing agent. It completed the development stage and has been commercialized in several countries in Europe, Asia and South America. Research and development activities surrounding WF10 for use in other indications are ongoing.

**Going concern**

These consolidated financial statements have been prepared on a going concern basis, which presumes that the Company will be able to realize its assets and discharge its liabilities in the normal course of operations for the foreseeable future. At December 31, 2009, the Company has an accumulated deficit of \$185,278. Although the Company had net income of \$15,018 in 2009, it included \$27,312 of Pennsaid milestone and licensing payments received pursuant to the U.S. Licensing Agreement with Mallinckrodt Inc., a subsidiary of Covidien plc ("Covidien") (see note 12) that will not recur. The Company's ability to continue as a going concern depends on the successful launch of Pennsaid in the U.S., as it will earn royalties and sales milestone payments based on net sales, and its ability to secure additional licensing fees, secure co-development agreements, obtain additional capital, gain regulatory approval for other drugs and ultimately achieve profitable operations.

These consolidated financial statements do not include any 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.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**General**

These consolidated financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles ("Canadian GAAP"). The most significant accounting policies are summarized below.

### Use of estimates

The preparation of financial statements in conformity with Canadian GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting periods. Significant estimates include, but are not limited to, revenue recognition, the period over which certain deferred revenue is recognized, long-lived asset valuations including impairment assessments, government assistance, the measurement of the valuation allowance for future tax assets, tax credits, convertible debentures, foreign currency translation, the assessment of outstanding legal and tax matters and contingencies, as well as stock-based compensation and other equity-based instruments. The Company reviews all significant estimates affecting the consolidated financial statements on a regular basis and records the effect of any adjustments when necessary. Actual results could differ from estimates and such differences could be material.

### Basis of consolidation

These consolidated financial statements include the accounts of the Company and all of its subsidiaries the most significant of which are as follows:

	% Ownership	
	December 31, 2009	December 31, 2008
fqubed, Inc.	100%	100%
Dimethaid (UK) Ltd.	100%	100%
Dimethaid Immunology Inc.	100%	100%
Dimethaid AG and its subsidiaries: Dimethaid GmbH; and, Nuvo Research GmbH	60%	60%

All significant inter-company balances and transactions have been eliminated upon consolidation.

### Cash and cash equivalents

Cash and cash equivalents include only highly liquid investments with original maturities of three months or less. Cost approximates fair value.

### Inventories

Inventory is comprised of raw materials, work-in-process and finished goods. Raw materials are stated at the lower of cost and replacement cost with cost determined on a first-in, first-out basis. Manufactured inventory (finished goods and work-in-process) is valued at the lower of cost and net realizable value determined on a first-in, first-out basis. Manufactured inventory cost includes the cost of raw materials, direct labour and an allocation of overhead.

### Property, plant and equipment

Property, plant and equipment are recorded at cost. Assets acquired under capital leases are carried at cost that is the present value of minimum lease payments after deduction of any executory costs.

Amortization of property, plant and equipment is provided for over the estimated useful lives from the date the asset becomes available for use as follows:

Buildings	10 to 25 years	Straight line
Leasehold improvements	Term of lease	Straight line
Furniture and fixtures	5 years	Straight line
Computer equipment	3 years	Straight line
Computer software	1 to 3 years	Straight line
Production, laboratory and other equipment	3 to 5 years	Straight line

**Impairment of long-lived assets**

Long-lived assets are comprised of property, plant and equipment. The Company reviews the carrying value of long-lived assets for potential impairment when there is evidence that events or changes in circumstances exist that indicate the carrying value might not be recoverable. The recoverability of long-lived assets is determined by evaluating whether the carrying value of such assets can be recovered from estimated undiscounted future operating cash flows. When an asset is impaired, according to the foregoing test, an impairment loss is measured and recognized as the excess of the carrying value of the asset over its fair value.

**Financing costs**

Financing costs associated with the issuance of debt are netted against the related debt and are deferred and amortized over the term of the related debt using the effective interest method.

**Leases**

Leases are classified as either capital or operating. Those leases which transfer substantially all the benefits and risks of ownership of property to the Company are accounted for as capital leases. The capitalized lease obligation reflects the present value of future lease payments, discounted at the appropriate interest rate. Assets under capital leases are amortized based on the useful life of the asset. All other leases are accounted for as operating with rental payments being expensed on a straight-line basis.

**Financial instruments**

All financial instruments are classified into one of the following five categories: held for trading, held-to-maturity investments, loans and receivables, available-for-sale assets or other financial liabilities. All financial instruments, including derivatives, are included on the balance sheet and are measured at fair market value upon inception. Subsequent measurement and recognition of changes in the fair value of financial instruments depends on their initial classification. Held-for-trading financial investments are measured at fair value and all gains and losses are included in operations in the period in which they arise. Available-for-sale financial instruments are measured at fair value with revaluation gains and losses included in other comprehensive income until the asset is removed from the balance sheet. Loans and receivables, investments held to maturity and other financial liabilities are measured at amortized cost using the effective interest method. Gains and losses upon inception, impairment write-downs and foreign exchange translation adjustments are recognized immediately.

The Company classifies its financial instruments as follows:

- Cash and cash equivalents are classified as held-for-trading and any period change in fair value is recorded through income.
- Accounts receivable are classified as loans and receivables and are measured at amortized cost. Interest income is recorded in net income, as applicable.
- Restricted cash is classified as held-to-maturity and measured at amortized cost.
- Accounts payable, accruals, long-term debt, capital lease obligations and convertible debentures are classified as other financial liabilities and are measured at amortized cost using the effective interest method. Interest expense is recorded in income, as applicable.

**Comprehensive income (loss)**

Comprehensive income (loss) is the change in equity from transactions and other events and circumstances from non-shareholder sources. Other comprehensive income (loss) refers to items recognized in comprehensive income (loss), but that are excluded from net income (loss) calculated in accordance with GAAP. The Company has "accumulated other comprehensive income" in the amount of \$114 relating to historic cumulative translation adjustments for previously self-sustaining foreign operations. Since May 31, 2005, all foreign operations have been considered integrated operations such that all foreign currency translation gains and losses since May 31, 2005 have been included in net income (loss). A separate statement of comprehensive income (loss) has not been presented as there are no components of comprehensive income (loss) in the years ended December 31, 2009 and 2008.

**Revenue recognition**

The Company recognizes revenue from product sales, research and development collaborations and licensing arrangements which may include multiple elements. Revenue arrangements with multiple

elements are reviewed in order to determine whether the multiple elements can be divided into separate units of accounting, if certain criteria are met. If separable, the consideration received is allocated among the separate units of accounting based on their respective fair values, and the applicable revenue recognition criteria are applied to each of the separate units. If not separable, the applicable revenue recognition criteria are applied to combined elements as a single unit of accounting.

Revenue from product sales is recognized upon shipment of the product to the customer provided transfer of title to the customer occurs upon shipment and provided the Company has not retained any significant risks of ownership or future obligations with respect to the product shipped, the price is fixed and determinable and collection is reasonably assured. Where applicable, revenue from product sales is recognized net of reserves for estimated sales discounts and allowances, returns, rebates and charge backs.

For upfront non-refundable payments received in accordance with the execution of licensing and collaboration agreements, distribution agreements and supply agreements revenue is deferred and recognized over the performance period, the period over which the Company maintains substantive contractual obligations. If the Company cannot reasonably estimate when its substantive contractual obligations cease then the revenue is deferred indefinitely. Once a reasonable estimate can be made, the amount deferred is recognized as revenue in accordance with the policy described above. Amounts the Company expects to earn in the current year are included in the current portion of deferred revenue and amounts expected to be earned in subsequent periods are included in deferred revenue. The term over which up-front fees are recognized can be revised if the period over which the Company maintains substantive contractual obligations changes.

Milestone payments are immediately recognized as licensing revenue when the condition is met, the milestone is not a condition to future deliverables and collectability is reasonably assured. Otherwise, they are recognized over the remaining term of the agreement or the performance period.

Revenues from research and development collaborations are generally recognized as the contracted services are performed and the related expenditures are incurred pursuant to the terms of the agreement and provided collectability is reasonably assured. Amounts received in advance of recognition are included in deferred revenue.

### **Research and development**

Research costs, other than capital expenditures, are charged to operations as incurred. Development expenses are charged to operations as incurred unless such costs meet Canadian GAAP criteria for deferral and amortization. No development costs have been deferred to date.

### **Government assistance**

Government assistance received under incentive programs, including investment tax credits for qualifying research and development activities, is accounted for using the cost reduction method, whereby the assistance is netted against the related expense or capital expenditure to which it relates when there is reasonable assurance that the credits will be realized.

Government assistance received under reimbursement or funding programs are accounted for using the cost reduction method, whereby a receivable is set-up as the costs are incurred based on the terms of reimbursement or funding program and the expected recoveries are netted against the related expense.

### **Foreign currency translation**

Transactions undertaken in foreign currencies are translated at exchange rates prevailing at the time the transaction occurred. Monetary assets and liabilities denominated in foreign currencies are translated at the exchange rate prevailing on the Consolidated Balance Sheet dates. Non-monetary assets and liabilities are translated at historical exchange rates. Exchange gains and losses are included in the Consolidated Statements of Income (Loss).

All subsidiaries are considered to be integrated operations and are translated into Canadian dollars using the temporal method; consequently, all monetary assets and liabilities are remeasured at the exchange rate prevailing at the Consolidated Balance Sheet dates. Non-monetary assets and liabilities are measured at historical exchange rates. Revenue and expense items are measured at the average rate of exchange in effect during the period in which they occur, except for amortization expense which is

measured at the historic exchange rate of the applicable asset. Resulting gains and losses are included in income during the period in which they occur.

### **Net income or loss per common share**

Basic net income or loss per common share is calculated using the weighted average number of common shares outstanding during the year.

Diluted net income or loss per common share is calculated assuming the weighted average number of common shares outstanding during the year is increased to include the number of additional common shares that would have been outstanding if the dilutive potential shares had been issued. The dilutive effect of warrants and stock options is determined using the treasury stock method. The treasury stock method assumes that the proceeds from the exercise of warrants and options are used to purchase common shares at the volume weighted average market price during the year. The dilutive effect of convertible securities is determined using the "if-converted" method. The "if-converted" method assumes that the convertible securities are converted into common shares at the beginning of the year and all income charges related to the convertible securities are added back to income.

### **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 differences between the financial reporting and tax bases of assets and liabilities and are measured using substantively enacted tax rates and laws expected to apply when the asset is realized or the liability settled. A valuation allowance is provided against the future tax assets to the extent that is more likely than not that the assets will not be realized.

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

The Company has four stock-based compensation plans: the Share Option Plan; the Share Purchase Plan; and the Share Bonus Plan, are each a component of the Company's Amended and Restated Share Incentive Plan and the fourth is the Deferred Share Unit Plan, all are described in note 13.

#### *Share Incentive Plan ("Share Incentive Plan")*

The Company measures and recognizes compensation expense for the Share Incentive Plan based on the fair value of the common shares or options issued.

Under the Share Option Plan, the Company issues either fixed awards or performance based options. For fixed award options, the fair value of an option is estimated on the date of the grant using the Black-Scholes option pricing model and is amortized as compensation expense over the vesting period. These expenses are included in stock-based compensation expense and credited to contributed surplus. When options are exercised, the proceeds received by the Company, together with the fair value amount in contributed surplus, are credited to common shares. Share options issued to non-employees are recorded as an expense at their fair value on the date they are earned. For performance-based options, the fair value is recognized over the estimated period to achievement of certain milestones.

Under the Share Purchase Plan, consideration paid by employees on the purchase of common shares is credited to common shares when the shares are issued. The fair value of the Company's matching contribution, determined based upon the trading price of the common shares, is recorded as compensation expense. These expenses are included in stock-based compensation expense and credited to common shares.

Under the Share Bonus Plan, the fair value of the direct award of common shares, determined based upon the trading price of the common shares, is recorded as compensation expense. These expenses are included in stock-based compensation expense and credited to common shares.

#### *Deferred Share Unit ("DSU") Plan*

Under the DSU Plan, the Company issues DSUs to non-employee directors. DSUs that are intended to be settled in cash are recorded as liabilities. Upon issuance, the fair value of the DSUs is recorded as compensation expense and a corresponding liability (the "DSU Accrual") is established using the underlying value of the common shares. At all subsequent reporting dates, the DSU Accrual is adjusted to the market value of the underlying shares and the adjustment is recorded as compensation cost.

Forfeitures of awards are accounted for in the period in which they occur. This policy was adopted by the Company upon establishment of the DSU Plan on January 1, 2009.

#### **Issuance costs of equity instruments**

The Company records issuance costs of equity instruments against the equity instrument that was issued.

#### **Changes 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 Issues 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 came into effect for interim and annual periods beginning on or after January 1, 2009. Upon adoption, there was no impact on the Company's consolidated financial statements.

##### ***Financial Instruments Disclosures***

In June 2009, the CICA amended *Section 3862, Financial Instruments – Disclosures*, to include additional disclosure requirements about fair market value measurements for financial instruments and liquidity risk disclosures. These amendments require a three-level hierarchy that reflects the significance of the inputs used in making the fair value measurements. Fair values of assets and liabilities included in Level 1 are determined by reference to quoted prices in active markets for identical assets and liabilities. Assets and liabilities in Level 2 include valuations using inputs other than quoted prices for which all significant outputs are observable, either directly or indirectly. Level 3 valuations are based on inputs that are unobservable and significant to the overall fair value measurement. This new standard became effective for the Company on December 31, 2009. The Company has assessed its financial instruments that are reported at market value, cash and cash equivalents and restricted cash, and determined that they are based on Level 1 inputs.

### **3. NEW ACCOUNTING PRONOUNCEMENTS**

#### **Harmonizing Of Canadian and International Standards**

In February 2008, the Accounting Standards Board ("AcSB") of the CICA confirmed that Canadian GAAP for publicly 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. In the period leading up to the conversion, the AcSB will continue to issue accounting standards that are converged with IFRS, thus mitigating the impact of adopting IFRS at the mandatory transition date. The Company continues to monitor changes arising from this convergence and, as required by CSA Staff Notice 52-320, the Company has included a discussion of the key elements and timing of its IFRS changeover plan in its Management's Discussion & Analysis ("MD&A").

#### **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*.

### **Multiple Deliverable Revenue Arrangements**

In December 2009, the CICA issued *EIC 175, Multiple Deliverable Revenue Arrangements*, replacing *EIC 142, Revenue Arrangements with Multiple Deliverables*. This abstract was amended to: (1) provide updated guidance on whether multiple deliverables exist, how the deliverables in an arrangement should be separated and the consideration allocated; (2) require, in situations where a vendor does not have vendor-specific objective evidence ("VSOE") or third-party evidence of selling price, that the entity allocate revenue in an arrangement using estimated selling prices of deliverables; (3) eliminate the use of the residual method and require an entity to allocate revenue using the relative selling price method; and (4) require expanded qualitative and quantitative disclosures regarding significant judgments made in applying this guidance. The accounting changes summarized in EIC 175 are effective for fiscal years beginning on or after January 1, 2011, with early adoption permitted. Adoption may either be on a prospective basis or by retrospective application. If the Abstract is adopted early, in a reporting period that is not the first reporting period in the entity's fiscal year, it must be applied retroactively from the beginning of the Company's fiscal period of adoption. The Company is currently assessing the future impact of these amendments on its financial statements and has not determined the timing and method of its adoption.

## **4. RESTRICTED CASH**

At December 31, 2008, the Company had \$170 in term deposits that were posted as collateral against the previously outstanding mortgage included in long-term debt. A portion of these term deposits \$77, was included in cash and cash equivalents to offset the then current portion of this long-term debt. The mortgage was repaid in full during 2009 and the cash collateral was released. (see note 8 – "Long-Term Debt and Capital Lease Obligations – Mortgage").

## 5. INVENTORIES

Inventories consist of the following as at:

	December 31, 2009	December 31, 2008
	\$	\$
Raw materials	1,015	453
Work in process	269	271
Finished goods	794	669
	<b>2,078</b>	<b>1,393</b>

## 6. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment consists of:

	As at December 31, 2009		
	Cost	Accumulated amortization	Net book value
	\$	\$	\$
Land	124	-	124
Buildings	2,122	1,217	905
Leasehold improvements	123	75	48
Furniture and fixtures	271	224	47
Computer equipment	335	311	24
Computer software	444	406	38
Production, laboratory and other equipment <sup>(i)</sup>	3,274	2,626	648
	<b>6,693</b>	<b>4,859</b>	<b>1,834</b>

	As at December 31, 2008		
	Cost	Accumulated amortization	Net book Value
	\$	\$	\$
Land	124	-	124
Buildings	2,105	1,066	1,039
Leasehold improvements	123	53	70
Furniture and fixtures	271	184	87
Computer equipment	326	296	30
Computer software	442	334	108
Production, laboratory and other equipment <sup>(i)</sup>	2,911	2,379	532
	<b>6,302</b>	<b>4,312</b>	<b>1,990</b>

- (i) Production, laboratory and other equipment at December 31, 2009 includes cost of \$339 [2008 - \$339] and accumulated amortization of \$123 [2008 - \$55] for assets under capital leases. Amortization of property, plant and equipment for the year ended December 31, 2009 includes \$68 [2008- \$28] related to assets under capital leases.

## 7. DEFERRED REVENUE

Deferred revenue is as follows:

	December 31, 2009 \$	December 31, 2008 \$
Balance, beginning of year	5,562	6,380
Upfront Payment from Paladin	-	1,014
	<b>5,562</b>	7,394
<i>less:</i>		
Amortization of license and supply agreements	2,241	1,621
Delivery of promotional goods under supply agreement	-	200
Recognition of prior year research contract revenue	-	11
Balance, end of year	<b>3,321</b>	5,562
Amount to be recognized within one year	<b>2,241</b>	2,241
Long-term balance	<b>1,080</b>	3,321

### Paladin Agreement

On July 7, 2008, the Company and its Canadian distributor, Paladin, reached an agreement to amend and restate the Pennsaid and Pennsaid Plus licensing, supply and other arrangements. Under the terms of the new arrangements, Paladin made payments totaling \$2.5 million to the Company as follows:

- a. \$0.6 million in full settlement of the Ontario Innovation Tax Credit's ("OITC"). This amount relates to potentially refundable OITCs that were transferred to Paladin as part of the sale of the common shares of Dimethaid Health Care Limited ("DHCL") in August 2005. Under the terms of the agreement, any amounts received would be returned to Nuvo, subject to holdback provisions. As part of the amended and restated agreements, Paladin returned this amount to the Company;
- b. \$0.9 million to settle obligations under the original licensing arrangements incurred prior to July 7, 2008. This amount had not previously been considered earned by the Company as it was only payable by Paladin upon the attainment of certain future performance targets for Pennsaid in Canada, the achievement of which could not be reasonably estimated up to the point of executing the new licensing, supply and other arrangements; and,
- c. \$1.0 million as a prepayment of future royalties relating to Canadian sales of Pennsaid for the period from July 7, 2008 through December 31, 2010.

As part of the new arrangements, the Company no longer has an ongoing obligation relating to the market performance of Pennsaid in the Canadian market that could have resulted in potential payments to Paladin and it no longer has the right to receive a share of future operating profits that exceed specified targets. Under the new arrangements, effective January 1, 2011, Paladin will pay the Company a royalty based upon Canadian sales of Pennsaid for the duration of the term which was increased to 99 years and now ends in August 2104.

Under the amended and restated Pennsaid Plus license agreement, Paladin acquired the rights to market Pennsaid Plus in some additional territories, including South Africa and Israel, (the "Additional Territories") and will pay the Company royalties on future sales of Pennsaid Plus in Canada and these additional territories and a potential milestone payment. Additionally in 2009, under the terms of this agreement, the territories of Central and South America were added to the Additional Territories as the Company did not license these territories to Covidien by December 31, 2009.

In addition, Paladin invested \$2.0 million in the Company by way of a two-year convertible debenture that paid interest at 8% per annum and was convertible into Nuvo common shares at a price of \$0.138 per share. This debenture was converted into Nuvo common shares during 2009 (see note 9 – "Debentures").

## 8. LONG-TERM DEBT AND CAPITAL LEASE OBLIGATIONS

Long-term debt and capital lease obligations consist of the following as at:

	December 31, 2009 \$	December 31, 2008 \$
Mortgage	-	231
Capital lease obligations	144	270
	144	501
Less amounts due within one year	79	181
Balance, end of year	65	320

### Mortgage

During 2009, the Company requested that the mortgage holder apply the cash collateral, which was in excess of the remaining mortgage principal, to the outstanding mortgage balance, waive any early repayment penalties and interest and return the excess cash collateral to the Company. In November 2009, the mortgage holder agreed to the request and applied Euro 92 to the then outstanding mortgage balance and returned Euro 18 of cash collateral including interest to the Company. This mortgage was collateralized by the plant, equipment and inventory of the Company's subsidiary located in Wanzleben, Germany. Interest was fixed at 6.0% per annum and payable quarterly.

### Capital lease obligations

The Company leases lab and office equipment under capital leases expiring at various dates through November 2011, for which the minimum future lease payments are as follows for the years ending December 31:

	\$
2010	89
2011	67
Total minimum lease payments	156
Less: amount representing interest (approximately 9.1%)	(12)
Present value of minimum lease payments	144
Current portion of capital lease obligations	79
	65

For the year ended December 31, 2009, interest paid on capital lease obligations amounted to \$20 [2008 - \$13]. The Company's capital lease obligations are denominated in both Canadian and U.S. dollars. As at December 31, 2009, \$152 [2008 - \$291] of minimum lease payments were denominated in U.S. dollars.

Aggregate maturities of capital lease obligations are estimated to be as follows for the years ending December 31:

	\$
2010	79
2011	65
	144

## 9. DEBENTURES

The following table summarizes the debentures outstanding as at:

	Face Value	Carrying Value	
	December 31, 2009 \$	December 31, 2009 \$	December 31, 2008 \$
November 2004 Unsecured Convertible Debentures, interest payable semi-annually at 5%, maturing November 2010, convertible into common shares at \$0.138 <sup>(i)</sup>	3,486	3,038	2,948
July 2008 Convertible Debenture, interest payable semi-annually at 8%, maturing July 2010, collateralized and convertible into common shares at \$0.138 <sup>(ii)</sup>	-	-	1,826
	<b>3,486</b>	<b>3,038</b>	<b>4,774</b>

- (i) On September 18, 2008 (the "Amendment Date"), the Company amended the terms of the November 2004 Unsecured Convertible Debentures, pursuant to a written resolution, whereby the November 2004 Unsecured Convertible Debenture Holders had agreed to amend certain terms of the November 2004 Convertible Unsecured Debentures. The terms were amended to extend the maturity date of the November 2004 Unsecured Convertible Debentures by one year from November 16, 2009 to November 16, 2010 and to adjust the conversion price of all November 2004 Debentures (including those held by directors and officers) to \$0.138, the five day volume-weighted average trading price of Nuvo common shares as of August 1, 2008, the date the offer to the debenture holders was announced. The November 2004 Unsecured Convertible Debentures were originally convertible into Nuvo common shares at a conversion price of \$0.30 per share except for certain debentures held by directors and officers of Nuvo, which were convertible at a price of \$0.39 per share. The amendments to the Debentures resulted in a significant change to their future cash flows and as a consequence the transaction was accounted for as an extinguishment of the then outstanding November 2004 debentures ("Old Debentures") and an issuance of new November 2004 debentures under the amended terms ("New Debentures"). The carrying value of the Old Debentures was \$2,654 on the Amendment Date and the Company determined the fair value of the debt component of the New Debentures to be \$2,953 using a discount rate of 25%. The difference between the carrying value of the Old Debentures and the fair value of the New Debentures of \$299 was recorded as a loss in 2008.

For the year ended December 31, 2009, \$500 of these convertible debentures were converted into 3.623 million common shares at \$0.138. The Company followed the guidance of EIC Abstract 96, "Accounting for the Early Extinguishment of Convertible Securities through 1) Early Redemption or Repurchase and 2) Induced Early Conversion". Accordingly, the Company recorded a charge of \$704 through deficit representing the incremental consideration received by the debenture holder through the conversion option.

Subsequent to year end, the Company announced that it will be redeeming these Debentures (see note 27).

- (ii) On July 7, 2008, in connection with the agreement to amend and restate the licensing arrangements with Paladin, as described in note 7, Paladin invested \$2.0 million in the Company by way of a two-year convertible debenture. This debenture was collateralized by revenue from Pennsaid sales in Europe, a mortgage over Nuvo's manufacturing facility in Québec, a charge on all manufacturing assets and inventory in Québec and the Company's manufacturing intellectual property rights to the extent required to manufacture and market Pennsaid in Canada. Upon issuance, the Company determined the fair value of the debt component of the debenture to be \$1,824 using a discount rate of 13.6% and allocated the balance of \$176, related to the conversion feature, to contributed surplus. Transaction costs of \$44 were recorded as a reduction to the carrying value of the debenture and as a result the effective interest rate of the debenture is approximately 15%. This debenture was converted into 14.493 million common shares in 2009.

The following is a continuity schedule of the debentures outstanding:

	Common shares issuable upon conversion (000s)	Carrying value \$	Value at Maturity \$
Balance, December 31, 2007	14,236	2,506	4,636
Repayment of convertible debenture	(833)	(500)	(500)
Issuance of July 2008 Convertible Debenture, net of related costs	14,493	1,780	2,000
Amendments to November 2004 Unsecured Convertible Debentures, net of related costs	16,568	267	-
November 2004 Unsecured Convertible Debentures converted into common shares	(1,087)	(107)	(150)
Accretion charged to interest expense		828	
Balance, December 31, 2008	43,377	4,774	5,986
July 2008 Convertible Debenture converted into common shares	(14,493)	(1,868)	(2,000)
November 2004 Unsecured Convertible Debentures converted into common shares	(3,623)	(406)	(500)
Accretion charged to interest expense		538	
<b>Balance, December 31, 2009</b>	<b>25,261</b>	<b>3,038</b>	<b>3,486</b>

## 10. CAPITAL STOCK

### Authorized

- Unlimited first and second preferred shares, non-voting, non-participating, issuable in series, number, designation, rights, privileges, restrictions and conditions are determinable by the Company's Board of Directors.
- Unlimited common shares, voting, without par value.

### Transactions

On May 29, 2008, the Company closed a private placement equity financing with Paladin (the "May 2008 Financing"). At closing, a total of 7,692,307 common shares of the Company were issued to Paladin at a price of \$0.13 per share for gross proceeds of \$1 million. In addition, the Company issued 769,230 common share purchase warrants of the Company (the "Paladin Warrants"), each whole warrant entitling Paladin to acquire one common share at a price of \$0.169 per share until May 29, 2010. Once expenses associated with the financing of \$54 were deducted, net cash proceeds were \$946. The warrants were valued using the Black-Scholes option pricing model with \$32 of the net cash proceeds being allocated to the Paladin Warrants and the balance of \$914 allocated to the common shares.

On May 16, 2008, the Company negotiated the settlement of an outstanding accounts payable owing to a key supplier. The settlement consisted of a cash payment of \$214 and the issuance of 1,761,675 Nuvo common shares with a fair value of \$214. The Company incurred share issuance costs of \$2 which were recorded against the common shares.

### Shareholders' rights plan

The Company initially instituted a shareholder rights plan (the "Rights Plan") in 1992. Since that time, the Rights Plan has been amended, restated and continued from time-to-time. Most recently, in May 2008, the shareholders approved certain amendments to the Rights Plan including continuing it until the annual meeting of shareholders in 2013. The Rights Plan is intended to provide some protection to shareholders of the Company from unfair take-over strategies, including the acquisition of control of the Company by a bidder in a transaction or series of transactions that does not treat all shareholders equally or fairly or afford all shareholders an equal opportunity to share in the premium paid upon an acquisition of control. One right is, or will be, issued in respect of each outstanding common share. The rights become exercisable only when an acquiring person acquires or announces its intention to acquire 20% or more of the Company's outstanding common shares without complying with the "permitted bid" provisions of the

Rights Plan. Subject to the terms of the Rights Plan, each right will entitle the holder thereof to purchase a common share of the Company at a 50% discount to the market price..

## 11. WARRANTS

The warrants previously outstanding by tranche were as follows:

	Expiry date	Exercise price \$	As at	
			December 31, 2009 <sup>(i)</sup> (000s)	December 31, 2008 (000s)
November 2004 Warrants	November 16, 2009	0.48	-	20,012
June 2006 Warrants	June 20, 2009	0.50	-	3,902
July 2007 Underwriter Warrants	July 13, 2009	0.20	-	5,000
July 2007 Warrants	July 13, 2009	0.30	-	50,000
Paladin Warrants	May 29, 2010	0.169	-	769
			-	79,683

(i) In 2009, 58,650 warrants were converted to common shares, 23,470 warrants expired and 2,437 additional July 2007 Warrants were issued upon the exercise of the July 2007 Underwriter Warrants.

### Warrant Incentive Programs

On January 6, 2009, the Company announced that the Toronto Stock Exchange ("TSX") had approved a warrant incentive program designed to encourage the early exercise of June 2006 Warrants, July 2007 Warrants and November 2004 Warrants (the "2009 Warrant Incentive Program"). 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 (which represented the 5-day volume weighted average trading price of Common Shares as at the time the 2009 Warrant Incentive Program was announced) 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 Company provided the holders of the June 2006 Warrants, the July 2007 Warrants and the November 2004 Warrants an exercise period that commenced on January 21, 2009 and ended on April 3, 2009. Any warrants not exercised under the 2009 Warrant Incentive Program continued to be exercisable for Common Shares on the same terms as previously existed. Total proceeds received from the 2009 Warrant Incentive Program, net of professional fees, were \$3.7 million from the exercise of: 3.2 million November 2004 Warrants; 0.8 million June 2006 Warrants; and, 26.8 million July 2007 Warrants.

Subsequent to the expiry of the 2009 Warrant Incentive Program, the Company received proceeds of \$7.8 million from the exercise of: 25,000 June 2006 Warrants; 0.8 million Paladin Warrants; and, 27.2 million July 2007 Warrants.

## 12. LICENSE FEES

On June 15, 2009 (the "Effective Date"), the Company entered into a License and Development Agreement ("U.S. Licensing Agreement") with Mallinckrodt, Inc., a subsidiary of Covidien, granting Covidien exclusive rights to market and sell Pennsaid in the United States through the transfer of the New Drug Application ("NDA") to Covidien upon FDA approval in the United States. Under the terms of the agreement, Nuvo received a non-refundable upfront payment of \$11.3 million (US\$10 million) (the "Initial Payment") upon signing the U.S. Licensing Agreement. Upon FDA Approval in November 2009, the Company received a \$16.0 million (US\$15 million) milestone payment (the "FDA Approval Payment") and concurrently transferred the Pennsaid NDA to Covidien. Under the terms of the U.S. Licensing Agreement, Covidien assumed responsibility for all development activities and costs related to Pennsaid subsequent to the Effective Date and subsequent to the transfer of the NDA all regulatory responsibility. As the Company had no substantive contractual obligations remaining after the transfer of the NDA, these payments were recognized as revenue and included in licensing fees revenue.

In addition, under the terms of the U.S. Licensing Agreement, Nuvo is eligible to receive payments for royalties on net U.S. sales of Pennsaid and escalating sales milestone payments for the products totaling up to US\$100 million.

Under the terms of the U.S. Licensing Agreement, Covidien assumed responsibility for managing, planning, executing and paying for all development activities for Pennsaid's follow-on product Pennsaid Plus subsequent to the Effective Date. If Pennsaid Plus is approved by the FDA, Nuvo would be entitled to receive royalties and escalating sales milestone payments.

All costs reimbursed or recovered from Covidien for Pennsaid and Pennsaid Plus are recorded as reductions to research and development expenses.

### **13. STOCK-BASED COMPENSATION AND OTHER STOCK-BASED PAYMENTS**

The Company has four stock-based compensation plans: the Share Option Plan; the Share Purchase Plan; and the Share Bonus Plan, are each a component of the Company's Amended and Restated Share Incentive Plan (the "Share Incentive Plan") and the fourth is the DSU Plan..

#### **Share Incentive Plan**

Under the Company's Share Incentive Plan, there are three sub plans: the Share Purchase Plan, the Share Option Plan, and the Share Bonus Plan. The original plan was amended and restated effective September 21, 2005 when shareholders of the Company approved an amendment changing the maximum number of Common Shares that may be issued under the plan from a fixed maximum number to a fixed maximum percentage. The amendment changes the maximum number of common shares that may be issued under the Share Incentive Plan to a fixed maximum percentage of 15% of the Company's outstanding common shares (on a fully-diluted basis other than stock options) from time to time. The common shares that may be issued under the plan are allocated to the three sub-plans as follows: Share Option Plan 10%, Share Purchase Plan 3%, and Share Bonus Plan 2%. As the Share Incentive Plan is a "rolling plan", the TSX requires that it, along with any unallocated options, rights or other entitlements receive shareholder approval at the Company's annual meeting every three years. At the Annual and Special Meeting of Shareholders of the Company held on May 1, 2008, the Common Shareholders approved an ordinary resolution affirming, ratifying and approving the Share Incentive Plan and approving all of the unallocated common shares issuable pursuant to the Share Incentive Plan.

#### **Share Option Plan**

Under the Share Option Plan the Company may grant options to purchase common shares to officers, directors, employees or consultants of the Company or its affiliates. Options issued under the Share Option Plan are granted for a term not exceeding ten years from the date of grant. All options issued to date have a life of 10 years. In general, options have vested either immediately upon grant, or over a period of one to three years, or upon the achievement of certain performance related measures or milestones. Under the provisions of the Plan, the exercise price of all stock options shall not be less than the closing price of the common shares on the last trading date immediately preceding the grant date of the option.

As at December 31, 2009, the number of unoptioned shares available to be reserved was 7,055,141. Any unexercised options that are surrendered, terminate or expire without being exercised become unoptioned and are available for reissuance under the Share Option Plan.

The following is a continuity schedule of the options outstanding:

	Number of options (000s)	Range of exercise price (\$)	Weighted average exercise price (\$)
Balance, December 31, 2007	30,671	0.135 – 5.95	0.24
Granted	3,949	0.10 – 0.125	0.12
Forfeited	(825)	0.20 – 5.95	1.16
Balance, December 31, 2008	33,795	0.10 – 5.95	0.20
Granted	500	0.33	0.33
Exercised	(150)	0.20	0.20
Expired	(350)	0.39	0.39
Forfeited	(133)	0.125 – 2.01	0.46
<b>Balance, December 31, 2009</b>	<b>33,662</b>	<b>0.10 – 5.95</b>	<b>0.20</b>

The following table summarizes the outstanding and exercisable options held by directors, officers, employees and consultants at December 31, 2009:

Exercise Price Range	Outstanding			Exercisable	
	Number of Options (000s)	Remaining contractual life (years)	Weighted average exercise price	Vested Options	Weighted average exercise price
\$0.10 - \$0.135	18,032	8.0	\$0.13	17,099	\$0.13
\$0.18 - \$0.25	9,923	5.8	\$0.20	9,923	\$0.20
\$0.30 – \$0.57	5,550	5.6	\$0.33	5,216	\$0.33
\$1.12 – \$5.95	157	2.3	\$3.59	157	\$3.59
	<b>33,662</b>	<b>6.9</b>	<b>\$0.20</b>	<b>32,395</b>	<b>\$0.20</b>

In 2007, the Company issued 10.5 million options at a weighted average exercise price of \$0.135 that vested upon the achievement of performance related milestones as determined by the Board of Directors at the time of issuance. These milestones include criteria measured by product related goals, such as regulatory approval and the signing of licensing partners in specific territories. The cost of these options was measured at fair value on the date of grant and was being amortized over their expected life of two years. In 2009, all milestones were achieved and these options became fully vested.

The Company determines compensation expense by estimating the fair value of stock options at the date of grant using the Black-Scholes option pricing model. The weighted-average fair value of stock options granted during the period and the assumptions used to determine fair value on the dates of grant were as follows:

	Year ended December 31, 2009	Year ended December 31, 2008
Expected option life (years)	2	2
Expected volatility	75%	78%
Risk-free interest rate	1.3%	2.8%
Expected dividend yield	0%	0%
Weighted average fair value of options granted	\$0.14	\$0.05

#### Share Purchase Plan

Under the Share Purchase Plan eligible officers, employees or consultants of the Company or its affiliates may contribute up to 10% of their annual base salary to the plan to purchase Nuvo common shares. The Company matches each participant's contribution by issuing Nuvo common shares having a value equal to the aggregate amount contributed by each participating employee. As at December 31, 2009, the number of shares available for issuance under this plan was 4,431,329.

During 2009, employees contributed \$120 [2008 – \$169] to the plan and the Company matched these contributions by issuing 338,001 common shares [2008 – 1,565,926] with a fair value of \$120 [2008 -

\$169] that was recorded as compensation expense. The total number of shares issued under this plan during the year ended December 31, 2009 was 676,002 [2008 - 3,131,852].

### Share Bonus Plan

Under the Share Bonus Plan, the Company can issue common shares to eligible directors, officers or employees of the Company or its affiliates as a discretionary bonus. In addition, consultants are also eligible to receive common shares in lieu of cash compensation. As at December 31, 2009, the number of shares available for issuance under this plan was 5,941,292.

During 2009, a total of \$nil [2008 – 326,042] common shares were issued under this plan. In 2008, professional fees were settled by the issuance of 134,543 common shares to a member of the Company's Scientific Advisory Board in lieu of cash compensation of \$12 and employees were issued 191,499 common shares for which the Company recorded compensation expense of \$18.

### DSU Plan

On January 1, 2009, the Company established the DSU Plan, a share-based compensation plan for non-employee directors. Under this DSU Plan, non-employee directors can be allotted and can elect to receive a portion of their annual retainers and other Board-related compensation in the form of DSUs. One DSU has a cash value equal to the market price of one of the Company's common shares and the number of DSUs issued to a director's DSU account for any payment is determined using the five-day volume weighted average price of the Company's common shares immediately preceding the payment date. Upon issuance, the fair value of the DSUs is recorded as compensation expense and the DSU Accrual is established. At all subsequent reporting dates, the DSU Accrual is adjusted to the market value of the underlying shares and the adjustment is recorded as compensation cost. Within a specified time after retirement, non-employee directors receive a cash payment equal to the market value of their DSUs. For the year ended December 31, 2009, \$225 was recorded in selling, general and administrative ("SG&A") as compensation expense (including \$153 related to the revaluation of the DSU Accrual to the market value of the underlying shares as at December 31, 2009). The DSU Accrual is included in accounts payable and accrued liabilities. At December 31, 2009, there were 712,734 DSUs with a market value of \$225 issued and outstanding.

### Summary of stock-based compensation and other stock-based payments

The composition of stock-based compensation and other stock-based payments is as follows:

	Year Ended December 31, 2009 \$	Year Ended December 31, 2008 \$
Stock option compensation expense under the Share Option Plan	478	616
Cost of the employer's portion of shares issued to employees under the Share Purchase Plan	120	169
Shares issued to employees under the Share Bonus Plan	-	18
<b>Stock-based compensation expense</b>	<b>598</b>	<b>803</b>
<b>Other stock-based payments</b>		
To settle accounts payable owing to a supplier <sup>(i)</sup>	-	214
Payment for professional fees included in research and development or selling, general and administrative expenses	-	12
Compensation expense related to the issuance and revaluation of DSUs included in SG&A	225	-

- (i) In 2008, the Company negotiated the settlement of outstanding accounts payable balance owing to a key supplier. The settlement consisted of a cash payment of \$214 and the issuance of approximately 1.8 million Nuvo common shares with a value of \$214. The Company incurred share issuance costs of \$2 which are recorded against the Common Shares.

#### 14. NET INCOME (LOSS) PER COMMON SHARE

Earnings (loss) per share are computed as follows:

(in thousands, except per share and share figures)	December 31, 2009 (000s)	December 31, 2008 (000s)
<b>Basic earnings (loss) per share:</b>		
Net income (loss)	\$ 15,018	\$ (10,552)
Average number of shares outstanding during the year	363,381	306,301
Basic earnings (loss) per share	\$ 0.04	\$ (0.03)
<b>Diluted earnings (loss) per share:</b>		
Net income (loss)	\$ 15,018	\$ (10,552)
Dilutive effect of:		
Interest on convertible debentures	785	-
Net income (loss), assuming dilution	\$ 15,803	\$ (10,552)
Average number of shares outstanding during the year	363,381	306,301
Dilutive effect of:		
Warrants and stock options	11,552	-
Convertible debentures	25,261	-
Weighted average common shares outstanding, assuming dilution	400,194	306,301
Diluted earnings (loss) per share	\$ 0.04	\$ (0.03)

The following table presents the maximum number of shares that would be outstanding if all dilutive and potentially dilutive instruments were exercised or converted as at:

	December 31, 2009 (000s)	December 31, 2008 (000s)
Common shares issued and outstanding	392,013	314,421
Warrants outstanding (note 11) <sup>(i)</sup>	-	79,683
Stock options outstanding (note 13)	33,662	33,795
Convertible debentures (note 9)	25,261	43,377
	450,936	471,276

- (i) The December 31, 2008 balance excludes 2,500 July 2007 Warrants that were potentially issuable upon the exercise of the July 2007 Underwriter Warrants.

#### 15. INTEREST EXPENSE

Interest expense consists of:

	Year Ended December 31, 2009 \$	Year Ended December 31, 2008 \$
Interest on long-term debt, capital lease obligations and debentures	274	333
Accretion of debentures	538	828
Other interest expense	3	122
Interest expense	815	1,283

## 16. CHANGE IN ESTIMATE OF CONTINGENCY

A \$2.0 million short-term loan from Leadenhall Bank & Trust Company Limited (“the Mortgagee”) was originally extended to the Company in July 2003. The terms of this loan were for interest to accrue at 2% per month and for full repayment to occur on May 31, 2004. The repayment date was extended on two occasions; first to September 30, 2004 and subsequently to February 28, 2005. The loan was collateralized by a subsidiary of the Company through a \$2.0 million mortgage charge on the Company’s Markham head office. In March 2005, the Company took the position that there were a number of deficiencies relating to the loan and that no interest or a lesser amount of interest was payable and ceased making payments of interest or principal on the mortgage. The Mortgagee commenced legal action in April 2005 as fully discussed in note 25, “Contingencies”. The Mortgagee subsequently entered receivership and is being run by a court appointed liquidator in the Bahamas.

In January 2006, in order to facilitate the sale of the building, the liquidator and the Company reached an agreement whereby the Company paid \$1,598 into escrow, and the liquidator discharged the mortgage.

In December 2008, the Company reversed the short-term loan of \$860 which consisted entirely of interest with a credit to income. This amount represented the amount subject to the Ontario Action which was dismissed for delay on August 30, 2007. Given the Liquidator had taken no subsequent action with respect to the dismissal and the passage of time since the dismissal, management believed that it was very unlikely that the Company faced any ongoing exposure to successful claims in Ontario in regards to this matter.

## 17. IMPAIRMENT OF INTANGIBLES

In December 2008, the Company conducted a review of its portfolio of potential drug candidates. This review resulted in changes to the Company’s drug development strategy that included, among other things, revised development timelines for certain drug candidates, reprioritizing the importance of specific drug candidates for development and identifying new drug candidates. Subsequent to this review, the Company assessed the impact of these drug development strategy changes on the recoverability of the carrying values of each of its intangible assets. Based on its assessment, it was determined that the carrying value of the patents was impaired and therefore an impairment charge of \$198 was recorded to income.

## 18. NET CHANGE IN NON-CASH WORKING CAPITAL

The net change in non-cash working capital consists of:

	Year Ended December 31, 2009 \$	Year Ended December 31, 2008 \$
Accounts receivable	(60)	367
Inventories	(767)	(249)
Prepaid expenses and other	(4)	351
Accounts payable and accrued liabilities	1,992	(199)
Net change in non-cash working capital	1,161	270

## 19. INCOME TAXES

### Future tax assets and liabilities

Future income taxes represent the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The tax effects of temporary differences that give rise to significant portions of the future tax assets are as follows:

	Year ended December 31, 2009 \$	Year ended December 31, 2008 \$
Non-capital loss carryforwards	15,231	13,718
Canadian Scientific Research and Experimental Development [SR&ED] expenditure pool carry forward	2,216	2,181
Investment tax credits	1,677	1,464
Financing costs	251	452
Tax basis of property, plant and equipment and intangibles in excess of accounting value	4,168	11,235
Deferred revenue	475	902
Federal and Ontario tax harmonization benefit	88	87
Other	6	14
Future tax assets before valuation allowance	24,112	30,053
Less: Valuation allowance	(24,112)	(30,053)
Net future tax assets	-	-

A reconciliation between the Company's statutory and effective tax rates is presented below:

	Year ended December 31, 2009 %	Year ended December 31, 2008 %
Statutory rate	32.5	32.6
Permanent differences	(7.9)	(7.2)
Impact of foreign income tax rate differential	(0.6)	(0.5)
Revaluation of future taxes as a result of enacted tax rate changes	16.0	(0.4)
Change in valuation allowances due to the revaluation of the future taxes as a result of enacted rate changes	(16.0)	0.4
Unrecognized benefit of current year's tax loss and other	(24.0)	(24.9)
	-	-

#### Loss carry forwards and Canadian SR&EDs

The Company and its subsidiaries have non-capital losses available for carry forward to reduce future years' taxable income, the benefit of which has not been recorded. These losses and the related future tax asset by jurisdiction are as follows:

	Expiry Period	Non-capital losses \$	Future tax asset \$
Canada	2010 to 2029	50,228	12,798
United States (i)	2010 to 2013	1,583	624
United States	2026 to 2029	2,660	1,065
Switzerland	2010 to 2016	5,170	501
Germany	Indefinite	838	243
		60,479	15,231

- (i) These United States losses carried forward relate to losses acquired upon the purchase of fqubed in 2005. Due to our acquisition of control of this entity there are restrictions imposed on the use of these losses.

The Company has approximately \$8.7 million of Canadian SR&ED expenditures for federal tax purposes that are available to reduce taxable income in future years and have an unlimited carry forward period, the benefit of which has not been reflected in these financial statements. SR&ED expenditures are subject to audit by the tax authorities and accordingly, these amounts may vary.

The Company has net capital losses of \$6.2 million in Canada available to offset net taxable capital gains in future years.

### Government assistance

A portion of the Company's research and development expenditures are eligible for Canadian federal investment tax credits that it may carry forward to offset any future Canadian federal income tax payable as follows:

Year of credit	Amount \$	Year of expiry
December 31, 2005	438	2015
December 31, 2006	700	2026
December 31, 2007	335	2027
December 31, 2008	420	2028
December 31, 2009	152	2029
	2,045	

The benefits of these non-refundable Canadian federal investment tax credits have not been recognized in the financial statements.

## 20. COMMITMENTS

### Commitments

The Company has commitments under research and other service contracts and minimum future rental payments under operating leases for the years ending December 31 as follows:

	Research and other service contracts <sup>(i)</sup>	Operating leases	Total
	\$	\$	\$
2010	303	430	733
2011	10	201	211
2012	1	20	21
2013	-	2	2
2014	-	1	1
	314	654	968

(i) Included under the caption "Research and other service contracts" are commitments totaling \$232 that the Company has made for services that are reimbursable under the terms of the U.S. Licensing Agreement.

For the year ended December 31, 2009, payments under operating leases totaled \$444 [2008 - \$366].

Under the terms of a 2009 agreement to purchase rights to reference proprietary research, the Company may be required to make a future payment not exceeding US\$500, if a specific milestone is achieved. Under the terms of the U.S. Licensing Agreement, Covidien must reimburse the Company for this payment.

In three separate transactions, the first of which closed on August 16, 2005, the Company completed the sale of 100% of the common shares of DHCL to Paladin and the transfer of Canadian sales and marketing rights for Pennsaid to Paladin. Among other things, as part of these arrangements, Nuvo is contractually obligated to manufacture Pennsaid for Paladin and, until December 31, 2010, must do so at a fixed price. Paladin is also entitled to receive a 0.5% royalty from Nuvo on all U.S. Pennsaid revenue the Company receives including the Initial Payment and the FDA Approval Payment received in 2009 and future royalties or milestone payments, if any. During 2009, the Company recorded \$136 as royalty expense in selling, general and administrative expenses.

Under the terms of the U.S. Licensing Agreement, the Company will manufacture and supply Pennsaid to Covidien at a fixed price for a period of one year with semi-annual price adjustments thereafter based upon raw material increases and changes in the level of an agreed upon price index.

The Company has a long-term supply agreement with a third party manufacturer for the supply of dimethyl sulfoxide, one of its key raw materials, for an initial term extending through October 31, 2012. The agreement obligates the Company to purchase 100% of its dimethyl sulfoxide requirements from the third party at specified pricing, but does not contain any minimum purchase commitments.

The Company has a long-term supply agreement with a third party manufacturer for the supply of diclofenac sodium, one of its key raw materials, for an initial term extending through October 31, 2012. The agreement obligates the Company to purchase a declining fixed percentage of its annual U.S. requirements for diclofenac sodium from the third party at specified pricing but does not contain any minimum purchase commitments.

Under the terms of a government reimbursement agreement in Europe, the Company has committed to maintaining a minimum employee level over three years commencing with its first claim for reimbursement under the agreement which has not yet been made.

The Company is obligated to pay royalties to the former shareholders of fqubed to a maximum of US\$1.0 million for pharmaceutical products and US\$3.0 million for non-pharmaceutical products based on future sales of yet to be developed transdermal products that use specifically identified formulations developed by fqubed prior to its acquisition by the Company. No amounts have been paid or are payable.

Under certain licensing agreements, the Company may be required to make payments upon the achievement of specific developmental, regulatory, or commercial milestones. As it is uncertain if, and when, these milestones will be achieved, the Company did not accrue for any of these payments at December 31, 2009 or 2008.

Under the terms of a 2004 agreement to restructure a portion of the Company's debt, the Company is obligated to pay the former debt holder six percent of future WF10 licensing and royalty revenue. No amounts have been paid or are payable.

### **Guarantees**

The Company periodically enters into research, licensing, distribution or supply agreements with third parties that include indemnification provisions that are customary in the industry. These guarantees generally require the Company to compensate the other party for certain damages and costs incurred as a result of third-party intellectual property claims or damages arising from these transactions. In some cases, the maximum potential amount of future payments that could be required under these indemnification provisions is unlimited. These indemnification provisions generally survive termination of the underlying agreements. The nature of the intellectual property indemnification obligations prevents the Company from making a reasonable estimate of the maximum potential amount it could be required to pay. Historically, the Company has not made any indemnification payments under such agreements and no amount has been accrued in the accompanying consolidated financial statements with respect to these indemnification obligations.

## **21. 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 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 December 31, 2009, the Company had \$41.4 million invested with a single financial institution in various bank accounts 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 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 to the 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 licensees or distributors in these territories during the term of the agreement. At December 31, 2009, the Company's four largest customers located in North America and Europe represent 84% [2008 - 83%] of accounts receivable and accounts receivable from customers located outside of North America and the European Union represent 5% [2008 - 13%] of accounts receivable.

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

	\$
Current	1,870
0-30 days past due	83
31-60 days past due	5
61-90 days past due	-
Over 90 days past due	133
	<u>2,091</u>

As at February 17, 2010, \$216 of the past due amounts had been collected.

### Liquidity risk

While the Company has \$42.1 million in cash and cash equivalents at December 31, 2009, it continues to have 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 is currently marketed and in the United States although it is approved and the Company is eligible to receive royalties on net sales at rates consistent with industry standards and potential sales milestones it is not yet marketed. Therefore, the Company is not yet receiving an ongoing revenue stream from the United States. nor can it be certain that it will receive any significant revenue unless the U.S. launch is successful. Even if the launch is successful, Pennsaid's patents have expired such that its only protection is its three year period of exclusivity granted in

November 2009 under the "Hatch-Waxman Act" and C.F.R. 314.108(b)(4). As a result, Pennsaid revenues may not 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, develop or commercialize any further products based on its topical and transdermal drug delivery or immune system regulation 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 or the commercial launch of Pennsaid in the United States is not successful, or Pennsaid is genericized in the United States after it loses its exclusivity, the Company may have to substantially reduce or eliminate planned expenditures, reduce staff and curtail its drug development programs. If the Company is unable to obtain additional financing when and if required, the Company may be unable to continue operations.

### Interest rate risk

All debentures 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 December 31 are as follows:

	Euros		U.S. Dollars	
	2009 €	2008 €	2009 \$	2008 \$
Cash and cash equivalents	1,667	213	4,846	343
Accounts receivable	1,035	1,117	355	-
Other current assets	7	8	27	31
Restricted cash	-	100	-	-
Accounts payable and accrued liabilities	(239)	(257)	(1,448)	(712)
Long-term debt and capital lease obligations	-	(136)	(133)	(212)
	<b>2,470</b>	<b>1,045</b>	<b>3,647</b>	<b>(550)</b>

Based on the aforementioned net exposure as at December 31, 2009, and assuming that all other variables remain constant, a 10% appreciation or depreciation of the Canadian dollar against the U.S. dollar and Euro would have resulted in decreases (increases) in net income (loss) and total comprehensive income (loss) as follows:

Canadian Dollar	Net income (loss) and Comprehensive income (loss)	
	Appreciates 10%	Depreciates 10%
Versus U.S. dollar	348	(426)
Versus Euro	338	(413)

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, its Euro denominated cash and cash equivalents and sales of Pennsaid by the Canadian operations to European distributors. In terms of the U.S. dollar, the Company has four significant exposures: its net investment and net cash flows in its U.S. operations, its U.S. dollar denominated cash and cash equivalents, the cost of running trials and other studies at U.S. sites and purchasing raw materials either priced in U.S. dollars or sourced from U.S. suppliers that are needed to produce Pennsaid.

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 from the Company's U.S. dollar denominated cash and cash equivalents.

Sales to European distributors are primarily 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. Periodically, the Company reviews the amount of Euros held 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.

In June 2009, the Company signed the U.S. Licensing Agreement. Under the terms of the U.S. Licensing Agreement, the Company has received US\$25 million and has the potential to receive royalties, milestone payments and product sales all denominated in U.S. dollars. In the past, the Company has not had any meaningful U.S. dollar inflows. Currently, the Company plans to manage its U.S. inflows in a manner similar to its management of Euro denominated inflows by regularly reviewing the amount of U.S. dollars held and if excessive compared to the Company's projected future U.S. cash outflows, converting the excess amount in to Canadian dollars or other currencies needed for its operations.

### **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. Dimethyl sulfoxide (one of the key ingredients in Pennsaid) is the Company's most significant cost subject to commodity risk. The Company has entered into a supply agreement with a U.S. supplier for its pharmaceutical grade dimethyl sulfoxide 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 some of the chemicals required and the regulatory paths to approving new suppliers, this is not always possible.

## **22. CAPITAL MANAGEMENT**

The Company's objectives in managing capital are to ensure sufficient liquidity to pursue the Company's development plans for each of its drug candidates through commercialization and to maintain its ongoing operations. Product revenues from the Company's approved drug products are not yet significant enough to fund ongoing operations. As a result, to secure the capital necessary to pursue its development plans and fund ongoing operations, the Company will need to raise additional funds through the issuance of debt or equity, by entering into distribution and license agreements or by entering into co-development agreements.

The Company defines its capital to include its cash and cash equivalents, debentures and capital lease obligations and shareholders' equity excluding accumulated other comprehensive income. In the past, the Company has financed its operations primarily through the net proceeds received from the sale of common shares and warrants, issuance of secured debt and convertible debentures, capital leases, proceeds from collaborative relationships and investment income earned on cash balances and short-term investments.

The Company expects to utilize its cash and cash equivalents which were \$42.1 million at December 31, 2009, revenue from its product sales, investment income earned on cash balances and subsequent to the U.S. launch of Pennsaid, royalty payments and potential milestone payments to fund its operations, including research and development of its drug product candidates. The Company currently anticipates that its cash and cash equivalents together with the revenues it expects to generate from product sales, royalty payments from its U.S. Licensing agreement and interest it expects to earn on invested funds will be sufficient to execute its plan and fund operations in 2010. Nonetheless, companies in our industry typically require periodic funding in order to continue developing their drug candidate pipelines until they have successfully commercialized at least one of their drug candidates and receive sufficient revenue to fund their operations. Nuvo has not yet reached this stage and therefore, 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. There can be no assurance, especially considering the economic environment, that additional financing would be available on acceptable terms, or at all, when and if required. If adequate funds were not available when needed, the Company may have to substantially reduce or eliminate planned expenditures, delay preclinical studies for its product candidates, reduce staff and curtail product development programs. If the Company is unable to obtain additional financing when and if required, the Company may be unable to continue operations.

During the year, the Company modified its approach to capital management as a result of signing the U.S. Licensing Agreement and receiving the Initial Payment and the FDA Approval Payment. The Company now regularly reviews the amount of U.S. dollars held and if excessive compared to the Company's projected future U.S. cash outflows net of its projected revenues under the U.S. Licensing Agreement, will convert excess amounts held in to Canadian dollars or other currencies needed for its operations.

## 23. SEGMENTED INFORMATION

### Segments

The Company is focused on two distinct businesses, Pain and Immunology that utilize its TTDD and ISR platforms. The accounting policies for the segments are the same as those described in note 2 to these consolidated financial statements. Intersegment transactions are accounted for at exchange values. From a financial perspective, executive management uses the income (loss) from operations to assess the performance of each segment.

The following tables show certain information with respect to operating segments:

	Pain \$	Immunology \$	Total \$
<b>Year ended December 31, 2009</b>			
Total revenue <sup>(i)</sup>	37,873	774	38,647
Amortization of property, plant and equipment	440	107	547
Interest income	70	9	79
Interest expense	805	10	815
Income (loss) from operations	15,099	(81)	15,018
Assets	47,151	1,399	48,550
Property, plant and equipment	1,570	264	1,834
Additions to property, plant and equipment	377	14	391
<b>Year ended December 31, 2008</b>			
Total revenue <sup>(i)</sup>	9,765	962	10,727
Amortization of property, plant and equipment and intangibles and impairment of intangibles	963	105	1,068
Interest income	488	9	497
Interest expense	1,278	5	1,283
Loss from operations	(10,410)	(703)	(11,113)
Assets	19,665	1,770	21,435
Property, plant and equipment	1,633	357	1,990
Additions to property, plant and equipment <sup>(ii)</sup>	387	8	395

(i) The ISR segment currently derives all of its revenue from product sales.

(ii) Includes \$244 of assets acquired under capital leases.

### Geographic information

The Company's revenue is derived from sales to and licensing revenue derived from external customers located in the following geographic areas:

	Year Ended December 31, 2009 \$	Year Ended December 31, 2008 \$
Canada	4,183	4,009
United States	27,611	205
Europe	6,156	5,698
Other foreign countries	697	815
	<b>38,647</b>	<b>10,727</b>

The geographic location of the Company's property, plant and equipment is as follows as at:

	December 31, 2009 \$	December 31, 2008 \$
Canada	1,297	1,333
Europe	264	357
United States	273	300
	<b>1,834</b>	<b>1,990</b>

### Significant customers

At December 31, 2009, the Company's four largest customers, all of which are customers of the Pain segment, represent 84% [December 31, 2008 - 81%] of product and research contract revenue and 96% [December 31, 2008 - 77%] of total revenue.

## 24. ECONOMIC DEPENDENCE

The Company purchases key raw materials necessary for the manufacture of its products from a limited number of suppliers around the world. It may be difficult for the Company to find other manufacturers if any of these suppliers is unable to supply it with a sufficient amount of raw material or if it is forced for any other reason to find another supplier. In addition, the FDA and similar bodies in other regulated jurisdictions require that suppliers of certain raw materials be approved, their Drug Master File ("DMF") or equivalent be referenced in the sponsor's NDA and that adequate stability data exist for the drug product using the approved supplier's raw material. As a result, in the case where only a single approved supply source exists for product marketed in the U.S. (or other regulated jurisdictions) the Company is at risk should a supplier lose its FDA manufacturing approval, terminate access to its DMF, be unable to manufacture product, choose not to supply the Company or decide to increase prices. The loss of any of these suppliers of key raw materials could have a material adverse effect on the Company's financial position and results of operations.

The Company has limited sales and marketing experience and resources and relies on the efforts of its licensees and distributors to generate its revenue. In the U.S., the Company's revenue from products sales, royalties and milestones will be dependent upon on the success of the launch by Covidien. In 2009, the Company's four largest customers accounted for 84% [2008 - 81%] of the Company's product and research contract revenue. The loss of any of these customers could have a material adverse effect on the Company's financial position and results of operations.

## 25. CONTINGENCIES

### 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 the Mortgagee. The Mortgage dispute centres 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) (the "Escrow Amount") 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 the Settlement Amount would be released from escrow and paid to the Liquidator and the balance, US\$303 (CDN\$318), would be released to the Company (the "Excess Amount"). In January 2006, the Liquidator discharged the mortgage, the Company completed the sale of its head office and it paid the Escrow Amount into escrow with the Liquidator's Bahamian counsel.

Subsequent to receipt of the Escrow Amount, 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 Excess Amount 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 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 in March 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.

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 has hindered the Company's Bahamian legal counsel's efforts to obtain a date for a hearing at which a judge could consider the Settlement Agreement. Late in 2008, the Company's Bahamian legal counsel

informed the Company that a commercial court judge had been assigned to handle all aspects of the Leadenhall liquidation; however, early in 2009, prior to obtaining a hearing this judge resigned from the Bench and the case has not yet been assigned to another judge.

Given these delays, the Company through its Bahamian legal counsel, reinitiated dialogue with the Liquidator's counsel and presented a proposal aimed at resolving all outstanding matters between the Company and the Liquidator, if acceptable we would jointly approach the courts to seek its approval. The Company did not receive a response to its proposal from the Liquidator's counsel. In November 2009, the Company's Bahamian counsel was notified that the Liquidator had switched legal counsel in this matter. The Company's Bahamian counsel has contacted the Liquidator's new counsel but they have indicated that they are not yet in a position to discuss the matter as they are in the process of developing an understanding of all matters related to the Mortgagee's liquidation.

### **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 on January 1, 2009) 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 (the "2008 CRA Reassessments") 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 (the "Reassessed Transactions") that impact all of the Tax Years. A certain provincial tax authority also reassessed certain of the Tax Years and other provincial tax authorities could have proposed 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 disagreed with the position taken by the CRA and believed it to be without merit. Paladin contested the reassessments through the CRA appeals process and filed a Notice of Objection with the CRA in October 2008. In January 2010, the CRA responded to the Notice of Objection by issuing reassessments for the Tax Years ("January 2010 Reassessments") that reversed all of the adjustments made by the CRA relating to the Reassessed Transactions, in essence agreeing with Paladin's original filing position. The January 2010 Reassessments have been forwarded to the provincial tax authority to begin the process of having the adjustments for the Reassessed Transactions reversed as the province previously agreed in writing to be bound by the CRA's decision. The Company estimates its remaining potential obligation under the indemnification provisions of the SPA relating to the provincial reassessments is in the range of \$0.8 million to \$1.2 million, including interest and penalties. 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. If a favourable resolution is not achieved on the remaining provincial reassessments, it 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, in September 2008 the CRA took action to collect 50% of the amounts reassessed in the 2008 CRA Reassessments. Paladin suggested that it may have a claim against the Company pursuant to the SPA for a portion of the collected amount. 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") to Paladin for potential indemnity obligations that arise from or relate to the CRA Reassessments and to pay half of Paladin's ongoing out-of-pocket costs to contest the CRA Reassessments. The Indemnity Security charges the revenue from Pennsaid sales in Europe, a mortgage over Nuvo's manufacturing facility in Québec, a charge on all manufacturing assets in Québec and all Pennsaid inventory and receivables as well as all intellectual property rights required to manufacture and market Pennsaid in Canada. 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 determined to have become insolvent as defined in the Letter Agreement.

### **Research Capital Company (“RCC”)**

On June 7, 2006, the Company received a letter from counsel to RCC asserting that as a result of the bought deal equity financing completed by the Company on June 20, 2006, RCC was entitled to payment of \$1.5 million and such number of common shares equal to 8% of the common shares issuable pursuant to an engagement letter for an offering that was contemplated but did not proceed in September 2005. RCC was not involved in the financing. The letter further stated that if the demanded cash payment and common shares were not received on or before June 12, 2006 then a court action would commence by RCC against the Company. 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 Defense and Counterclaim in October 2006 and vigorously defended its position. In November 2006, RCC served its reply and defense 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. 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.

### **26. COMPARATIVE FIGURES**

Certain figures in the December 31, 2008 financial statements have been re-classified to conform to the basis of presentation for the year ended December 31, 2009.

### **27. SUBSEQUENT EVENT**

On February 4, 2010, the Company announced that it will be redeeming the November 2004 Unsecured Convertible Debentures (“Debentures”) for cash on March 12, 2010 (the “Redemption Date”). A redemption amount of \$1,035.75 (the “Redemption Price”) will be paid for each \$1,000 of principal amount of Debentures, being an amount equal to the aggregate of: i) \$1,020 for each \$1,000 principal amount of Debentures plus ii) all accrued and unpaid interest up to, but excluding, the Redemption Date.

Holders of the Debentures have the right to convert their Debentures into common shares at any time prior to the close of business on the business day immediately preceding the Redemption Date. Holders converting their Debentures are entitled to receive, in addition to the applicable number of shares, accrued and unpaid interest for the period up to, but excluding, the date of conversion from the day immediately following the latest interest payment date, all in accordance with the trust indenture and supplemental indentures.

As at February 18, 2010, \$132 of face value was converted into 956,521 of the Company's common shares.