

Nuvo Research Inc. Q1 2007 First Quarter Report



Message to Shareholders:

Our top priority remains the final approval of Pennsaid by the U.S. FDA as quickly as possible.

By way of background, we anticipated receiving an approvable letter from the FDA for Pennsaid in late December 2006, with resolution of product labeling as the only condition to final approval to market Pennsaid in the United States. Notwithstanding that the approvable letter included other unanticipated conditions, we remain confident that Pennsaid will be approved and are continuing to work with the FDA to determine the most appropriate path forward to approval.

We are pleased that Pennsaid has moved from being non-approvable to being approvable. The FDA has confirmed that no additional Phase III trials are required which means that we have taken a giant step toward final approval by eliminating the clinical safety and efficacy risks that are typically the biggest risks in any drug development program. We believe that the remaining issues can be addressed and we are addressing them. While this means that Pennsaid final approval is delayed, we are working hard to ensure that the time to approval is the shortest time possible.

Our vision is that Nuvo will be a world leading transdermal drug delivery company. We have continued to make progress on this front through the efforts of our team at fqubed Inc., the San Diego based research and development facility that we acquired in December 2005. Before we purchased fqubed, we had no internal transdermal penetration enhancer screening capability and lacked a strong proprietary position in transdermal formulations. Through the efforts of fqubed's scientists and engineers, we now have an established screening laboratory and proprietary high throughput experimentation capabilities. We have continued to improve and expand our screening capabilities and our multiplexed molecular penetration enhancer (MMPE™) platform which we are now using to develop new proprietary product formulations. Over the last nine months, we have implemented a product pipeline development process which has yielded attractive transdermal product formulations in our core focus area of pain treatment and opportunities in other therapeutic areas of interest. In the coming quarters, we will continue to broaden our transdermal product pipeline with further research and development of new product formulations.

In closing, we would like to thank all of our stakeholders for their patience as we continue to work with the FDA to resolve any issues standing in the way of final regulatory U.S. approval for Pennsaid. We also extend my sincere gratitude to our employees who are working tirelessly to make Nuvo a success.

Dan Chicoine, Chairman

John London, Vice Chairman

Henrich Guntermann, President and CEO

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

April 30, 2007 / The following information should be read in conjunction with the Company's interim financial statements and notes and should also be read in conjunction with the audited consolidated financial statements, notes and management's discussion and analysis contained in the Company's annual report for the year ended December 31, 2006. Additional information relating to the Company, including its Annual Information Form, can be found on SEDAR at [www.sedar.com](http://www.sedar.com)

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

### Forward-looking Statements

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

### Overview

Nuvo is a publicly traded, Canadian drug development company focused on the development of targeted therapeutic products designed to produce minimal side effects. The Company develops drugs based on two technology platforms: transdermal drug delivery and immune system regulation.

The Company's lead technology platform, a transdermal carrier, is designed to deliver therapeutic drugs through the skin directly to the disease site. Unlike oral medications, the Company's transdermal products do not rely on bloodstream circulation but offer site-specific treatment while limiting the body's systemic exposure to potentially harmful levels of chemical agents. Our first marketed transdermal product, Pennsaid® is a topical non-steroidal anti-inflammatory drug (NSAID) used for the treatment of osteoarthritis and is currently approved for sale and marketed under license or distribution agreements in Canada, several European countries and many Caribbean nations.

The Company's transdermal research division, U.S. based fqubed, Inc., continues to improve and expand its high throughput experimentation ("HTE") platforms. Several such platforms are operational including, the INSIGHT™ and STORM™ platforms that are used to screen the extent to which formulations permeabilize skin and the TEMPEST™ system that is used to screen drug permeation through skin. Management considers this set of HTE platforms to be both unique and advantageous as they allow the Company to make more measurements in a given period than is possible conventionally.

The Company's second technology platform focuses on immune system regulation. The immune system provides an essential defence against microorganisms, viruses, and substances it sees as foreign and potentially harmful. Nuvo's technology platform is based on a chlorite solution code-named WF10. The drug appears to encourage a switch in macrophage state from inflammatory to phagocytic, or vice versa, rebalancing

the system and restoring proper immune function. Products based on this technology are aimed at expanding treatment options in oncology, immunology and the therapeutic management of chronic viral infections. The Company is conducting a Phase II clinical trial in an effort to demonstrate the efficacy of WF10 in combination with Xeloda® (capecitabine) in the treatment of pancreatic cancer. The Company markets a diluted form of WF10 through a European subsidiary in parts of Europe, Asia and South America as a topical wound healing agent under several trade names including Oxoferin.

The Company and its subsidiaries employ a total of 85 full-time employees at the head office in Mississauga, Ontario, the Pennsaid® manufacturing plant in Varennes, Québec, the international sales office in Barbados, the WF10 manufacturing plant in Wanzleben, Germany and fqubed.

## First Quarter Highlights

During the first quarter the Company:

- Raised an additional \$5.2 million from its earlier announced early warrant incentive program;
- Continued discussions with the FDA regarding the Approvable Letter that confirmed Pennsaid could be approved for sale in the U.S. once certain conditions were satisfied. None of the conditions relate to the clinical efficacy or clinical safety of Pennsaid, which were evidenced in Nuvo's Phase III trials. Based on these discussions, the Company commenced studies that it expects to conclude in time to file a response to the FDA in the fourth quarter of 2007. The Company continues to correspond with the FDA to resolve other matters raised in the Approvable Letter including whether Nuvo should have to evidence the dermal safety of Pennsaid and its constituent components through longer term dermal animal safety studies. The Company remains hopeful that based on the abundance of dermal safety data that it has submitted to the FDA, these studies will not be required or, if required, may be submitted post approval. Should the FDA require the Company to conduct these studies pre-approval, final U.S. approval for Pennsaid would be delayed to 2010 / 2011;
- Continued to validate, broaden and extend its proprietary formulations platform technology, multiplexed molecular penetration enhancer (MMPE™) technology. This process has yielded several attractive transdermal product possibilities. Patent protection for several MMPE™ systems has been applied for.

## Liquidity

The Company has incurred substantial losses since its inception as it has invested significantly in drug development activities and other legacy ventures. At March 31, 2007 the Company had an accumulated deficit of \$180.2 million including a loss of approximately \$3.5 million in the first quarter of 2007. At March 31, 2007 the Company had cash and cash equivalents of \$13.2 million. The Company expects that it will continue to incur losses as it expands research and development activities, its pipeline and works toward the approval of Pennsaid in the United States. Even though management believes the cash resources currently available to the Company are sufficient to execute its 2007 plan, the Company's ability to continue as a going concern, expand its product pipeline and complete any longer term animal studies the FDA may

require prior to the approval of Pennsaid depends on its ability to secure additional licensing fees, co-development agreements and capital and ultimately achieve profitable operations. While our discussions with potential US licensing partners continue the uncertainty surrounding the timeframe for Pennsaid approval has caused them to proceed cautiously while we attempt to clarify the timeframe with the FDA.

## Selected Financial Information

in thousands (except per share and share information)

	Three-months ended March 31, 2007	Three-months ended March 31, 2006
<b>Operations</b>		
Product and research contract revenue, net of revenue allocation	\$ 728	\$ 489
Licensing fees	250	144
Total revenue	978	633
Cost of goods sold	361	253
Operating expenses	4,104	4,098
Total expenses	4,465	4,351
Loss from operations	(3,487)	(3,718)
Other income	-	947
<b>Net loss and total comprehensive income</b>	<b>\$ (3,487)</b>	<b>\$(2,771)</b>

### Share Information

Net loss per share	\$ (0.02)	\$ (0.02)
Weighted average outstanding shares for the period (in millions)	192.7	129.9

	As at March 31, 2007	As at December 31, 2006
<b>Financial Position</b>		
Cash and cash equivalents	\$13,246	\$ 11,213
Total assets	18,945	17,619
Deferred revenue, including current portion	7,628	7,904
Long term debt, debentures and capital lease obligations, including current portions	2,672	3,013
Total liabilities	13,512	14,482

## Fluctuations in Operating Results

Our results of operations have fluctuated significantly from period to period in the past and are likely to do so in the future. We anticipate that our quarterly and annual results of operations will be impacted for the foreseeable future by several factors, including the timing and amount of payments received pursuant to our current and future collaborations, and the progress and timing of expenditures related to our research, development and commercialization efforts. Due to these fluctuations, we believe that

the period-to-period comparisons of our operating results are not necessarily a good indication of our future performance.

## Results of Operations

### Product Sales, Contract Research Revenue and Gross Profit

in thousands (except gross profit percentage)

	Three-months ended March 31, 2007	Three-months ended March 31, 2006
Pennsaid revenue	\$ 550	\$ 232
WF10 revenue	131	148
Research and other contract revenue	47	109
Total product sales and research contract revenue	728	489
Cost of goods sold	361	253
<b>Gross profit</b>	<b>\$ 367</b>	<b>\$ 236</b>
<b>Gross profit percentage</b>	<b>50%</b>	<b>48%</b>

### Revenue and Gross Profit

Product and research contract revenue for the three-months ended March 31, 2007 increased 49% to \$728,000 compared with \$489,000 for the three-months ended March 31, 2006. This increase was primarily a result of the 137% increase in Pennsaid revenue which reflects initial orders related to the launch of Pennsaid in Greece by our distributor Vianex S.A. as well as an increase in orders from our Italian distributor. Sales to our Canadian partner, Squire Pharmaceuticals Inc. ("Squire"), were down 8% from last year; however, the market demand continues to increase as shipments of Pennsaid to Canadian wholesalers in the first quarter increased by 6% over the comparable quarter last year.

The increased sales in the quarter allowed gross profit for the three-month period ended March 31, 2007 to increase 56% to \$367,000 compared with \$236,000 for the comparable quarter ended March 31, 2006.

### License Fees

During the quarter ended March 31, 2007, Nuvo recorded \$250,000 in license fee revenue that was previously deferred, compared with \$144,000 for the comparable quarter ended March 31, 2006. This represents the systematic recognition of a portion of the up-front fees received from Squire in 2005 and 2006 for the Canadian marketing rights for Pennsaid.

## Operating Expenses

in thousands

	<b>Three-months ended March 31, 2007</b>	Three-months ended March 31, 2006
Research and development	<b>\$ 1,738</b>	\$ 1,479
Selling, general and administrative	<b>1,849</b>	1,715
Stock-based compensation	<b>163</b>	396
Amortization of property, plant and equipment	<b>211</b>	177
Interest, net	<b>133</b>	304
	<b>4,094</b>	4,071
Foreign currency loss	<b>10</b>	27
<b>Total operating expenses</b>	<b>\$4,104</b>	\$4,098

Total operating expenses for the quarter ended March 31, 2007 of \$4.1 million were unchanged from the same quarter last year with reduced interest costs and stock-based compensation offsetting increases in research and development spending as well as in selling, general and administrative costs.

### Research and Development

Research and development expenses increased 18% to \$1.7 million for the three-month period ended March 31, 2007, compared with \$1.5 million for the three-months ended March 31, 2006. The increase is attributable to activities surrounding the Pennsaid approvable letter and the expansion of formulation and enhancer development activities at fqubed. During the current quarter the Company established a Pennsaid project team to begin preparing the "roadmap" to address each of the FDA's issues as outlined in the December 2006 Approvable letter. As part of this process, the team has used several outside consultants to assist in determining appropriate responses to each issue and design any required study protocols. During the quarter the Company began the first of these studies and was preparing others to begin during the second quarter. At fqubed the Company continued to validate, broaden and extend its proprietary multiplexed molecular penetration enhancer (MMPE™) formulations platform technology. The MMPE™ technology, developed through internal HTE campaigns, uses special combinations of molecular penetration enhancer (MPE™) materials to permeabilize the skin for enhanced delivery of a given drug. The Company is currently considering exploitation of the MMPE™ technology in for onychomycosis, for which fungal kill assays were completed in Q1 2007.

In the comparable period ending March 31, 2006 the Company completed the analysis of the Pennsaid Phase III efficacy and safety trial (designated 'Study 112') and the Pennsaid Phase III long-term open-label safety trial (designated 'Study 112E') which were a key part the Company's submission in June 2006 leading to the FDA approvable letter for Pennsaid received in December 2006. Research and development costs are expected to increase versus 2006 over the remainder of 2007 as the Company conducts

the studies necessary to address the issues raised in the Approvable Letter and engages in a higher level of activity at fqubed.

### **Selling, General and Administrative (SG&A)**

SG&A expenses increased 8% to \$1.8 million for the three-month period ended March 31, 2007 compared to \$1.7 million for the three-month period ended March 31, 2006. The increase is attributable primarily to higher professional fees related to: compliance with Bill 198; legal fees arising from the OSC and Leadenhall matters; tax planning; and, legal fees related to the Company's intellectual property portfolio.

### **Stock-Based Compensation**

Compensation expense related to stock based compensation for the three-months ended March 31, 2007 was \$163,000 compared with \$396,000 for the comparable period in 2006. During the comparable period the Company recorded \$182,000 of compensation expense as its share of the cost of the Share Purchase Plan versus \$nil in the current quarter. Under the Share Purchase Plan, eligible employees may contribute up to 10% of their annual base salary to the plan for the purchase of 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. The Plan is typically offered to employees only once a year. Subsequent to the change in the year end on December 31, 2005 the plan was offered to employees in February 2006 on account of the 2005 transition year. In late 2006, it was decided that the program would be offered to employees in December each year and as such the expense related to the current year will not be recorded until the program is offered to employees later in 2007.

### **Amortization of Property, Plant and Equipment**

Amortization expense for the three-month period ended March 31, 2007 was \$211,000, compared to \$177,000 for the three-month period ended March 31, 2006. The increase is attributable to the amortization of the cost of new computer equipment and software acquired over the past year and the amortization of leasehold improvements in the new head office premises the Company began leasing in late March 2006.

### **Foreign Currency Losses**

The foreign currency loss for the three-month period ended March 31, 2007 was \$10,000 compared with \$27,000 for the comparable period in 2006.

### **Interest, Net**

Net interest expense declined 56% to \$133,000 for the three-month period ended March 31, 2007 from \$304,000 for the three-month period ended March 31, 2006. The decrease is primarily due to higher levels of interest income earned as cash balances were significantly higher than a year ago, and a reduction in interest expense on long-term debt due to principal repayments over the past year.

### **Loss from Operations**

The loss from operations declined by 6% for the three-months ended March 31, 2007 to \$3.5 million versus \$3.7 million in the three-months ended March 31, 2006. The slightly smaller loss was a result of the increased margin on product and research contract revenue, increased licensing fees, reduced net interest expense and lower stock-based

compensation expense; offset by, increased research and development expenditures and higher SG&A costs.

### Gain on Sale of Assets

In January 2006 the Company sold its former head office in Markham, Ontario for \$2,744,000, net of commissions and closing costs. Net book value was \$1,797,000 resulting in a gain of \$947,000. On closing, US\$1,370,000 (CDN\$ 1,598,000) was paid into escrow to discharge the mortgage on the property and \$45,000 was retained by the purchaser to cover the Company's leaseback of the office from closing to March 31, 2006. The resulting net cash proceeds to the Company were \$1.1 million. On March 13, 2006 the Company moved its head office to smaller, more cost-efficient leased premises in Mississauga. There was no comparable amount for 2007.

### Net Loss for the Period and Total Comprehensive Loss

The loss for the period and total comprehensive loss for the three-months ended March 31, 2007 was \$3.5 million versus \$2.8 million in the three-months ended March 31, 2006. The lower loss in the comparable period was a result of the \$947,000 gain on sale assets. There were no comprehensive income or loss components in 2007 or 2006.

### Net Loss per Share

Net loss per common share on both a basic and diluted basis was \$0.02 for the three month period ending March 31, 2007 and the comparable period in 2006. The weighted average number of common shares outstanding on both a basic and diluted basis was 192.7 million for the quarter ending March 31, 2007 versus 129.9 million for the quarter ended March 31, 2006. The majority of the increase is attributable to the bought deal public offering completed in June 2006 that added 37.5 million shares and the exercise of 19.5 million warrants under the warrant incentive program during December 2006 and January 2007.

## Liquidity and Capital Resources

in thousands

	<b>Three-months ended March 31, 2007</b>	Three-months ended March 31, 2006
Net loss	<b>\$ (3,487)</b>	\$(2,771)
Items not involving current cash flows	<b>363</b>	(387)
Cash used in operations	<b>(3,124)</b>	(3,158)
Net change in non-cash working capital	<b>160</b>	(104)
Cash used in operating activities	<b>(2,964)</b>	(3,262)
Cash provided by investing activities	-	2,415
Cash provided by financing activities	<b>5,002</b>	3,625
	<b>2,038</b>	2,778
Effect of exchange rates on cash and cash equivalents	<b>(5)</b>	15
Net increase in cash and cash equivalents	<b>2,033</b>	2,793
Cash and cash equivalents, beginning of period	<b>11,213</b>	2,716
Cash and cash equivalents, end of period	<b>\$ 13,246</b>	\$ 5,509

## **Cash and Cash Equivalents**

Consolidated cash and cash equivalents increased to \$13.2 million at March 31, 2007, compared to \$11.2 million at December 31, 2006. At March 31, 2007 cash and cash equivalents include \$154,000 in term deposits that are posted as collateral against long-term debt and \$110,000 in guaranteed investment certificates that are posted as collateral against certain accounts payable.

## **Operating Activities**

Cash used in operating activities was \$3.0 million for the quarter ended March 31, 2007 compared to \$3.3 million for the quarter ended March 31, 2006. The decrease in funds used during the three-months was primarily due to recovery of non-cash working capital due to the collection of trade and commodity tax receivables and a reduction in inventory offset partially by a reduction in accounts payable and accrued liabilities versus an investment in non-cash working capital in the comparable period of 2006.

## **Investing Activities**

Net cash provided by investing activities were \$nil for the three-month period ended March 31, 2007 compared with \$2.4 million for the three-month period ended March 31, 2006. In 2006 the sale of the Company's former head office and furnishings generated \$2.7 million in proceeds that were partially offset by \$329,000 in expenditures on computer upgrades and furniture and leasehold improvements for the new head office.

## **Financing Activities**

Net cash provided by financing activities for the three-months ended March 31, 2007 totaled \$5.0 million and consisted primarily of \$5.3 million in proceeds from exercise of warrants offset by \$328,000 in debt repayments. Approximately, 12.7 million of the 13.1 million warrants exercised in the quarter were exercised in January under the warrant incentive program designed to encourage the early exercise of warrants from each of the three outstanding tranches. Under this program the Company amended the terms of the warrants issued in June 2004, November 2004 and June 2006 so that upon payment of a reduced exercise price of \$0.60, \$0.40 and \$0.40, respectively, and surrender of the holder's warrant the holder was entitled to receive one common share of Nuvo. The program commenced on December 11, 2006 and expired on January 31, 2007. If a warrant holder did not exercise his or her warrants prior to February 1, 2007, the warrants continue to be exercisable for common shares on the same terms as previously existed.

In the comparable three-month period ended March 31, 2006 net cash provided by financing activities totaled \$3.6 million. The January 2006 transactions whereby the Company sold additional Pennsaid licensing rights in Canada provided proceeds of \$3.75 million. Under the terms of this agreement, Squire made an up-front payment of \$3.25 million and invested \$500,000 in Nuvo through a three-year debenture convertible into Nuvo shares. In addition, during the first quarter of 2006 a total of \$1.9 million was generated from the exercise of warrants, stock options and employee contributions to the Share Purchase Plan. These proceeds were partially offset by a \$1.6 million payment into escrow to discharge the mortgage on the Company's former head office and \$430,000 in scheduled term loan repayments.

## Selected Quarterly Information (unaudited)

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

(in thousands, except per share data)

	<b>June 30, 2006</b>	<b>September 30, 2006</b>	<b>December 31, 2006</b>	<b>March 31, 2007</b>
	3 Months	3 Months	3 Months	3 Months
Revenue	\$ 1,360	\$ 1,250	\$ 1,005	\$ 978
Net loss	(3,847)	(3,385)	(3,012)	(3,487)
Loss per share	\$ (0.03)	\$ (0.02)	\$ (0.02)	\$ (0.02)

	<b>May 31, 2005</b>	<b>August 31, 2005</b>	<b>December 31, 2005</b>	<b>March 31, 2006</b>
	3 Months	3 Months	4 months	3 Months
Revenue	\$ 2,118	\$ 1,296	\$ 1,604	\$ 633
Net loss	(19,083) <sup>(3)</sup>	(1,612) <sup>(4)</sup>	(4,011) <sup>(5)</sup>	(2,771) <sup>(6)</sup>
Net income (loss) <sup>(1)</sup> per share	\$ 0.02 <sup>(2)</sup>	\$ (0.01)	\$ (0.03)	\$ (0.02)

(1) For all periods ending prior to June 1, 2005 net loss per share calculations are based on the net loss for the period, adjusted for charges to deficit for both accretion of and gains on acquisition commitments.

(2) In the quarter ended May 31, 2005 there was a \$22.9 million gain on restructuring of acquisition commitments that exceeded the net loss of \$19.1 million for the quarter ended May 31, 2005; as a result, that quarter showed positive \$0.02 net income per share.-

(3) The quarter ended May 31, 2005 includes a charge of \$15.5 million for the impairment of intangible assets and goodwill.

(4) The quarter ended August 31, 2005 includes a \$2.0 million gain on the sale of a subsidiary.

(5) The four-months ended December 31, 2005 includes a significant portion of the Phase III clinical trial costs for Pennsaid as final patient visits were completed.

(6) The quarter ended March 31, 2006 includes a \$1.0 million gain on the sale of the Company's former head office.

## Contractual Obligations

The following table lists the Company's contractual obligations as at March 31, 2007.

(in thousands)	Payments due by year ended						
	Total	April 1 – December 31, 2007	2008	2009	2010	2011	Thereafter
Short-term loan	\$ 584	\$ 584	\$ -	\$ -	\$ -	\$ -	\$ -
Long-term debt	606	326	70	70	70	70	-
Capital lease obligations	91	27	36	24	3	1	-
Debentures	\$4,636	-	-	\$4,636	-	-	-
Operating leases	960	209	262	167	154	155	13
Research and other contracts	686	686	-	-	-	-	-
<b>Total</b>	<b>\$7,563</b>	<b>\$1,832</b>	<b>\$368</b>	<b>\$4,897</b>	<b>\$227</b>	<b>\$226</b>	<b>\$13</b>

## Off-Balance Sheet Arrangements

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

## Related Party Transactions

Contract research services totaling \$14,000 for the three-months ended March 31, 2007 (\$12,000 for the three-months ended March 31, 2006) were provided by a researcher who holds a PhD in pharmacokinetics and who is a family member of one of the Company's officers. These services have been charged at fair market value and have been accounted for in research and development costs.

## Outstanding Share Data

The number of common shares outstanding as at March 31, 2007 is 197,033,679 an increase of approximately 13.7 million since December 31, 2006. The increase is due to the issue of 13.1 million common shares on the exercise of warrants, 346,491 issued on the conversion of \$158,000 of debentures and 294,656 issued to settle \$132,000 of professional fees.

As at March 31, 2007 there are 32,546,445 warrants and 16,667,340 options outstanding.

## Litigation

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

## Leadenhall

The Company's former head office property was subject to a \$2.0 million mortgage (the "Mortgage"). As previously disclosed, the Mortgage balance due is in dispute with Leadenhall Bank & Trust Company Limited ("the Mortgagee"). The Mortgage dispute centers on the calculation and amount of interest owing and is the subject of an Ontario court action (the "Ontario Action") commenced 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 cent per annum pursuant to the provisions of the Interest Act (Canada). 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\$1,067 (CDN\$1,241) (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. 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 which the Liquidator agreed that upon payment of US\$1,370 (CDN\$1,598) to the Liquidator in escrow to be held pending court approval of the Settlement Agreement, the Liquidator would deliver a discharge of the Mortgage. In January 2006, the said amount was paid to the Liquidator in escrow, the Mortgage was discharged and the sale of the head office was completed. Under the terms of the Escrow Agreement, the balance of the amount paid into escrow, US\$303 (approximately CDN\$350 at current exchange rates), is to be released to the Company upon approval by the Bahamian court of the Settlement Agreement.

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 it still intends to present the Settlement Agreement to the court for its consideration, it will not recommend that the court approve it. In addition, in its February 2007 Affidavit the Liquidator indicates that if the Court does not approve the Settlement Agreement, it will request that the Bahamian court order that all escrowed funds, including the US\$303 (CDN\$350) be released to it and not 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. If the Bahamian court does not approve the Settlement Agreement, the Escrow Agreement contemplates that the Ontario Action will continue to determine the respective rights of the parties to the escrow funds. The Company has retained legal counsel in the Bahamas to pursue 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 so that entitlement to the escrow funds can be determined in the Ontario Action.

A hearing in the Bahamian court was held on March 8, 2007 to review these matters and while nothing was ruled upon the judge did agree to schedule a subsequent hearing. At this hearing on March 20, 2007 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 did issue an Order that the funds continue to be held in escrow for at least 90 days so that the Company has the opportunity to bring an action in the Bahamian courts for the release of the funds based upon the non-ratification of the Settlement Agreement. In late March 2007 the judge retired and it is not known when the case will be reassigned to a new judge to be heard.

### **Ontario Securities Commission ("OSC")**

In October 2004, the Company received a letter from the OSC indicating it was reviewing the disclosures and trading activity of the Company and requesting that the Company provide, among other things, records pertaining to the FDA and the late-stage or Phase III testing of Pennsaid, as well as the Company's May 21, 2004 special warrant financing.

During 2006, the Company received a series of letters from the OSC requesting additional information and documentation related to the disclosure of the status of the Company's original application to the FDA for approval of Pennsaid. In these letters, the

OSC expressed concerns about the accuracy of the disclosure surrounding the status of the Company's New Drug Application with respect to Pennsaid in the United States contained in two prospectuses filed by the Company prior to the election of the new Board of Directors and appointment of the current management team in late September 2004. On October 6, 2004, the new Board of Directors and management issued a press release which included corrective statements indicating that the Pennsaid New Drug Application in the United States had been effectively on hold pending the development of clinical protocols and the completion of the studies contemplated thereby. The Company has co-operated with the OSC throughout their investigation which began shortly after the October 6, 2004 press release was issued.

On April 24, 2007 the Company reached a conditional settlement with the OSC that was subsequently approved by the OSC and became effective on April 26, 2007. The settlement involves a voluntary independent third party review of the Company's disclosure and reporting practices and procedures that have been implemented by the new Board of Directors and management. The Company agreed to implement any recommendations made as a result of this third party review within a reasonable time period and will pay \$15 towards the cost of the OSC's investigation. There were no other fines or penalties imposed against the Company. However, the Company could still be subject to civil liability in the event of a determination that there was any misrepresentation in its historical disclosures.

The OSC is still taking proceedings against the former President and CEO, Rebecca Keeler; however, the Staff of the OSC has advised certain of the former outside directors of the Company that they do not intend to commence any proceedings against those individuals at this time. These former directors have made a claim against the Company under the indemnity provisions contained in the Corporate By-Law for reimbursement of their legal costs associated with their interactions with the OSC in this matter. The Company's insurer has denied coverage for these costs. Although some of these costs may be recoverable under the Company's insurance if a successful challenge can be mounted against the insurer, management has accrued \$73, the amounts claimed for as at March 31, 2007.

## **Changes in Accounting Policies**

On January 1, 2007 the Company retroactively adopted the provisions of sections 1530, "Comprehensive Income", and 3251, "Equity", of the Canadian Institute of Chartered Accountants ("CICA") Handbook that deal with the disclosure of Comprehensive Income. The Company had no "other comprehensive income or loss" during the three-month periods ended March 31, 2007 and March 31, 2006. Upon adoption, the balance sheet line entitled "Currency translation adjustment" in the amount of \$114,000 was renamed "accumulated other comprehensive income". This balance arose prior to January 1, 2006 and relates 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.

On January 1, 2007 the Company retroactively adopted the provisions of sections 3855, "Financial Instruments – Recognition and Measurement", and 3861, "Financial Instruments – Disclosure and Presentation", of the CICA Handbook. Based on the

Company's previous accounting policies and the nature of its financial instruments, there has been no impact on the Company's financial statements as a result of the adoption of these two sections.

In conjunction with these new sections the CICA also issued Handbook section 3865, "Hedges", which describes when and how hedge accounting is applied. This guidance is effective for fiscal years commencing on or after October 1, 2006; however, the Company has not entered into any hedge transactions.

## **Critical Accounting Policies and Estimates**

The Company's consolidated financial statements are prepared in accordance with Canadian generally accepted accounting principles, applied on a consistent basis (except as noted above under Changes in Accounting Policies). In preparing our consolidated financial statements, we are required 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. We have identified revenue recognition, government assistance, valuation allowance for future tax assets, stock-based compensation and other equity-based instruments and impairment of long-lived assets as the accounting policies we believe require application of management's most subjective judgments, often requiring the need to make estimates about the effect of matters that are inherently uncertain and may change in subsequent periods. Our actual results could differ from these estimates and such differences could be material. For a more detailed discussion of the Company's critical accounting policies, please refer to the Management Discussion & Analysis included in the Company's December 2006 Annual Report.

## **Management's Responsibility for Financial Reporting**

### **Disclosure Controls**

The Company's Chief Executive Officer ("CEO") and Vice President, Finance and Chief Financial Officer ("CFO") have reviewed the disclosure controls in place as at March 31, 2007 and have concluded that they provide reasonable assurance that all material information relating to the Company would be made known to them. While the CEO and CFO believe that the Company's disclosure controls and procedures provide reasonable assurance they are also aware that any control system can only provide reasonable, not absolute, assurance of achieving its control objectives.

### **Internal Controls over Financial Reporting**

Management is also responsible for the design of internal controls over financial reporting ("ICFR") within the Company in order to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with Canadian generally accepted accounting principles ("Canadian GAAP"). Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. In addition, the design of any system of control is based upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all future events, no matter how remote, or that the degree of compliance with the policies or procedures may not deteriorate. Accordingly, even

effective ICFR can only provide reasonable, not absolute, assurance of achieving the control objectives for financial reporting.

At December 31, 2006 the Company evaluated its ICFR and determined disclosable weaknesses existed in the areas of segregation of duties, inventory, information technology systems and reliance on spreadsheets. A full discussion of these weaknesses is included in its annual MD&A contained in the Company's 2006 Annual Report. During the first quarter, no changes were made to ICFR; however, the Company initiated projects to remedy the weaknesses and will report on its progress in during the remainder of 2007.

## **Risk Factors**

Risk factors that could materially affect the results of operations and the financial condition of the Company are discussed in detail in the "Management's Discussion and Analysis" section of our December 2006 Annual Report and the "Risk Factors" section of our Annual Information Form filed March 23, 2007 and remain substantially unchanged.

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**NUVO RESEARCH INC.  
CONSOLIDATED BALANCE SHEETS**

(thousands of Canadian dollars)	As at <b>March 31, 2007</b> Unaudited \$	As at December 31, 2006 Audited \$
<b>ASSETS</b>		
<b>CURRENT</b>		
Cash and cash equivalents (note 3)	13,246	11,213
Accounts receivable	728	968
Other receivable	375	375
Inventories (note 4)	942	1,051
Prepaid expenses and other	745	892
<b>TOTAL CURRENT ASSETS</b>	<b>16,036</b>	14,499
Property, plant and equipment (note 5)	2,909	3,120
<b>TOTAL ASSETS</b>	<b>18,945</b>	17,619
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>CURRENT</b>		
Accounts payable and accrued liabilities	2,628	3,008
Short term loan (note 6)	584	557
Deferred revenue (note 7)	1,376	1,352
Current portion of long term debt and capital lease obligations (note 8)	390	677
<b>TOTAL CURRENT LIABILITIES</b>	<b>4,978</b>	5,594
Deferred revenue (note 7)	6,252	6,552
Long term debt and capital lease obligations (note 8)	296	337
Debentures (note 9)	1,986	1,999
<b>TOTAL LIABILITIES</b>	<b>13,512</b>	14,482
<b>SHAREHOLDERS' EQUITY</b>		
Common shares (note 10)	173,768	165,400
Warrants (note 11)	6,654	9,402
Contributed surplus (note 12)	5,048	4,885
Accumulated other comprehensive income (note 2)	114	114
Deficit	(180,151)	(176,664)
<b>TOTAL SHAREHOLDERS' EQUITY</b>	<b>5,433</b>	3,137
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<b>18,945</b>	17,619

*See accompanying notes.*

**NUVO RESEARCH INC.**  
**CONSOLIDATED STATEMENTS OF LOSS AND DEFICIT**

Unaudited (thousands of Canadian dollars except per share amounts)	<b>Three-months ended</b>	
	<b>March 31, 2007</b>	March 31, 2006
	\$	\$
<b>REVENUE</b>		
Product and research contract revenue	728	489
Licensing fees (note 7)	250	144
	<b>978</b>	<b>633</b>
<b>EXPENSES</b>		
Cost of goods sold	361	253
Research and development	1,738	1,479
Selling, general and administrative expenses	1,849	1,715
Stock-based compensation (note 13)	163	396
Amortization of property, plant, and equipment	211	177
Foreign currency loss	10	27
Interest, net (note 15)	133	304
	<b>4,465</b>	<b>4,351</b>
<b>LOSS FROM OPERATIONS</b>	<b>(3,487)</b>	<b>(3,718)</b>
Gain on sale of assets (note 16)	-	947
<b>NET LOSS FOR THE PERIOD AND TOTAL COMPREHENSIVE LOSS</b>	<b>(3,487)</b>	<b>(2,771)</b>
Deficit, beginning of period	<b>(176,664)</b>	<b>(163,649)</b>
<b>DEFICIT, END OF PERIOD</b>	<b>(180,151)</b>	<b>(166,420)</b>
<b>Net loss per common share – basic and diluted (note 14)</b>	<b>\$(0.02)</b>	<b>\$(0.02)</b>

*See accompanying notes.*

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

Unaudited	<b>Three-months ended</b>	
(thousands of Canadian dollars)	<b>March 31,</b>	March 31,
	<b>2007</b>	2006
	<b>\$</b>	<b>\$</b>
<b>OPERATING ACTIVITIES</b>		
Net loss	<b>(3,487)</b>	(2,771)
Items not involving current cash flows:		
Amortization	<b>211</b>	177
Deferred revenue recognized	<b>(276)</b>	(144)
Stock-based compensation and payments (note 13)	<b>295</b>	396
Accretion of interest on debentures (note 9)	<b>145</b>	131
Gain on sale of assets (note 16)	<b>-</b>	(947)
Other	<b>(12)</b>	-
Net change in non-cash working capital balances (note 18)	<b>160</b>	(104)
<b>CASH USED IN OPERATING ACTIVITIES</b>	<b>(2,964)</b>	(3,262)
<b>INVESTING ACTIVITIES</b>		
Acquisition of property, plant and equipment	<b>-</b>	(329)
Proceeds from sale of assets (note 16)	<b>-</b>	2,744
<b>CASH PROVIDED BY INVESTING ACTIVITIES</b>	<b>-</b>	2,415
<b>FINANCING ACTIVITIES</b>		
Issuance of common shares, net of related costs (note 10)	<b>5,330</b>	1,903
Issue of debenture (note 9)	<b>-</b>	500
Proceeds from license and supply agreements (note 7)	<b>-</b>	3,250
Repayment of short term loan (note 6)	<b>-</b>	(1,598)
Repayments of long term debt and capital lease obligations	<b>(328)</b>	(430)
<b>CASH PROVIDED BY FINANCING ACTIVITIES</b>	<b>5,002</b>	3,625
Effect of exchange rate changes on cash and cash equivalents	<b>(5)</b>	15
Net increase in cash and cash equivalents during the period	<b>2,033</b>	2,793
Cash and cash equivalents, beginning of period	<b>11,213</b>	2,716
<b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>	<b>13,246</b>	5,509
<b>Interest paid</b>	<b>43</b>	43

*See accompanying notes.*

*Significant non-cash financing activities are discussed in notes 9 and 10*

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

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

### **1. BASIS OF PRESENTATION**

These unaudited interim consolidated financial statements of Nuvo Research Inc. (the "Company") have been prepared by management in accordance with Canadian generally accepted accounting principles ("Canadian GAAP") and follow the same accounting policies and methods of application as the audited annual financial statements for the year ended December 31, 2006, except as described in note 2. These interim consolidated financial statements do not contain all disclosures required by Canadian GAAP and should be read in conjunction with the audited annual consolidated financial statements.

#### **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 March 31, 2007 the Company has an accumulated deficit of \$180,151 including a loss of \$3,487 during the first quarter of fiscal 2007. The Company's ability to continue as a going concern depends on its ability to secure additional licensing fees, secure co-development agreements, obtain additional capital 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. CHANGES IN ACCOUNTING POLICIES**

On January 1, 2007 the Company retroactively adopted the provisions of sections 1530, "Comprehensive Income", and 3251, "Equity", of the Canadian Institute of Chartered Accountants ("CICA") Handbook that deal with the disclosure of Comprehensive Income. The Company had no "other comprehensive income or loss" during the three-month periods ended March 31, 2007 and March 31, 2006. Upon adoption, the balance sheet line entitled "Currency translation adjustment" in the amount of \$114 was renamed "accumulated other comprehensive income". This balance arose prior to January 1, 2006 and relates 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.

On January 1, 2007 the Company retroactively adopted the provisions of sections 3855, "Financial Instruments – Recognition and Measurement", and 3861, "Financial Instruments – Disclosure and Presentation", of the CICA Handbook. Based on the Company's previous accounting policies and the nature of its financial instruments, there has been no impact on the Company's financial statements as a result of the adoption of these sections.

In conjunction with these new sections the CICA also issued Handbook section 3865, "Hedges", which describes when and how hedge accounting is applied. This guidance is effective for fiscal years commencing on or after October 1, 2006; however, the Company has not entered into any hedge transactions.

### **3. CASH AND CASH EQUIVALENTS**

Cash and cash equivalents include \$154 in term deposits that are posted as collateral against long term debt and \$110 in guaranteed investment certificates that are posted as collateral against certain accounts payable.

#### 4. INVENTORIES

Inventories consist of the following as at:

	March 31, 2007	December 31, 2006
	\$	\$
Raw materials	319	423
Work in process	491	486
Finished goods	132	142
	942	1,051

#### 5. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment consists of:

	As at March 31, 2007		
	Cost	Accumulated amortization	Net book value
	\$	\$	\$
Land	124	-	124
Buildings	2,105	804	1,301
Leasehold improvements	122	25	97
Furniture and fixtures	240	92	148
Computer equipment	320	226	94
Computer software	257	151	106
Production, laboratory and other equipment (i)	2,632	1,593	1,039
	5,800	2,891	2,909

	As at December 31, 2006		
	Cost	Accumulated amortization	Net book value
	\$	\$	\$
Land	124	-	124
Buildings	2,105	766	1,339
Leasehold improvements	122	20	102
Furniture and fixtures	240	82	158
Computer equipment	320	206	114
Computer software	257	135	122
Production, laboratory and other equipment (i)	2,632	1,471	1,161
	5,800	2,680	3,120

- (i) Production, laboratory and other equipment at March 31, 2007 includes cost of \$96 and accumulated amortization of \$13 for assets under capital leases [December 31, 2006 - \$96 and \$8 respectively]. Amortization of property, plant and equipment for the three-months ended March 31, 2007 includes \$5 related to assets under capital leases [three-months ended March 31, 2006 - \$nil]

## 6. SHORT TERM LOAN

The following is a continuity schedule of the short term loan:

	Three-months ended March 31,		Year ended December 31,
	2007	2006	2006
	\$	\$	
Balance, beginning of period	557	2,041	2,041
Accrued interest expense	33	98	105
Payment into escrow	-	(1,598)	(1,598)
Foreign currency loss (gain)	(6)	8	9
Balance, end of period	584	549	557

The balance owing under this loan, originally provided by Leadenhall Bank and Trust Company (“Leadenhall”) is in dispute and the subject of legal actions between the Company and Leadenhall’s court appointed liquidator as discussed in note 21, “Contingencies and Other Matters”.

## 7. DEFERRED REVENUE

Deferred revenue is as follows:

	Three-months ended March 31,		Year ended December 31,
	2007	2006	2006
	\$	\$	\$
Balance, beginning of period	7,904	5,344	5,344
Upfront payments from Squire Pharmaceuticals Inc. (i)	-	3,250	3,500
Advances on research contracts not recognized in the period received	-	30	85
	7,904	8,624	8,929
<i>less:</i>			
Amortization of license and supply agreements	250	144	789
Delivery of promotional goods under supply agreement	-	-	200
Recognition of prior year research contract revenue	26	36	36
Balance, end of period	7,628	8,444	7,904
Amount to be recognized within one year	1,376	1,241	1,352
Long-term balance	6,252	7,203	6,552

On January 16, 2006 the Company and Squire Pharmaceuticals Inc. (“Squire”), a subsidiary of Paladin Labs Inc., entered into an agreement which expanded their relationship with respect to the sale and marketing of Pennsaid in Canada. The terms of this expanded agreement included Squire making an upfront payment of \$3,250, providing an additional share of future operating profits, future royalties on the sales of Pennsaid commencing in 2010 and an investment of \$500 in Nuvo through a three-year convertible debenture (see note 9). The Company has provided certain guarantees of the ongoing market performance of Pennsaid in the Canadian market over a four year period, which could require payments to be made if certain targets are not met. The first interim measurement occurs in mid 2007. The Company’s debenture and performance obligations are collateralized by revenue from Pennsaid sales in Europe, a second mortgage over Nuvo’s manufacturing facility in Québec, a second 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.

## 8. LONG TERM DEBT AND CAPITAL LEASE OBLIGATIONS

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

	March 31, 2007	December 31, 2006
	\$	\$
Government debt	291	511
Mortgage	315	418
Capital lease obligations	80	85
	686	1,014
Less amounts due within one year	390	677
Balance, end of period	296	337

### Capital Lease Obligations

The Company leases lab and office equipment under capital leases expiring at various dates through May 2011, for which the minimum future lease payments are as follows for the twelve-month periods ending March 31:

	\$
2008	36
2009	36
2010	16
2011	3
Total minimum lease payments	91
Less: amount representing interest (approximately 9.8%)	(11)
Present value of minimum lease payments	80
Current portion of capital lease obligations	29
	51

Interest paid on capital lease obligations amounted to \$2 for the quarter ended March 31, 2007 [March 31, 2006 - \$nil].

### Principal Repayments

Aggregate maturities of long term debt and capital lease obligations are estimated to be as follows for the twelve-month periods ending March 31:

	\$
2008	390
2009	102
2010	86
2011	73
2012	35
	686

## 9. DEBENTURES

The following table summarizes the debentures outstanding as at:

	Face Value	Carrying Value	
	Outstanding as at March 31, 2007 \$	March 31, 2007 \$	December 31, 2006 \$
November 2004 Unsecured Convertible Debentures, interest payable semi-annually at 5%, maturing November 2009, convertible into common shares at \$0.30 or \$0.39	4,136	<b>1,486</b>	1,341
January 2006 Convertible Debenture, interest payable semi-annually at 8%, maturing January 2009, collateralized and convertible into common shares at \$0.456	-	-	158
December 2006 Convertible Debenture, interest payable semi-annually at 8%, maturing December 2009, collateralized and convertible into common shares at \$0.60	500	<b>500</b>	500
	4,636	<b>1,986</b>	1,999

The following is a continuity schedule of the debentures outstanding:

	Common shares issuable upon conversion (000s)	Carrying value \$	Value at maturity \$
Balance, December 31, 2005	17,948	1,158	5,500
First Quarter 2006			
Issued [note 7]	1,096	500	500
Converted to shares	(1,212)	(80)	(364)
Accretion charged to interest expense		131	
Balance, March 31, 2006	17,832	1,709	5,636
April to December 2006			
Issued	834	500	500
Converted to shares	(4,084)	(648)	(1,342)
Accretion charged to interest expense		438	
Balance, December 31, 2006	14,582	1,999	4,794
Converted to shares	(346)	(158)	(158)
Accretion charged to interest expense		145	
<b>Balance, March 31, 2007</b>	<b>14,236</b>	<b>1,986</b>	<b>4,636</b>

## 10. COMMON SHARES

The following is a continuity schedule of the common shares outstanding:

	Number of shares (000's)	Consideration \$
Balance, December 31, 2006	183,299	165,400
Debtures converted to shares	346	158
Warrants exercised	13,094	8,078
Professional fees settled in shares	295	132
<b>Balance, March 31, 2007</b>	<b>197,034</b>	<b>173,768</b>

## 11. WARRANTS

The following is a continuity schedule of the warrants outstanding:

	Number of warrants (000's)	Exercise Price \$	Fair value \$	Expiry date
Balance, December 31, 2006	45,532	0.50	9,402	
Issued on exercise of Underwriter warrants	108	0.50	-	June 20, 2009
Exercised under the warrant incentive program	(12,727)	0.41	(2,686)	
Other warrants exercised	(367)	0.44	(62)	
<b>Balance, March 31, 2007</b>	<b>32,546</b>	<b>0.51</b>	<b>6,654</b>	

On November 20, 2006 the Company announced a warrant incentive program (the "Incentive Program") designed to encourage the early exercise of warrants. The Company amended the June 2004 Warrants, the November 2004 Warrants and the June 2006 Warrants so that upon payment of a reduced exercise price of \$0.60, \$0.40 and \$0.40, respectively, and surrender of the holder's warrant in accordance with applicable procedures, the holder was entitled to receive one common share of Nuvo. The period to exercise warrants under the Incentive Program commenced December 11, 2006 and expired on January 31, 2007. If a warrant holder did not exercise his or her warrants prior to February 1, 2007, the warrants continue to be exercisable for common shares on the same terms as previously existed. The warrants outstanding by tranche are as follows:

	Expiry Date	Original Exercise Price \$	Incentive Program Exercise Price \$	Number of warrants as at	
				<b>March 31, 2007 (000's)</b>	December 31, 2006 (000's)
June 2004 Warrants	June 10, 2007	0.73	0.60	<b>6,799</b>	7,235
November 2004 Warrants	November 16, 2009	0.45	0.40	<b>20,012</b>	27,141
June 2006 Underwriter Warrants <sup>(i)</sup>	June 20, 2008	0.40	n/a	<b>1,833</b>	2,156
June 2006 Warrants	June 20, 2009	0.50	0.40	<b>3,902</b>	9,000
				<b>32,546</b>	45,532

(i) The June 2006 Underwriter Warrants were not eligible to participate in the Incentive Program.

## 12. CONTRIBUTED SURPLUS

The following table summarizes the changes in the contributed surplus account:

	Three-months ended March 31,		Year ended
	2007	2006	December 31,
	\$	\$	2006
			\$
Balance, beginning of period	4,885	3,957	3,957
Compensation expense recognized on employee, consultant and director stock options	163	214	900
Employee and director stock options exercised	-	(13)	(26)
Warrants expired	-	-	54
Balance, end of period	5,048	4,158	4,885

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

Information concerning the Company's Share Incentive Plan consisting of the share option plan, share purchase plan and share bonus plan is included in Note 16 "Stock-Based Compensation and Other Stock-Based Payments" of the Company's audited consolidated financial statements for the year ended December 31, 2006 contained in the Company's December 2006 Annual Report.

### Share Option Plan

The following is a continuity schedule of the options outstanding:

	Number of options (000's)	Range of exercise price \$	Weighted average exercise price \$
Balance, December 31, 2006	16,677	0.18 - 5.95	0.33
Expired	(10)	0.57 - 3.10	2.06
<b>Balance, March 31, 2007</b>	<b>16,667</b>	<b>0.18 - 5.95</b>	<b>0.33</b>

The following table summarizes the outstanding and exercisable options held by directors, officers, employees and consultants at March 31, 2007:

Exercise Price Range	Outstanding			Exercisable	
	Number of Options (000's)	Remaining contractual life (years)	Weighted average exercise price	Vested Options	Weighted average exercise price
\$0.18 - \$0.20	10,175	8.5	\$0.20	6,783	\$0.20
\$0.30 - \$0.39	6,029(i)	7.8	\$0.34	5,146	\$0.33
\$0.57	95	7.2	\$0.57	63	\$0.57
\$1.12 - \$5.95	368	4.3	\$3.80	368	\$3.80
	16,667	8.2	\$0.33	12,360	\$0.36

- (i) Includes 400 options at \$0.385 with a remaining contractual life of 9.6 years granted to a consultant that are forfeitable and unvested.

## Summary of Stock-Based Compensation and Other Stock-Based Payments

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

	Three-months ended March 31,	
	2007	2006
	\$	\$
Stock option compensation expense	163	214
Cost of the employer's portion of shares issued to employees under the Share Purchase Plan	-	182
<b>Stock-based compensation expense</b>	<b>163</b>	<b>396</b>
<b>Other stock-based payments</b>		
Payment for consulting services included in selling, general and administrative expenses	132	-

## 14. NET LOSS PER COMMON SHARE

Net loss per common share is calculated as follows:

	Three months ended March 31,	
	2007	2006
	\$	\$
Net loss	(3,487)	(2,771)
Average number of basic and diluted common shares outstanding for the period (millions)	192.7	129.9
Basic and diluted net loss per common share	<b>(\$0.02)</b>	<b>(\$0.02)</b>

The calculation of diluted loss per common share excludes all options, warrants and convertible debentures for all periods as they were anti-dilutive.

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:

	March 31, 2007 (000s)	December 31, 2006 (000s)
Common shares issued and outstanding (note 10)	197,034	183,299
Warrants outstanding (note 11) (i)	32,546	45,532
Stock options outstanding (note 13) (ii)	16,267	16,077
Convertible debentures (note 9)	14,236	14,582
	<b>260,083</b>	<b>259,490</b>

- (i) Excludes 610 warrants [December 31, 2006 – 719] potentially issuable upon the exercise of the June 2006 Underwriter Warrants.
- (ii) Excludes 400 options [December 31, 2006 – 600] granted to a consultant that are unvested and forfeitable.

## 15. INTEREST, NET

Interest, net consists of:

	Three months ended March 31,	
	2007	2006
	\$	\$
Interest on long term debt, capital lease obligations and debentures	78	114
Interest on short term loan	33	98
Accretion of debentures	145	131
Interest income	(133)	(48)
Other	10	9
Interest, net	133	304

## 16. GAIN ON SALE OF ASSETS

On January 6, 2006 the Company sold its former head office for \$2,744, net of commissions and closing costs. Net book value was \$1,797, resulting in a gain on disposal of \$947. On closing, US\$1,370 (CDN\$1,598) was paid into escrow to discharge the mortgage on the property (see note 21).

## 17. RESTRUCTURING COST ACCRUAL

Total restructuring costs accrued in the financial statements are as follows as at:

	March 31, 2007	December 31, 2006
	\$	\$
Restructuring accrual, beginning of period	44	181
Restructuring costs (recovery)	-	(86)
Payments	(26)	(51)
Restructuring accrual, end of period	18	44

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

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

	Three-months ended March 31,	
	2007	2006
	\$	\$
Accounts payable and accrued liabilities	(336)	175
Accounts receivable	240	28
Inventories	109	(288)
Prepaid expenses and other	147	(19)
Net change in non-cash working capital	160	(104)

## 19. SEGMENTED INFORMATION

### Segments

Beginning in late 2004 the management of the Company undertook a program to reorganize the business of the Company. The program included: the sale of non-core product lines, the sale of non-strategic assets, the recapitalization of the Company, the outsourcing of product sales and marketing through licensing arrangements, refocusing on two research and development platforms: transdermal drug delivery and immune system modulation. In late 2006 the reorganization was substantively completed.

Now that the reorganization has been completed segment reporting has been restated to reflect the Company's focus on its two key platforms. The accounting policies for the segments are the same as those described in note 2 to the consolidated financial statements. Intersegment transactions are accounted for at exchange values. From a financial perspective executive management uses the loss from operations to assess the performance of each segment.

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

	<b>Transdermal Drug Delivery</b>	<b>Immune System Modulation</b>	<b>Total</b>
	<b>\$</b>	<b>\$</b>	<b>\$</b>
<b>Three months ended March 31, 2007</b>			
Total revenue	847	131	978
Amortization of property, plant and equipment	174	37	211
Interest revenue	132	1	133
Interest expense	260	6	266
Loss from operations	(3,395)	(92)	(3,487)
Assets	17,479	1,466	18,945
Property, plant and equipment	2,369	540	2,909
Additions to property, plant and equipment	-	-	-
<b>Three months ended March 31, 2006</b>			
Total revenue	486	148	633
Amortization of property, plant and equipment	138	39	177
Interest revenue	48	-	48
Interest expense	344	8	352
Loss from operations	(2,756)	(15)	(2,771)
Assets	11,179	506	11,685
Property, plant and equipment	2,678	691	3,369
Additions to property, plant and equipment	328	1	329

### Geographic information

The geographic destination of the Company's sales to its external customers is as follows:

	<b>Three months ended March 31,</b>	
	<b>2007</b>	<b>2006</b>
	<b>\$</b>	<b>\$</b>
Canada	412	327
Europe	426	95
Other foreign countries	140	211
	<b>978</b>	<b>634</b>

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

	<b>March 31, 2007</b>	December 31, 2006
	<b>\$</b>	<b>\$</b>
Canada	<b>1,795</b>	1,893
Europe	<b>540</b>	577
Other foreign countries	<b>574</b>	650
	<b>2,909</b>	3,120

## **20. RELATED PARTY TRANSACTIONS**

Contract research services totalling \$14 for the quarter ended March 31, 2007 [March 31, 2006 - \$12] were provided by a researcher who holds a PhD in pharmacokinetics and who is a family member of one of the Company's officers. These services have been charged at fair market value and have been accounted for in research and development expenses.

## **21. CONTINGENCIES AND OTHER MATTERS**

### **Leadenhall**

The Company's former head office property was subject to a \$2.0 million mortgage (the "Mortgage"). As previously disclosed, the Mortgage balance due is in dispute with Leadenhall Bank & Trust Company Limited ("the Mortgagee"). The Mortgage dispute centers on the calculation and amount of interest owing and is the subject of an Ontario court action (the "Ontario Action") commenced 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 cent per annum pursuant to the provisions of the Interest Act (Canada). 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\$1,067 (CDN\$1,241) (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. 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 which the Liquidator agreed that upon payment of US\$1,370 (CDN\$1,598) to the Liquidator in escrow to be held pending court approval of the Settlement Agreement, the Liquidator would deliver a discharge of the Mortgage. In January 2006, the said amount was paid to the Liquidator in escrow, the Mortgage was discharged and the sale of the head office was completed. Under the terms of the Escrow Agreement, the balance of the amount paid into escrow, US\$303 (approximately CDN\$350 at current exchange rates), is to be released to the Company upon approval by the Bahamian court of the Settlement Agreement.

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 it still intends to present the Settlement Agreement to the court for its consideration, it will not recommend that the court approve it. In addition, in its February 2007 Affidavit the Liquidator indicates that if the Court does not approve the Settlement Agreement, it will request that the Bahamian court order that all escrowed funds, including the US\$303 (CDN\$350) be released to it and not 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. If the Bahamian court does not approve the Settlement Agreement, the Escrow Agreement

contemplates that the Ontario Action will continue to determine the respective rights of the parties to the escrow funds. The Company has retained legal counsel in the Bahamas to pursue 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 so that entitlement to the escrow funds can be determined in the Ontario Action.

A hearing in the Bahamian court was held on March 8, 2007 to review these matters and while nothing was ruled upon the judge did agree to schedule a subsequent hearing. At this hearing on March 20, 2007 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 did issue an Order that the funds continue to be held in escrow for at least 90 days so that the Company has the opportunity to bring an action in the Bahamian courts for the release of the funds based upon the non-ratification of the Settlement Agreement. In late March 2007 the judge retired and it is not known when the case will be reassigned to a new judge to be heard. The continuity schedule outlining the transactions relating to and the amount accrued in these consolidated financial statements for this Short Term Loan are described in note 6.

### **Ontario Securities Commission (“OSC”)**

In October 2004, the Company received a letter from the OSC indicating it was reviewing the disclosures and trading activity of the Company and requesting that the Company provide, among other things, records pertaining to the FDA and the late-stage or Phase III testing of Pennsaid, as well as the Company’s May 21, 2004 special warrant financing.

During 2006, the Company received a series of letters from the OSC requesting additional information and documentation related to the disclosure of the status of the Company’s original application to the FDA for approval of Pennsaid. In these letters, the OSC expressed concerns about the accuracy of the disclosure surrounding the status of the Company’s New Drug Application with respect to Pennsaid in the United States contained in two prospectuses filed by the Company prior to the election of the new Board of Directors and appointment of the current management team in late September 2004. On October 6, 2004, the new Board of Directors and management issued a press release which included corrective statements indicating that the Pennsaid New Drug Application in the United States had been effectively on hold pending the development of clinical protocols and the completion of the studies contemplated thereby. The Company has co-operated with the OSC throughout their investigation which began shortly after the October 6, 2004 press release was issued.

On April 24, 2007 the Company reached a conditional settlement with the OSC that was subsequently approved by the OSC and became effective on April 26, 2007. The settlement involves a voluntary independent third party review of the Company’s disclosure and reporting practices and procedures that have been implemented by the new Board of Directors and management. The Company agreed to implement any recommendations made as a result of this third party review within a reasonable time period and will pay \$15 towards the cost of the OSC’s investigation. There were no other fines or penalties imposed against the Company. However, the Company could still be subject to civil liability in the event of a determination that there was any misrepresentation in its historical disclosures.

The OSC is still taking proceedings against the former President and CEO, Rebecca Keeler; however, the Staff of the OSC has advised certain of the former outside directors of the Company that they do not intend to commence any proceedings against those individuals at this time. These former directors have made a claim against the Company under the indemnity provisions contained in the Corporate By-Law for reimbursement of their legal costs associated with their interactions with the OSC in this matter. The Company’s insurer has denied coverage for these costs. Although some of these costs may be recoverable under the Company’s insurance if a successful challenge can be mounted against the insurer, management has accrued \$73, the amounts claimed for as at March 31, 2007.

## **22. COMPARATIVE FIGURES**

Certain figures in the March 31, 2006 financial statements have been re-classified to conform to the basis of presentation for the quarter ended March 31, 2007.