

Nuvo Research Inc. 2007 Second Quarter Report



Message to Shareholders:

Nuvo's top priority remains the final approval of Pennsaid, our topical anti-inflammatory drug for the treatment of the symptoms of osteoarthritis, by the U.S. FDA. We received an approvable letter for Pennsaid from the FDA in December 2006 and the FDA has recently clarified some key issues regarding the path forward to Pennsaid final approval. As a result of this clarification, we believe that we will be in a position to file a complete resubmission of our application for Pennsaid approval in the first half of 2009 and be eligible to receive final marketing approval in the second half of 2009.

None of the conditions to approval contained in the approvable letter relate to the clinical efficacy or clinical safety of Pennsaid which have been effectively demonstrated in our clinical trials. Accordingly, the FDA has not requested that we conduct any additional Phase III clinical trials.

To satisfy the FDA's additional informational requirements, we will conduct additional testing including long-term dermal animal studies prior to resubmitting our application for final approval. We have started or are about to start all of these studies.

More than 21 million Americans suffer from osteoarthritis, a very painful and debilitating condition, and the United States market is estimated at US\$4 billion annually. Given that Pennsaid could be the first topical NSAID product approved in the United States for the treatment of the symptoms of osteoarthritis, we believe Pennsaid would be able to capture a significant share of this market.

In July, we completed a bought deal financing that generated gross proceeds of \$20 million that will be used to fund the additional studies to address Pennsaid approvable letter requirements and to continue with our transdermal drug development plans. The financing attracted some leading U.S.-based institutional biotechnology investors, which is a testament to the potential of Pennsaid and Nuvo.

While Pennsaid remains our top priority, we are aware of the need to expand our transdermal drug pipeline. We are continuing to develop Pennsaid® Plus, a proprietary formulation designed to provide users with the efficacy of original Pennsaid, but with less frequent dosing and easier application.

During the quarter, we continued to validate, broaden and extend our proprietary formulations platform utilizing Multiplexed Molecular Penetration Enhancer technology (MMPE™) developed by our fqubed, Inc., subsidiary in San Diego. Formulations for the treatment of acute pain like sport injuries, to provide relief for superficial pain, and to treat onychomycosis, or nail-bed fungus, are now under development.

In closing, we would like to thank all of our stakeholders for their patience as we work through the final issues standing in the way of the final regulatory U.S. approval for Pennsaid. We also would like to extend our 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")

August 1, 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

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 83 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 qubed.

Highlights

During the second quarter and prior to the release of second quarter results the Company:

- Closed a bought deal equity financing that was announced in June 2007 for a total of 100 million units (“Units”) issued at a price of \$0.20 per Unit for gross proceeds of \$20 million on July 13, 2007 (“July Bought Deal”). Each Unit consisted of one common share and one-half of a common share purchase warrant of the Company, each whole warrant entitling the holder thereof to acquire one common share at a price of \$0.30 per share until July 13, 2009. Net cash proceeds are estimated to be \$18.4 million, after deducting the underwriters’ fee of 6% and the estimated expenses of the offering. As part of the transaction the Underwriters will receive 5 million warrants (the “Underwriter Warrants”) for services provided in conjunction with the July Bought Deal. The Underwriter Warrants are each exercisable into one Unit at a price of \$0.20 per Unit for a period of 24 months following the Closing Date; and
- Received FDA minutes confirming the conclusions reached in the discussions with and the contents of informal communications from the FDA in June 2007 regarding the Approvable Letter that confirmed Pennsaid could be approved for sale in the United States. Based on the results of these discussions, the FDA has agreed that the longest study can be submitted post approval, provided no safety concerns have arisen from any of the required studies at the time the Company resubmits its new drug application (“NDA”) for Pennsaid. Nuvo anticipates that it will complete all necessary studies and be in a position to file a complete resubmission of its application for Pennsaid approval with the FDA in the first half of 2009 and be eligible to receive final marketing approval in the second half of 2009. There can be no assurance that these anticipated timelines will be achieved, as they are dependant on a number of factors, including successful completion of other shorter studies to address other conditions within the Approvable Letter.

Additionally during the first half of the year the Company:

- Raised an additional \$5.2 million from its early warrant incentive program;
- 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 June 30, 2007 the Company had an accumulated deficit of \$183.2 million including losses of \$3.0 million and \$6.5 million in the three and six-months ended June 30, 2007, respectively. At June 30, 2007 the Company had cash and cash equivalents of \$9.3 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, including the net proceeds from the July Bought Deal, are sufficient to execute its plans, the Company's ability to continue as a going concern, expand its product pipeline, move current product candidates into clinical trials and complete longer term animal studies the FDA requires 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 have been attempting to clarify the timeframe with the FDA.

Selected Financial Information

in thousands (except per share and share information)

	Three- months ended June 30, 2007	Three- months ended June 30, 2006	Six-months ended June 30, 2007	Six-months ended June 30, 2006
<i>Operations</i>				
Product and research contract revenue	\$ 1,185	\$ 1,216	\$ 1,913	\$ 1,705
Licensing fees	250	144	500	288
Total revenue	1,435	1,360	2,413	1,993
Cost of goods sold	587	777	948	1,030
Operating expenses	3,882	4,345	7,986	8,443
Total expenses	4,469	5,122	8,934	9,473
Loss from operations	(3,034)	(3,762)	(6,521)	(7,480)
Other expense (income)	-	85	-	(862)
Net loss and total comprehensive loss	\$ (3,034)	\$ (3,847)	\$ (6,521)	\$ (6,618)

Share Information

Net loss per share	\$ (0.01)	\$ (0.03)	\$ (0.03)	\$ (0.05)
Weighted average outstanding shares for the period (in millions)	197.1	138.0	194.9	134.5

Financial Position

	As at June 30, 2007	As at December 31, 2006
Cash and cash equivalents	\$ 9,258	\$ 11,213
Total assets	15,648	17,619
Deferred revenue, including current portion	7,319	7,904
Long term debt, debentures and capital lease obligations, including current portions	2,581	3,013
Total liabilities	13,038	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 June 30, 2007	Three- months ended June 30, 2006	Six- months ended June 30, 2007	Six- months ended June 30, 2006
Pennsaid revenue	\$ 881	\$ 932	\$ 1,431	\$ 1,164
WF10 revenue	167	256	298	404
Research and other contract revenue	137	28	184	137
Total product sales and research contract revenue	1,185	1,216	1,913	1,705
Cost of goods sold	587	777	948	1,030
Gross profit	\$ 598	\$ 439	\$ 965	\$ 675
Gross profit percentage	50%	36%	50%	40%

Revenue and Gross Profit

Product sales and research contract revenue for the three-months ended June 30, 2007 decreased slightly to \$1.185 million compared to \$1.216 million for the three-months ended June 30, 2006. This decrease is primarily the result of slightly lower Pennsaid revenue of \$881,000 during the three-months ended June 30, 2007 compared to \$932,000 for the three-months ended June 30, 2006. The higher Pennsaid revenue in the prior year quarter was primarily due to a spike in Canadian sales during June 2006 as our distributor, Squire Pharmaceuticals ("Squire"), introduced Pennsaid in its new product format. This new format consisted of a 120ml twin pack (two 60 ml bottles) versus a single 60ml bottle. While this level of sales was not repeated in June 2007 Canadian sales were nonetheless encouraging as they grew versus the first quarter of 2007. Partially offsetting the decrease versus a year ago was the increase in European sales as Vianex S.A. launched Pennsaid in Greece during February 2007 and sales to our Italian distributor increased. Product sales and research contract revenue for the six-months ended June 30, 2007 increased to \$1.9 million compared to \$1.7 million for the six-months ended June 30, 2006. This increase is primarily a result of the launch of Pennsaid in Greece and higher sales to our Italian distributor, partially offset by slightly lower sales in Canada.

The gross margin for the three and six-months ended June 30, 2007 increased to 50% compared to 36% and 40% for the three and six-months ended June 30, 2006, respectively. This increase is due to product mix, high gross margin on our research contract revenue and the positive effect of foreign exchange as the translated value of our European sales increased due to the strengthening of the euro and British pound against the Canadian dollar.

License Fees

During the quarter and six-months ended June 30, 2007, Nuvo recorded \$250,000 and \$500,000 in license fee revenue that was previously deferred, compared with \$144,000 and \$288,000 for the comparable quarter and six-months ended June 30, 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

	Three- months ended June 30, 2007	Three- months ended June 30, 2006	Six- months ended June 30, 2007	Six- months ended June 30, 2006
Research and development	\$1,684	\$ 2,161	\$ 3,422	\$ 3,640
Selling, general and administrative	1,699	1,437	3,548	3,152
Stock-based compensation	211	311	374	707
Amortization of property, plant and equipment	215	196	426	373
Interest, net	164	303	297	607
	3,973	4,408	8,067	8,479
Foreign currency gain	(91)	(63)	(81)	(36)
Total operating expenses	\$ 3,882	\$ 4,345	\$ 7,986	\$ 8,443

Total operating expenses decreased by 11% to \$3.9 million and 5% to \$8.0 million for the three and six-months ended June 30, 2007 compared to \$4.3 million and \$8.4 million for the comparable periods last year. This decrease is primarily due to lower research and development costs, stock-based compensation and interest expense offsetting increases in selling, general and administrative costs.

Research and Development

Research and development expenses decreased 22% to \$1.7 million and 6% to \$3.4 million for the three and six-month periods ended June 30, 2007, compared with \$2.2 million and \$3.6 million for the three and six-months ended June 30, 2006. In the current quarter costs declined and were lower than expected as the Company delayed spending on many of the Approvable Letter related studies as it attempted to clarify the path to approval with the FDA. As a result of discussions in June 2007, that were confirmed in FDA minutes received in July 2007, the Company now has the clarity it requires to commence the longer term dermal animal studies. As a result, research and development spending for the remainder of 2007 is expected to be significantly higher than in 2006. In the quarter ending June 30, 2006, research and development costs were higher than in 2007 as the Company employed a higher level of clinical, regulatory and research staff as it completed all work related to the FDA submission for Pennsaid and incurred filing fees related to the submission.

The decrease in research and development spending for the six-months ended June 30, 2007, is due the delayed spending of the Approvable Letter related studies as discussed above, partially offset by the costs related to developing the plan (including all necessary

studies) to address each of the FDA's issues as outlined in the Approvable Letter and continued activity at fqubed as the Company continues 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 for onychomycosis, for which fungal kill assays were completed in the first quarter of 2007. In the comparable period ending June 30, 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 of the Company's June 2006 FDA submission for Pennsaid.

Selling, General and Administrative (SG&A)

SG&A expenses increased 18% to \$1.7 million and 13% to \$3.5 million for the three and six-month periods ended June 30, 2007 respectively, compared to \$1.4 million and \$3.2 million for the respective periods ended June 30, 2006. The increase for the three and six-month periods ending June 30, 2007 is attributable primarily to higher costs related to: compliance with Bill 198; legal fees arising from the OSC and Leadenhall matters; tax planning; legal fees related to the Company's intellectual property portfolio; higher investor relation costs; and, increased costs at some of the Company's operations.

Stock-Based Compensation

Compensation expense related to stock based compensation for the three-months ended June 30, 2007 was \$211,000 compared with \$311,000 for the comparable period in 2006. For the six-month period ended June 30, 2007 stock-based compensation was \$374,000 compared with \$707,000 for the six-month period ended June 30, 2006. The decrease in the quarter and six-month periods ending June 30, 2007 is primarily due to a significant number of options that became fully amortized in the second half of 2007 such that no further compensation expense was recorded in 2007. During the six-months ended June 30, 2006 the Company also recorded \$182,000 of compensation expense as its share of the cost of the Share Purchase Plan versus \$nil during the six-months ended June 30, 2007. 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 Company's 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 June 30, 2007 was \$215,000, compared to \$196,000 for the three-month period ended June 30, 2006. For the six-month period ended June 30, 2007 amortization was \$426,000 compared with \$373,000 for the six-month period ended June 30, 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 leased lab equipment in the Company's manufacturing and research and development facilities acquired in the second half of 2006.

Foreign Currency Gains

The foreign currency gain for the three-month period ended June 30, 2007 was \$91,000 compared with \$63,000 for the comparable period in 2006. For the six-months ended June 30, 2007, the foreign currency gain was \$81,000 compared to a gain of \$36,000 for the six-months ended June 30, 2006. The gain in the quarter is attributable to the strengthening of the Canadian dollar against the United States dollar ("USD") and the euro. The Company's long-term debt denominated in USDs and euro is translated into Canadian dollars and as the Canadian dollar strengthens the translated value of the debt declines and a foreign exchange gain is reported.

Interest, Net

Net interest expense declined 46% to \$164,000 and 51% to \$297,000 for the three and six-month periods ended June 30, 2007 compared to \$303,000 and \$607,000 for the three and six-month periods ended June 30, 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 19% and 13% to \$3.0 million and \$6.5 million for the three and six-months ended June 30, 2007 compared to \$3.8 million and \$7.5 million in the three and six-months ended June 30, 2006. The decrease in the loss was a result of the increased margin on product sales and research contract revenue, an increase in licensing fee revenue, reduced net interest expense, lower research and development costs and stock-based compensation expense; offset partially by 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 in 2007.

Net Loss and Total Comprehensive Loss

The net loss and total comprehensive loss for the three and six-months ended June 30, 2007 was \$3.0 million and \$6.5 million, respectively versus \$3.8 million and \$6.6 million in the three and six-months ended June 30, 2006. The six-month loss for fiscal 2007 is essentially unchanged from the prior year as the \$1.0 million higher loss from operations in 2006 was almost entirely offset by the \$947,000 asset gain (discussed above). 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 \$0.01 and \$0.03 for the three and six-month periods ending June 30, 2007 compared to \$0.03 and \$0.05 for the comparable periods in 2006. The weighted average number of common shares outstanding on both a basic and diluted basis was 197.1 million for the quarter ending June 30, 2007 versus 138.0 million for the quarter ended June 30, 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

	Three- months ended June 30, 2007	Three- months ended June 30, 2006	Six- months ended June 30, 2007	Six- months ended June 30, 2006
Net loss from continuing operations	\$ (3,034)	\$ (3,897)	\$ (6,521)	\$ (6,668)
Items not involving current cash flows	220	406	583	13
Cash used in operations	(2,814)	(3,491)	(5,938)	(6,655)
Net change in non-cash working capital	(687)	236	(527)	130
Cash used in operating activities	(3,501)	(3,255)	(6,465)	(6,525)
Cash provided by (used in) investing activities	(189)	(54)	(189)	2,361
Cash provided by (used in) financing activities	(227)	13,469	4,775	17,096
	(3,917)	10,160	(1,879)	12,932
Effect of exchange rates on cash and cash equivalents	(71)	(23)	(76)	(2)
Net increase (decrease) in cash and cash equivalents	(3,988)	10,137	(1,955)	12,930
Cash and cash equivalents, beginning of period	13,246	5,509	11,213	2,716
Cash and cash equivalents, end of period	\$ 9,258	\$ 15,646	\$ 9,258	\$ 15,646

Cash and Cash Equivalents

Consolidated cash and cash equivalents decreased to \$9.3 million at June 30, 2007, compared to \$11.2 million at December 31, 2006. At June 30, 2007 cash and cash equivalents include \$144,000 in term deposits that are posted as collateral against long-term debt and \$111,000 in guaranteed investment certificates that are posted as collateral against certain accounts payable.

Operating Activities

Cash used in operating activities was \$3.5 million for the quarter ended June 30, 2007 compared to \$3.3 million for the quarter ended June 30, 2006. The increase is primarily due to an investment in working capital relating to a decrease in accounts payable and accruals and an increase in accounts receivable and inventory to support the launch of Pennsaid in Greece versus a decrease in funds used for non-cash working capital in the comparable period of 2006 as the loss for the period was lower. For the six-month

period ended June 30, 2007 funds used in operating activities was consistent with the previous year at \$6.5 million.

Investing Activities

Net cash used in investing activities was \$189,000 for the three-month period ended June 30, 2007 compared with \$54,000 for the three-month period ended June 30, 2006. The increase relates to current period expenditures on lab equipment at the Company's manufacturing facility and a new accounting system to improve the Company's internal controls over financial reporting. For the six-month period ended June 30, 2007 funds used in investing activities was \$189,000 compared to funds provided by investing activities of \$2.4 million in the previous year. In 2006, the sale of the Company's former head office and furnishings generated \$2.7 million in proceeds that were partially offset by \$383,000 in expenditures on computer upgrades and furniture and leasehold improvements for the new head office.

Financing Activities

Net cash used in financing activities for the three-months ended June 30, 2007 was \$0.2 million and related to scheduled debt repayments. In the comparable three-month period ended June 30, 2006 net cash provided by financing activities totaled \$13.5 million as the Company completed a bought deal financing consisting of 37.5 million units ("Units") issued at a price of \$0.40 per Unit for gross proceeds of \$15.0 million. Each Unit consisted of one common share and one-third of one common share purchase warrant of the Company, each whole warrant entitling the holder thereof to acquire one common share at a price of \$0.50 per share until June 20, 2009. Once expenses associated with this financing were deducted, including the underwriter fee of 5.75%, net cash proceeds were \$13.7 million.

Net cash provided by financing activities for the six-month period ended June 30, 2007 totaled \$4.8 million and consisted primarily of \$5.3 million in proceeds from the exercise of warrants offset by \$555,000 of debt repayments. Approximately, 12.7 million of the 13.1 million warrants exercised in the first six months were exercised in January under the warrant incentive program designed to encourage the early exercise of warrants from each of three outstanding tranches. Under the 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 six-month period ended June 30, 2006 net cash provided by financing activities totaled \$17.1 million and consisted primarily of \$13.7 million relating to the June 2006 bought deal discussed above and the January 2006 transactions whereby the Company sold additional Pennsaid licensing rights in Canada for 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, a total of \$2.0 million was generated from the exercise of warrants, stock options and employee contributions to the Share Purchase Plan but these proceeds were more than offset by a \$1.6 million payment into escrow to discharge the mortgage on the Company's former head office and \$0.7 million in scheduled debt 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)

	September 30, 2006	December 31, 2006	March 31, 2007	June 30, 2007
	3 Months	3 Months	3 Months	3 Months
Revenue	\$ 1,250	\$ 1,005	\$ 978	\$ 1,435
Net loss	(3,385)	(3,012)	(3,487)	(3,034)
Loss per share	\$ (0.02)	\$ (0.02)	\$ (0.02)	\$ (0.01)

	August 31, 2005	December 31, 2005	March 31, 2006	June 30, 2006
	3 Months	4 months	3 Months	3 Months
Revenue	\$ 1,296	\$ 1,604	\$ 633	\$ 1,360
Net loss	(1,612) ⁽¹⁾	(4,011) ⁽²⁾	(2,771) ⁽³⁾	(3,847)
Loss per share	\$ (0.01)	\$ (0.03)	\$ (0.02)	\$ (0.03)

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

(2) 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.

(3) 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 June 30, 2007.

(in thousands)	<u>Payments due by year ended</u>						
	Total	July 1 – December 31, 2007	2008	2009	2010	2011	Thereafter
Short-term loan	\$ 569	\$ 569	\$ -	\$ -	\$ -	\$ -	\$ -
Long-term debt	366	105	65	65	65	65	-
Capital lease obligations	81	18	35	24	3	1	-
Debentures	4,636	-	-	4,636	-	-	-
Operating leases	882	140	254	166	154	155	13
Research and other contracts	762	762	-	-	-	-	-
Total	\$7,296	\$1,594	\$ 354	\$4,891	\$ 222	\$ 221	\$ 13

Off-Balance Sheet Arrangements

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

Related Party Transactions

Contract research services totaling \$13,000 and \$27,000 for the three and six-months ended June 30, 2007 (\$15,000 and \$27,000 for the three and six-months ended June 30, 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 June 30, 2007 is 197,229,657 an increase of approximately 13.9 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, 294,656 issued to settle \$132,000 of professional fees and 195,978 issued under the Share Bonus Plan.

As at June 30, 2007 there were 25,747,204 warrants and 17,040,512 options outstanding.

On July 13, 2007, subsequent to the closing of the July Bought Deal, the number of common shares outstanding increased to 297,229,657 and the number of warrants outstanding increased to 80,747,204.

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 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\$1,067,000 (CDN\$1,241,000) (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\$1,370,000 (CDN\$1,598,000) 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\$303,000 (approximately CDN\$320,000 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\$303,000 (CDN\$320,000) 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.

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. In June 2007, the Company's Bahamian legal counsel filed a summons in the Leadenhall liquidation proceedings requesting that the court consider the settlement agreement for approval, however, to date, they have not been able to obtain a date for a hearing at which a judge will consider the issue.

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 paid \$15,000 towards the cost of the OSC’s investigation. 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 Company has commenced the process relating to the voluntary independent third-party review of the Company’s disclosure and reporting practices and procedures implemented by the new Board of Directors and management. As the review is still at a preliminary stage, no recommendations have yet been made. However, once the review has been completed, the Company will implement any recommendations made as a result of this third party review within a reasonable time period.

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 it does not intend to commence any proceedings against those individuals at this time. These former directors made aggregate claims of \$71,000 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 denied coverage for these costs and, in May 2007 the Company paid the claims in full.

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 June 30, 2007 and June 30, 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 June 30, 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 second quarter of 2007, the company upgraded the accounting software at its two largest reporting entities to remediate several of its disclosable information technology systems weaknesses. The Company has other projects underway to remedy the other disclosable weaknesses and will report on its progress 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, except as discussed in the Company's Short Form Prospectus filed on July 9, 2007.

**NUVO RESEARCH INC.
CONSOLIDATED BALANCE SHEETS**

(thousands of Canadian dollars)	As at June 30, 2007 Unaudited \$	As at December 31, 2006 Audited \$
ASSETS		
CURRENT		
Cash and cash equivalents (note 3)	9,258	11,213
Accounts receivable	1,009	968
Other receivable	375	375
Inventories (note 4)	1,091	1,051
Prepaid expenses and other	904	892
TOTAL CURRENT ASSETS	12,637	14,499
Property, plant and equipment (note 5)	2,883	3,120
Deferred financing costs (note 24)	128	-
TOTAL ASSETS	15,648	17,619
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT		
Accounts payable and accrued liabilities	2,569	3,008
Short term loan (note 6)	569	557
Deferred revenue (note 7)	1,367	1,352
Current portion of long term debt and capital lease obligations (note 8)	166	677
TOTAL CURRENT LIABILITIES	4,671	5,594
Deferred revenue (note 7)	5,952	6,552
Long term debt and capital lease obligations (note 8)	270	337
Debentures (note 9)	2,145	1,999
TOTAL LIABILITIES	13,038	14,482
SHAREHOLDERS' EQUITY		
Common shares (note 10)	173,812	165,400
Warrants (note 11)	6,482	9,402
Contributed surplus (note 12)	5,387	4,885
Accumulated other comprehensive income (note 2)	114	114
Deficit	(183,185)	(176,664)
TOTAL SHAREHOLDERS' EQUITY	2,610	3,137
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	15,648	17,619

See accompanying notes.

NUVO RESEARCH INC.
CONSOLIDATED STATEMENTS OF LOSS AND DEFICIT

Unaudited (thousands of Canadian dollars except per share amounts)	Three-months ended		Six-months ended	
	June 30, 2007	June 30, 2006	June 30, 2007	June 30, 2006
	\$	\$	\$	\$
REVENUE				
Product and research contract revenue	1,185	1,216	1,913	1,705
Licensing fees (note 7)	250	144	500	288
	1,435	1,360	2,413	1,993
EXPENSES				
Cost of goods sold	587	777	948	1,030
Research and development	1,684	2,161	3,422	3,640
Selling, general and administrative expenses	1,699	1,437	3,548	3,152
Stock-based compensation (note 13)	211	311	374	707
Amortization of property, plant, and equipment	215	196	426	373
Foreign currency gain	(91)	(63)	(81)	(36)
Interest, net (note 15)	164	303	297	607
	4,469	5,122	8,934	9,473
LOSS FROM OPERATIONS	(3,034)	(3,762)	(6,521)	(7,480)
Gain on sale of assets (note 16)	-	-	-	947
Impairment charge (note 17)	-	(135)	-	(135)
LOSS FROM CONTINUING OPERATIONS	(3,034)	(3,897)	(6,521)	(6,668)
NET INCOME FROM DISCONTINUED OPERATIONS (note 18)	-	50	-	50
NET LOSS FOR THE PERIOD AND TOTAL COMPREHENSIVE LOSS	(3,034)	(3,847)	(6,521)	(6,618)
Deficit, beginning of period	(180,151)	(166,420)	(176,664)	(163,649)
DEFICIT, END OF PERIOD	(183,185)	(170,267)	(183,185)	(170,267)
Net loss per common share – basic and diluted (note 14)	(0.01)	(0.03)	(0.03)	(0.05)

See accompanying notes.

NUVO RESEARCH INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS

Unaudited (thousands of Canadian dollars)	Three-months ended		Six-months ended	
	June 30, 2007	June 30, 2006	June 30, 2007	June 30, 2006
	\$	\$	\$	\$
OPERATING ACTIVITIES				
Net loss from continuing operations	(3,034)	(3,897)	(6,521)	(6,668)
Items not involving current cash flows:				
Amortization	215	196	426	373
Deferred revenue recognized	(307)	(374)	(583)	(524)
Stock-based compensation and payments (note 13)	211	311	506	707
Impairment charge (note 17)	-	135	-	135
Accretion of interest on debentures (note 9)	158	138	303	269
Gain on sale of assets (note 16)	-	-	-	(947)
Other	(57)	-	(69)	-
Net change in non-cash working capital balances (note 20)	(687)	236	(527)	130
CASH USED IN OPERATING ACTIVITIES	(3,501)	(3,255)	(6,465)	(6,525)
INVESTING ACTIVITIES				
Acquisition of property, plant and equipment	(189)	(54)	(189)	(383)
Proceeds from sale of assets	-	-	-	2,744
CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES	(189)	(54)	(189)	2,361
FINANCING ACTIVITIES				
Issuance of common shares, net of related costs (note 10)	-	13,787	5,330	15,690
Issue of debenture (note 9)	-	-	-	500
Proceeds from license and supply agreements (note 7)	-	-	-	3,250
Repayment of short term loan (note 6)	-	-	-	(1,598)
Repayments of long term debt and capital lease obligations	(227)	(318)	(555)	(746)
CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES	(227)	13,469	4,775	17,096
Effect of exchange rate changes on cash and cash equivalents	(71)	(23)	(76)	(2)
Net increase (decrease) in cash and cash equivalents during the period	(3,988)	10,137	(1,955)	12,930
Cash and cash equivalents, beginning of period	13,246	5,509	11,213	2,716
CASH AND CASH EQUIVALENTS, END OF PERIOD	9,258	15,646	9,258	15,646
Interest paid	121	159	164	202

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 June 30, 2007 the Company has an accumulated deficit of \$183,185 including a loss of \$6,521 during the first six-months 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 six-month periods ended June 30, 2007 and June 30, 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 \$144 in term deposits that are posted as collateral against long term debt and \$111 in guaranteed investment certificates that are posted as collateral against certain accounts payable.

4. INVENTORIES

Inventories consist of the following as at:

	June 30, 2007	December 31, 2006
	\$	\$
Raw materials	501	423
Work in process	301	486
Finished goods	289	142
	1,091	1,051

5. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment consists of:

	As at June 30, 2007		
	Cost	Accumulated amortization	Net book value
	\$	\$	\$
Land	124	-	124
Buildings	2,105	841	1,264
Leasehold improvements	122	30	92
Furniture and fixtures	240	102	138
Computer equipment	320	246	74
Computer software	346	171	175
Production, laboratory and other equipment (i)	2,732	1,716	1,016
	5,989	3,106	2,883

	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 June 30, 2007 includes cost of \$96 and accumulated amortization of \$18 for assets under capital leases [December 31, 2006 - \$96 and \$8 respectively]. Amortization of property, plant and equipment for the six-months ended June 30, 2007 includes \$10 related to assets under capital leases [six-months ended June 30, 2006 - \$nil]

6. SHORT TERM LOAN

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

	June 30, 2007 \$	December 31, 2006 \$
Balance, beginning of period	557	2,041
Accrued interest expense	64	105
Payment into escrow	-	(1,598)
Foreign currency loss (gain)	(52)	9
Balance, end of period	569	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 23, "Contingencies and Other Matters".

7. DEFERRED REVENUE

Deferred revenue is as follows:

	Three-months ended June30,		Six-months ended June 30,	
	2007 \$	2006 \$	2007 \$	2006 \$
Balance, beginning of period	7,628	8,444	7,904	5,344
Upfront payments from Squire Pharmaceuticals Inc. (i)	-	-	-	3,250
	7,628	8,444	7,904	8,594
<i>less:</i>				
Amortization of license and supply agreements	250	144	500	288
Delivery of promotional goods under supply agreement	-	200	-	200
Recognition of prior year research contract revenue	59	30	85	36
Balance, end of period	7,319	8,070	7,319	8,070
Amount to be recognized within one year	1,367	1,167	1,367	1,167
Long term balance	5,952	6,903	5,952	6,903

- (i) 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 up-front 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 period ended June 30, 2007 and during this fifteen-month period the Company believes it met the contractual targets. 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:

	June 30, 2007	December 31, 2006
	\$	\$
Government debt	73	511
Mortgage	293	418
Capital lease obligations	70	85
	436	1,014
Less amounts due within one year	166	677
Balance, end of period	270	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 June 30:

	\$
2008	34
2009	34
2010	8
2011	3
Total minimum lease payments	79
Less: amount representing interest (approximately 9.9%)	(9)
Present value of minimum lease payments	70
Current portion of capital lease obligations	28
	42

Interest paid on capital lease obligations amounted to \$2 and \$4 for the three and six-months ended June 30, 2007 [\$nil for the three and six-months ended June 30, 2006].

Principal Repayments

Aggregate maturities of long term debt and capital lease obligations are estimated to be as follows for the twelve-month periods ending June 30:

	\$
2008	166
2009	96
2010	73
2011	68
2012	33
	436

9. DEBENTURES

The following table summarizes the debentures outstanding as at:

	Face Value	Carrying Value	
	Outstanding as at June 30, 2007 \$	June 30, 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	1,644	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	500	500
		2,144	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, 2006	14,582	1,999	4,794
Converted to shares	(346)	(158)	(158)
Accretion charged to interest expense		145	
Balance, March 31, 2007	14,236	1,986	4,636
Accretion charged to interest expense		158	
Balance, June 30, 2007	14,236	2,144	4,636

10. COMMON SHARES

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

	Number of shares (000s)	Consideration \$
Balance, December 31, 2006	183,299	165,400
Debentures converted to shares	346	158
Warrants exercised	13,094	8,078
Professional fees settled in shares	295	132
Balance, March 31, 2007	197,034	173,768
Shares issued under Share Bonus Plan	196	44
Balance, June 30, 2007	197,230	173,812

11. WARRANTS

The following is a continuity schedule of the warrants outstanding:

	Number of warrants (000s)	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)	
Balance, March 31, 2007	32,546	0.51	6,654	
Expired	(6,799)	0.73	(172)	
Balance, June 30, 2007	25,747	0.45	6,482	

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	
				June 30, 2007 (000s)	December 31, 2006 (000s)
June 2004 Warrants	June 10, 2007	0.73	0.60	-	7,235
November 2004 Warrants	November 16, 2009	0.45	0.40	20,012	27,141
June 2006 Underwriter Warrants ⁽ⁱ⁾	June 20, 2008	0.40	n/a	1,833	2,156
June 2006 Warrants	June 20, 2009	0.50	0.40	3,902	9,000
				25,747	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 June 30,		Six-months ended June 30,	
	2006 \$	2006 \$	2007 \$	2006 \$
Balance, beginning of period	5,048	4,158	4,885	3,957
Compensation expense recognized on employee, consultant and director stock options	167	311	330	525
Employee and director stock options exercised	-	-	-	(13)
Warrants expired	172	54	172	54
Balance, end of period	5,387	4,523	5,387	4,523

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
Balance, March 31, 2007	16,667	0.18 - 5.95	0.33
Granted	373	0.215 - 0.245	0.24
Balance, June 30, 2007	17,040	0.18 - 5.95	0.33

The following table summarizes the outstanding and exercisable options held by directors, officers, employees and consultants at June 30, 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 - \$0.25	10,547	8.3	\$0.20	7,089	\$0.20
\$0.30 - \$0.39	6,029(i)	7.6	\$0.34	5,387	\$0.33
\$0.57	96	6.9	\$0.57	96	\$0.57
\$1.12 - \$5.95	368	4.1	\$3.80	368	\$3.80
	17,040	8.0	\$0.33	12,940	\$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.

Share Bonus Plan

During the three and six month periods ended June 30, 2007, the Company issued 195,978 common shares under the Share Bonus Plan resulting in compensation expense of \$44. In the three and six month periods ending June 30, 2006 no shares were issued and no compensation expense was recognized under this plan.

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 June 30,		Six-months ended June 30,	
	2007	2006	2007	2006
	\$	\$	\$	\$
Stock option compensation expense	167	311	330	525
Cost of the employer's portion of shares issued to employees under the Share Purchase Plan	-	-	-	182
Shares issued under Share Bonus Plan	44	-	44	-
Stock-based compensation expense	211	311	374	707
Other stock-based payments				
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 June 30,		Six-months ended June 30,	
	2007	2006	2007	2006
	\$	\$	\$	\$
Net loss from continuing operations	(3,034)	(3,897)	(6,521)	(6,668)
Net income from discontinued operations	-	50	-	50
Net loss	(3,034)	(3,847)	(6,521)	(6,618)
Average number of basic and diluted common shares outstanding for the period (millions)	197.1	138.0	194.9	134.5
Net loss per common share from:				
Continuing operations – basic and diluted	(0.01)	(0.03)	(0.03)	(0.05)
Discontinued operations – basic and diluted	-	-	-	-
Net loss per common share - basic and diluted	(0.01)	(0.03)	(0.03)	(0.05)

The calculation of diluted loss per common share excludes all options, warrants and convertible debentures for all periods as they were anti-dilutive. Basic and diluted earnings per common share from discontinued operations are computed by dividing net earnings from discontinued operations by the respective average number of common shares.

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:

	June 30, 2007 (000s)	December 31, 2006 (000s)
Common shares issued and outstanding (note 10)	197,230	183,299
Warrants outstanding (note 11) (i)	25,747	45,532
Stock options outstanding (note 13) (ii)	16,640	16,077
Convertible debentures (note 9)	14,236	14,582
	253,853	259,490

- (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 June 30,		Six-months ended June 30,	
	2007	2006	2007	2006
	\$	\$	\$	\$
Interest on long term debt, capital lease obligations and debentures	71	110	149	224
Interest on short term loan	31	97	64	195
Accretion of debentures	158	138	303	269
Interest income	(109)	(49)	(242)	(97)
Other	13	7	23	16
Interest, net	164	303	297	607

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 23).

17. IMPAIRMENT CHARGE

An impairment charge of \$135 was recorded by the Company during the three-months ended June 30, 2006 on the Varennes facility that was sold on October 31, 2006. This impairment charge represents a reduction in the carrying value of this asset to its expected net realizable value.

18. DISCONTINUED OPERATIONS

During 2005 the Company sold the assets and operations of its non-strategic subsidiary, Dioptic Laboratories ("Dioptic"). Dioptic distributed branded diagnostic and therapeutic ophthalmic products in Canada.

As part of the sale of the assets of Dioptic in 2005 the Company was to receive \$175 contingent on receipt by the purchaser of Ontario formulary coverage for certain product rights (represented by "DINs" or Drug Information Numbers), failing which these rights would revert to the Company. The prescribed

time period elapsed without the purchaser receiving approval; however, during the quarter ended June 30, 2006 the purchaser agreed to pay the Company \$50 to extend the prescribed time period to June 30, 2007 and the Company, agreed to reduce the contingent consideration to \$125. The purchaser received approval for formulary coverage in the fourth quarter of 2006 and such contingent consideration was received and recorded by the Company in the fourth quarter of 2006.

19. RESTRUCTURING COST ACCRUAL

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

	June 30, 2007 \$	December 31, 2006 \$
Restructuring accrual, beginning of period	44	181
Restructuring costs (recovery)	-	(86)
Payments	(44)	(51)
Restructuring accrual, end of period	-	44

20. NET CHANGE IN NON-CASH WORKING CAPITAL

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

	Three-months ended June 30,		Six-months ended June 30,	
	2007	2006	2007	2006
	\$	\$	\$	\$
Accounts payable and accrued liabilities	(97)	670	(433)	843
Accounts receivable	(281)	(391)	(41)	(363)
Inventories	(149)	191	(40)	(97)
Prepaid expenses and other	(160)	(234)	(13)	(253)
Net change in non-cash working capital	(687)	236	(527)	130

21. 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:

	Transdermal Drug Delivery	Immune System Modulation	Total
	\$	\$	\$
Three months ended June 30, 2007			
Total revenue	1,268	167	1,435
Amortization of property, plant and equipment	182	33	215
Interest revenue	109	-	109
Interest expense	268	5	273
(Loss) income from operations	(3,104)	70	(3,034)
Assets	14,277	1,371	15,648
Property, plant and equipment	2,377	506	2,883
Additions to property, plant and equipment	189	-	189

Three months ended June 30, 2006			
Total revenue	1,104	256	1,360
Amortization of property, plant and equipment	158	38	196
Interest revenue	48	-	48
Interest expense	344	7	351
Loss from continuing operations	(3,749)	(148)	(3,897)
Assets	20,804	1,268	22,072
Property, plant and equipment	3,003	656	3,659
Additions to property, plant and equipment	51	3	54

	Transdermal Drug Delivery	Immune System Modulation	Total
	\$	\$	\$
Six months ended June 30, 2007			
Total revenue	2,115	298	2,413
Amortization of property, plant and equipment	356	70	426
Interest revenue	240	1	241
Interest expense	527	11	538
Loss from operations	(6,499)	(22)	(6,521)
Assets	14,277	1,371	15,648
Property, plant and equipment	2,377	506	2,883
Additions to property, plant and equipment	189	-	189

Six months ended June 30, 2006			
Total revenue	1,589	404	1,993
Amortization of property, plant and equipment	296	77	373
Interest revenue	97	-	97
Interest expense	689	15	704
Loss from continuing operations	(6,433)	(235)	(6,668)
Assets	20,804	1,268	22,072
Property, plant and equipment	3,003	656	3,659
Additions to property, plant and equipment	379	4	383

Geographic information

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

	Three-months ended June30,		Six-months ended June 30,	
	2007	2006	2007	2006
	\$	\$	\$	\$
Canada	623	757	1,035	1,084
Europe	539	341	965	436
Other foreign countries	273	262	413	473
	1,435	1,360	2,413	1,993

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

	June 30, 2007	December 31, 2006
	\$	\$
Canada	1,870	1,893
Europe	506	577
Other foreign countries	507	650
	2,883	3,120

22. RELATED PARTY TRANSACTIONS

Contract research services totalling \$13 and \$27 for the three and six-month periods ending June 30, 2007 [three and six-months period ending June 30, 2006 - \$15 and \$27] 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.

23. 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 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\$320 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\$320) 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.

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. In June 2007, the Company's Bahamian legal counsel filed a summons in the Leadenhall liquidation proceedings requesting that the court consider the settlement agreement for approval, however, to date, they have not been able to obtain a date for a hearing at which a judge will consider the issue. 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 26, 2007 the Company reached a settlement with the OSC. 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 paid \$15 towards the cost of the OSC's investigation. 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 Company has commenced the process relating to the voluntary independent third-party review of the Company's disclosure and reporting practices and procedures implemented by the new Board of Directors and management. As the review is still at a preliminary stage, no recommendations have yet been made. However, once the review has been completed, the Company will implement any recommendations made as a result of this third party review within a reasonable time period.

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 it does not intend to commence any proceedings against those individuals at this time. These former directors have made aggregate claims of \$71 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 and, in May 2007 the Company paid the claims in full.

24. SUBSEQUENT EVENTS

On July 13, 2007, the Company closed a bought deal equity financing. At closing, a total of 100 million units ("Units") of the Company were issued at a price of \$0.20 per Unit for gross proceeds of \$20 million. Each Unit consisted of one common share and one-half of a common share purchase warrant of the Company, each whole warrant entitling the holder thereof to acquire one common share at a price of \$0.30 per share until July 13, 2009. As part of the transaction the Underwriters will receive 5,000,000 warrants (the "Underwriter Warrants") for services provided in conjunction with the July 2007 Bought Deal. The Underwriter Warrants are each exercisable into one Unit at a price of \$0.20 per Unit for a period of 24 months following the Closing Date. Net cash proceeds are estimated to be \$18.4 million, after deducting the underwriters' fee of 6% and the estimated expenses of the offering. In the quarter ended June 30, 2007 the Company capitalized \$128 of expenditures related to the bought deal equity financing.

25. COMPARATIVE FIGURES

Certain figures in the June 30, 2006 financial statements have been re-classified to conform to the basis of presentation for the three and six months ended June 30, 2007.