

Consolidated Financial Statements

GeneNews Limited

[formerly ChondroGene Limited]

December 31, 2006

AUDITORS' REPORT

To the Shareholders of
GeneNews Limited

We have audited the consolidated balance sheets of **GeneNews Limited** [formerly ChondroGene Limited] as at December 31, 2006 and 2005 and the consolidated statements of operations and deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2006 and 2005 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Ernst & Young LLP

Toronto, Canada,
March 15, 2007.

Chartered Accountants

GeneNews Limited
[formerly ChondroGene Limited]

CONSOLIDATED BALANCE SHEETS

[See note 1 - Basis of Presentation]

[Expressed in Canadian dollars]

As at December 31

	2006	2005
	\$	\$
ASSETS		
Current		
Cash and cash equivalents	20,593,568	4,680,882
Accounts receivable [note 3]	135,315	1,356,392
Investment tax credits recoverable [note 4]	796,900	1,254,922
Prepaid expenses and deposits	685,819	365,715
Total current assets	22,211,602	7,657,911
Property, plant and equipment, net [notes 5 and 7]	1,645,488	1,251,014
Intellectual property, net [note 6]	842,528	1,284,675
	24,699,618	10,193,600
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Accounts payable and accrued liabilities	1,821,355	929,837
Deferred revenue [note 3]	—	2,134,361
Current portion of long-term debt [note 7]	102,549	139,427
Total current liabilities	1,923,904	3,203,625
Long-term debt [note 7]	—	102,549
Total liabilities	1,923,904	3,306,174
Commitments and contingencies [note 12]		
Shareholders' equity		
Capital stock [notes 8[a] and [b]]	44,234,409	20,138,831
Contributed surplus [note 8[c]]	2,255,390	1,527,007
Deficit	(23,714,085)	(14,778,412)
Total shareholders' equity	22,775,714	6,887,426
	24,699,618	10,193,600

See accompanying notes

On behalf of the Board:



K. Wayne Marshall, Director



Garth MacRae, Director

GeneNews Limited
[formerly ChondroGene Limited]

**CONSOLIDATED STATEMENTS OF OPERATIONS
AND DEFICIT**

[Expressed in Canadian dollars]

Years ended December 31

	2006 \$	2005 \$
REVENUE		
Milestone revenue	567,850	1,797,250
Up-front payment revenue <i>[note 3]</i>	2,112,323	2,724,373
Fees for services	603,095	816,855
	3,283,268	5,338,478
EXPENSES		
Research and development <i>[notes 9 and 10]</i>	9,518,383	5,884,270
General and administrative <i>[note 9]</i>	1,889,675	1,614,946
Stock-based compensation <i>[note 8[c]]</i>	728,383	599,160
Amortization of intellectual property <i>[note 6]</i>	442,147	442,148
Foreign exchange loss	68,797	14,377
Interest on long-term debt	19,758	35,316
	12,667,143	8,590,217
Interest income	448,202	176,632
Net loss for the year	(8,935,673)	(3,075,107)
Deficit, beginning of year	(14,778,412)	(11,703,305)
Deficit, end of year	(23,714,085)	(14,778,412)
Net loss per common share <i>[note 8[e]]</i>		
Basic and fully diluted	\$(0.18)	\$(0.08)
Weighted average number of common shares outstanding		
Basic and fully diluted	49,045,966	39,417,576

See accompanying notes

GeneNews Limited
[formerly ChondroGene Limited]

CONSOLIDATED STATEMENTS OF CASH FLOWS
[Expressed in Canadian dollars]

Years ended December 31

	2006 \$	2005 \$
OPERATING ACTIVITIES		
Net loss for the year	(8,935,673)	(3,075,107)
Add items not involving cash		
Stock-based compensation [note 8[c]]	728,383	599,160
Amortization of property, plant and equipment	389,639	322,727
Amortization of intellectual property [note 6]	442,147	442,148
	(7,375,504)	(1,711,072)
Changes in non-cash operating working capital		
Accounts receivable [note 3]	1,221,077	4,164,078
Investment tax credits recoverable	458,022	(454,922)
Prepaid expenses and deposits	(320,104)	(88,152)
Accounts payable and accrued liabilities	891,518	(402,519)
Deferred revenue [note 3]	(2,134,361)	(2,725,913)
Cash used in operating activities	(7,259,352)	(1,218,500)
FINANCING ACTIVITIES		
Net proceeds from share issue [note 8[a]]	23,896,716	—
Proceeds from exercise of employee stock options [note 8[a]]	165,410	17,042
Net proceeds from exercise of 2004 broker warrants [note 8[a] and [b]]	33,452	100,000
Repayments of long-term debt	(139,427)	(123,869)
Cash provided by (used in) financing activities	23,956,151	(6,827)
INVESTING ACTIVITIES		
Additions to property, plant and equipment	(784,113)	(475,661)
Cash used in investing activities	(784,113)	(475,661)
Net increase (decrease) in cash and cash equivalents during the year	15,912,686	(1,700,988)
Cash and cash equivalents, beginning of year	4,680,882	6,381,870
Cash and cash equivalents, end of year	20,593,568	4,680,882
Cash and cash equivalents are comprised of the following		
Cash	294,578	373,938
Investment in money market fund	20,298,990	4,306,944
	20,593,568	4,680,882
Supplemental cash flow information		
Interest received	360,368	176,632
Interest paid	19,758	35,316

See accompanying notes

GeneNews Limited
[formerly ChondroGene Limited]

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
[Expressed in Canadian dollars unless otherwise noted]

December 31, 2006

1. NATURE OF OPERATIONS AND BASIS OF PRESENTATION

GeneNews Limited [formerly ChondroGene Limited] [the "Company" or "GeneNews"] is incorporated under the laws of the Province of Ontario. The Company is focused on the application of functional genomics to enable early diagnosis and personalized therapeutic intervention based on disease-specific biomarkers.

The Company considers that its current operations fall principally into one industry segment, biomedical research. Substantially all of its identifiable assets as at December 31, 2006 and 2005 are located in Canada.

These consolidated financial statements have been prepared on the basis of accounting principles applicable to a going concern which assumes that the Company will realize the carrying value of its assets and satisfy its obligations and commitments as they become due in the normal course of operations.

The Company has incurred an accumulated deficit of \$23,714,085 as at December 31, 2006, expects to incur additional losses in its operations and will require additional financial resources to continue its research and achieve commercialization of its discoveries. It is not possible to predict the future outcome of the Company's research programs or the Company's ability to fund its future cash requirements.

A failure to continue as a going concern would then require that the stated amounts of assets and liabilities be reflected on a liquidation basis which could differ from the going concern basis.

2. SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements are expressed in Canadian dollars and have been prepared by management in accordance with Canadian generally accepted accounting principles. The significant accounting policies are as follows:

Basis of consolidation

These consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary companies, ChondroGene Inc. and GeneNews Inc. These consolidated financial statements also include the accounts of ChondroGene (Malaysia) Sdn. Bhd ["ChondroGene Malaysia"]. The shares of ChondroGene Malaysia, although beneficially owned and controlled by the Company, are legally wholly-owned by a founder of GeneNews. This founder has executed a trust acknowledgement and declaration with the Company to acknowledge that the shares of ChondroGene Malaysia are held in trust solely and exclusively for the Company on the direction of the Company.

GeneNews Limited
[formerly ChondroGene Limited]

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
[Expressed in Canadian dollars unless otherwise noted]

December 31, 2006

All significant intercompany balances and transactions have been eliminated.

Use of estimates

The preparation of consolidated financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and 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. Actual results could differ from those estimates. Significant estimates made by management include reserves for accounts receivable, investment tax credits recoverable, prepaid expenses, basis for stock-based compensation, impairment of intellectual property and other long-lived assets and the useful lives of long-lived assets.

Cash and cash equivalents

Cash and cash equivalents include cash on hand and investments in money market instruments with terms to maturity of less than 90 days at the date of acquisition.

Intellectual property

Intellectual property is recorded at cost less accumulated amortization and is amortized over its economic life, which is estimated to be five years. Intellectual property is periodically reviewed by management and any permanent impairment would be written off in the year in which it occurs.

Property, plant and equipment

Property, plant and equipment are recorded at cost less investment tax credits recoverable and accumulated amortization. Amortization is provided over their estimated useful lives using the following rates and methods:

Laboratory equipment	20% - 30% declining balance
Office furniture and equipment	20% - 30% declining balance
Leasehold improvements	20% straight-line over the term of the lease

GeneNews Limited
[formerly ChondroGene Limited]

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

[Expressed in Canadian dollars unless otherwise noted]

December 31, 2006

Management reviews the carrying amount of property, plant and equipment and intangible assets with finite lives if events or circumstances indicate that the carrying amount may not be recoverable. Recoverability is measured by comparing the carrying amounts of a group of assets to the future undiscounted net cash flows expected to be generated by that group of assets. If the carrying amount is not recoverable, the Company would recognize an impairment loss equal to the amount that the carrying value of a group of assets exceeds their fair value.

Revenue recognition

Revenues are derived exclusively from a business collaboration with a large pharmaceutical company. These revenues are comprised of up-front payments, milestone revenue and fees for services.

Non-refundable up-front payments which require no further activities from the Company are deferred and recognized on a straight-line basis over the contract term.

Revenues from collaborative research activities for the Company's provision of certain clinical data are reflected as milestone revenue. The collaborative activities include the delivery, acceptance and subsequent payment for the clinical data provided to the pharmaceutical company. The Company recognizes milestone revenue upon acceptance of this clinical data by the pharmaceutical company and when collectibility is reasonably assured.

Fees for services are billed and cash collected in advance of those services being performed and are recorded initially as deferred revenue on the consolidated balance sheets. During the term covered by the billing, the Company is continuously engaged in performing research and sharing information with the pharmaceutical company. Consequently, deferred amounts are recognized as revenue on a straight-line basis over the term covered by those billings.

Government assistance

Government assistance towards current expenses is included in the determination of income for the year as a reduction of the expenses to which it relates. Amounts received for future expenditures are recorded as a current liability. Government assistance towards the acquisition of property, plant and equipment is deducted from the cost of the related property, plant and equipment.

GeneNews Limited
[formerly ChondroGene Limited]

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
[Expressed in Canadian dollars unless otherwise noted]

December 31, 2006

Research and development expenses

Research and development expenses, net of related investment tax credits, are expensed in the year in which they are incurred. Development costs are expensed in the year incurred unless such costs meet Canadian generally accepted accounting criteria for deferral and amortization. No development costs have been deferred to date.

Income taxes

Income taxes are accounted for under the asset and liability method of accounting for income taxes. Under the asset and liability method, future tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Future tax assets and liabilities are measured using enacted or substantively enacted tax rates expected to apply when the asset is realized or the liability settled. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the period that substantive enactment or enactment occurs. A valuation allowance is provided for future tax assets to the extent that it is more likely than not that the assets may not be realized.

Stock-based compensation

Effective January 1, 2003, the Company prospectively adopted the fair value method for stock-based compensation in accordance with the recommendations of The Canadian Institute of Chartered Accountants' ["CICA"] Handbook Section 3870, "*Stock-Based Compensation and Other Stock-Based Payments*". Stock options awarded to employees on or after January 1, 2003 are accounted for using the fair value method. For stock options awarded to employees prior to January 1, 2003, pro forma disclosure of net loss and loss per share is provided as if these awards were accounted for using the fair value method. Fair value is calculated using the Black-Scholes option pricing model with the assumptions described in note 8. Consideration paid on the exercise of stock options is credited to capital stock.

Under the fair value based method, stock-based payments to non-employees are measured at the fair value of the consideration received, or the fair value of the equity instruments issued, or liabilities incurred, whichever is more reliably measured. The fair value of stock-based payments to non-employees is periodically remeasured until counterparty performance is complete, and any change therein is recognized over the period and in the same manner as if the Company had paid cash instead of paying with or using equity instruments. The cost of stock-based payments to non-employees that are fully vested and non-forfeitable at the grant date is measured and recognized at that date.

GeneNews Limited
[formerly ChondroGene Limited]

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
[Expressed in Canadian dollars unless otherwise noted]

December 31, 2006

Net loss per share

Diluted net loss per share reflects the dilution that would occur if outstanding stock options and warrants were exercised or converted into common shares using the treasury stock method. The inclusion of the Company's stock options and warrants in the computation of diluted net loss per share would have an anti-dilutive effect on net loss per share and therefore options and warrants are excluded from the computation.

Financial instruments

Fair value of a financial instrument is defined as the amount at which the instrument could be exchanged in a current transaction between willing parties. The Company's financial instruments recognized in the consolidated balance sheets consist of cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities, deferred revenue and long-term debt. The carrying values of these financial instruments approximate their fair values due to their short-term nature in the case of all items except long-term debt.

The fair value of long-term debt approximates its carrying value based on the Company's current expected borrowing rates from the same or similar parties.

The Company is exposed to foreign currency fluctuations to the extent that revenues are billed based on the value of the U.S. dollar and certain purchases are denominated in U.S. dollars as well as other foreign currencies. The Company currently does not use financial instruments to hedge these risks.

Foreign currency translation

The Company's foreign subsidiary is considered an integrated foreign entity and is accounted for in accordance with the temporal method, as are transactions in foreign currencies entered into by the Company. Under this method, monetary assets and liabilities recorded in a foreign currency are translated into Canadian dollars at year-end exchange rates and non-monetary assets and liabilities are translated at the exchange rates prevailing when the assets were acquired or liabilities were incurred. Revenue and expenses [other than depreciation and amortization, which are translated at the rate applicable to the corresponding assets] are translated at the average rate of exchange for the year.

Gains and losses on translation of foreign currencies are included in the consolidated statements of operations and deficit in the current year.

GeneNews Limited
[formerly ChondroGene Limited]

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
[Expressed in Canadian dollars unless otherwise noted]

December 31, 2006

Variable interest entities

Effective January 1, 2005, the Company adopted the recommendations of CICA Handbook Accounting Guideline 15 ["AcG-15"], "*Consolidation of Variable Interest Entities*", effective for annual and interim periods beginning on or after November 1, 2004. Variable interest entities ["VIEs"] refer to those entities that are subject to control on a basis other than ownership of voting interests. AcG-15 provides guidance for identifying VIEs and criteria for determining which entity, if any, should consolidate them.

The Company has determined that ChondroGene Malaysia constitutes a VIE on the basis that the shares are controlled by the Company by way of a trust acknowledgement and declaration executed by the legal owner of the shares of ChondroGene Malaysia. As a result, the accounts of ChondroGene Malaysia are consolidated with those of the Company.

3. ACCOUNTS RECEIVABLE AND DEFERRED REVENUE

In 2004, the Company entered into a business collaboration agreement with a major pharmaceutical company whereby the Company was contracted to receive a non-refundable, up-front payment, milestone payments and fees for services. The initial up-front payment of \$4,918,800 was collected in February 2005. This amount was amortized on a monthly basis over the term of the agreement, which, for revenue recognition purposes, began December 20, 2004. At December 31, 2005, \$2,112,323 of this amount was classified as deferred revenue.

In December 2006, the Company entered into an amended agreement that entitled the Company to receive additional milestone revenue of U.S. \$1,430,000. On March 8, 2007, the Company received this additional amount.

4. INVESTMENT TAX CREDITS RECOVERABLE

The Company is eligible for both federal and provincial investment tax credits on its qualifying research activities. Federal investment tax credits are not refundable but can be used to reduce income taxes otherwise payable. Provincial investment tax credits are refundable as cash refunds and these amounts are recorded as an asset in the period in which the related expenditures are incurred, with a corresponding credit to research and development expense.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
[Expressed in Canadian dollars unless otherwise noted]

December 31, 2006

5. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment consist of the following:

	2006		Net book value \$
	Cost \$	Accumulated amortization \$	
Laboratory equipment [net of investment tax credits of \$282,091]	2,275,852	1,129,850	1,146,002
Office furniture and equipment	830,703	456,216	374,487
Leasehold improvements	471,359	346,360	124,999
	3,577,914	1,932,426	1,645,488
	2005		Net book value \$
	Cost \$	Accumulated amortization \$	
Laboratory equipment [net of investment tax credits of \$282,091]	1,748,930	965,600	783,330
Office furniture and equipment	676,035	327,219	348,816
Leasehold improvements	368,836	249,968	118,868
	2,793,801	1,542,787	1,251,014

Included in the cost of laboratory equipment is \$432,137 [2005 - nil] of assets which have not been placed in service. No amortization has been recorded on these assets.

6. INTELLECTUAL PROPERTY

Intellectual property consists of the following:

	2006 \$	2005 \$
Acquired technology	2,324,015	2,324,015
Less accumulated amortization	(1,481,487)	(1,039,340)
	842,528	1,284,675

GeneNews Limited
[formerly ChondroGene Limited]

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
[Expressed in Canadian dollars unless otherwise noted]

December 31, 2006

Amortization of intellectual property for the year ended December 31, 2006 was \$442,147 [2005 - \$442,148].

7. LONG-TERM DEBT

The term loan bears interest of 11.89% and is repayable over a three-year period in monthly blended installments of \$13,265 including principal and interest. The term loan is collateralized by a Master Security Agreement covering all property, plant and equipment of the Company. The Company's intellectual property is not covered by the Master Security Agreement. The remaining principal amount of \$102,549 is due in 2007.

8. CAPITAL STOCK

Authorized

Unlimited non-voting preference shares, issuable in one or more series

Unlimited voting special shares, entitling the holder to a dividend, if and when declared by the Board of Directors, in parity with the common shares and convertible into common shares

Unlimited voting common shares

Included in capital stock are the following:

[a] Common shares

The changes in common shares are as follows:

	#	\$
Balance at December 31, 2004	39,264,248	19,803,159
Exercise of warrants	200,000	138,000
Exercise of stock options	40,149	17,042
Balance at December 31, 2005	39,504,397	19,958,201
Issue of shares for cash	15,625,000	23,540,466
Expiry of 2004 broker warrants	—	164,209
Exercise of 2004 broker warrants	31,578	49,873
Exercise of stock options	248,600	165,410
Balance at December 31, 2006	55,409,575	43,878,159

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
[Expressed in Canadian dollars unless otherwise noted]

December 31, 2006

In 2004, the Company closed a brokered private placement issuing 5,789,474 common shares for gross proceeds of U.S. \$5,500,000. The Company's financial advisors and agents for the transaction received a fee of U.S. \$330,000 and broker warrants to purchase 347,368 common shares of the Company as described in note 8[b] below. Aggregate net proceeds to the Company after deducting broker commissions, professional fees and other costs were \$6,443,419.

On May 25, 2006, the Company entered into a bought deal private placement financing of 15,625,000 common shares at \$1.60 per share, or \$25,000,000. The net cash proceeds were \$23,896,716. Of the net proceeds, \$23,540,466 was allocated to capital stock and \$356,250 to 625,000 broker warrants - note 8[b]. The warrants were issued to the Company's financial advisors as part of the private placement transaction. The warrants were valued using the Black-Scholes option pricing model which requires the use of subjective assumptions. The assumptions were: a stock asset price of \$1.60 per share, an exercise price of \$2.25 per share, a two year maturity, a risk-free interest rate of 5% and volatility of 80%.

[b]Broker warrants

The changes in broker warrants are as follows:

	#	\$
Balance at December 31, 2004	547,368	218,630
Exercised for cash	(200,000)	(38,000)
Balance at December 31, 2005	347,368	180,630
Issue of 2006 broker warrants	625,000	356,250
Exercise of 2004 broker warrants	(31,578)	(16,421)
Expiry of 2004 broker warrants	(315,790)	(164,209)
Balance at December 31, 2006	625,000	356,250

In May 2003, the Company granted its brokers, as payment for costs related to a private placement, 200,000 warrants. On May 17, 2005, these warrants were exercised for cash proceeds of \$38,000.

In connection with the 2004 financing as described in note 8[a], the Company issued to its financial advisors broker warrants for the purchase in two tranches of 347,368 common shares at an exercise price of U.S. \$0.95 per common share. The first tranche to purchase 315,790 common shares expired on August 25, 2006 with none having been exercised. The second tranche to purchase 31,578 common shares was exercised in September 2006 for cash proceeds of \$16,421.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
[Expressed in Canadian dollars unless otherwise noted]

December 31, 2006

On May 25, 2006, the Company granted 625,000 broker warrants in connection with the private equity financing described in note 8[a]. These warrants are exercisable until May 24, 2008 at \$2.25 per share. None of the 2006 broker warrants were exercised during the year.

[c] Contributed surplus

The balance in contributed surplus of \$2,255,390 [2005 - \$1,527,007] consists of employee stock option expense. The stock-based compensation expense for 2006 was \$738,383 [2005 - \$599,160]. The weighted average fair value of stock options granted during the year was \$1.53 [2005 - \$0.81].

In compliance with current accounting standards, the fair value of each stock option is estimated on the date of grant using the Black-Scholes option pricing model. The Black-Scholes model requires four highly subjective assumptions, including future stock price volatility and expected time until exercise, which greatly affect the calculated values. For the year ended December 31, 2006, the weighted average assumptions were: five-year term [2005 - five-year term]; expected dividend yield of nil [2005 - nil]; expected volatility of 98% [2005 - 74%]; risk-free interest rate of 4.0% [2005 - 4.0%]; and expected life of four to five years [2005 - four to five years].

[d] Employee stock option plan

On May 25, 2000, the Company adopted a Stock Option Plan [the "Plan"] pursuant to which the Company's Board of Directors [the "Board"] may grant stock options to employees, consultants, advisors or directors of the Company. The latest revision to the Plan, approved on June 13, 2005, increased the limit for stock option grants up to an amount not exceeding 7,854,849. Some options vest on the date of grant and the remaining options are subject to various vesting requirements that range from one year to three years after the grant date. The options must be exercised no later than 10 years after the date of the grant; however, pursuant to the Company's listing on the TSX Venture Exchange in December 2000, all options issued subsequent to that date must be exercised no later than five years after the date of the grant, in compliance with securities regulations. The Board will determine the fair market value of the common shares of the Company and will establish the exercise price of the option provided that the exercise price is not less than the "Discounted Market Price" [as defined in the TSX Venture Exchange Corporate Finance Manual]. As at December 31, 2006, there were 5,312,565 [2005 - 4,457,276] options outstanding and a cumulative number of 442,933 [2005 - 194,333] options that had been exercised for a total of 5,785,498 [2005 - 4,651,609], leaving a balance of 2,099,351 [2005 - 3,203,240] options available for issuance under the Plan.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
[Expressed in Canadian dollars unless otherwise noted]

December 31, 2006

A summary of the status of the Plan as at December 31 and changes during the years then ended is presented below:

	<u>2006</u>		<u>2005</u>	
	Weighted average exercise price		Weighted average exercise price	
	#	\$	#	\$
Outstanding, beginning of year	4,457,276	0.842	3,894,781	0.844
Granted	1,501,289	1.529	643,000	0.814
Exercised	(248,600)	0.666	(40,149)	0.424
Forfeited	(397,400)	1.138	(40,356)	1.056
Outstanding, end of year	5,312,565	1.022	4,457,276	0.842
Options exercisable, end of year	3,618,103	0.881	2,590,730	0.772

The following table summarizes information about stock options outstanding and exercisable as at December 31, 2006:

Range of exercise price per share	Number outstanding	Weighted average remaining contractual life	Weighted average strike price	Options exercisable
\$	#	[in years]	\$	#
0.25 to 0.69	516,104	2.231	0.45	516,104
0.70 to 1.14	3,415,447	2.514	0.90	2,737,612
1.15 to 1.59	1,084,914	4.515	1.39	314,317
1.60 to 2.04	140,267	4.277	2.00	23,405
2.05 to 2.50	155,833	4.296	2.09	26,665
	5,312,565	2.994	1.02	3,618,103

GeneNews Limited
[formerly ChondroGene Limited]

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
[Expressed in Canadian dollars unless otherwise noted]

December 31, 2006

[e] Pro forma net loss and loss per share

The Company does not recognize compensation expense for stock options granted to employees prior to January 1, 2003. The table below presents pro forma net loss and basic and diluted net loss per common share as if stock options granted to employees had been determined based on the fair value method. The table includes all employee stock options granted by the Company between June 1, 2002 and December 31, 2002.

In compliance with current accounting standards, the fair value of each employee option was estimated on the date of grant using the Black-Scholes option pricing model. The weighted average assumptions used were: dividend yield of nil; expected volatility of 71%; risk-free interest rate of 4.5%; and expected life of four to five years.

	2006	2005
	\$	\$
Net loss as reported	(8,935,673)	3,075,107
Estimated stock-based compensation expense	—	1,620
Pro forma net loss	(8,935,673)	3,076,727
Pro forma basic and diluted net loss per common share	\$(0.18)	\$0.08

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
[Expressed in Canadian dollars unless otherwise noted]

December 31, 2006

9. RELATED PARTY TRANSACTIONS

The following transactions, in which one or more of the founders has an interest, occurred during the years ended December 31:

	2006	2005
	\$	\$
[a] Consulting fees were paid to one of the founders pursuant to a renewable one-year agreement. In addition, included in stock-based compensation expense is \$85,351 [2005 - \$71,299] related to stock options granted to this founder in his capacity as a consultant. This amount is included in research and development expenses in the consolidated statements of operations and deficit.	312,294	220,000
[b] The Company paid rent for a portion of its premises pursuant to a lease agreement with the spouse of one of the founders. This amount is included in general and administrative expenses in the consolidated statements of operations and deficit.	69,848	70,821
[c] The Company incurred fees for research performed by laboratories run by one of the founders. This amount is included in research and development expenses in the consolidated statements of operations and deficit. As at December 31, 2006, \$52,000 [2005 - \$19,500] was unpaid.	78,000	78,000

These transactions have been measured at their respective exchange amounts, being the consideration established and agreed to by the related parties.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
[Expressed in Canadian dollars unless otherwise noted]

December 31, 2006

10. GOVERNMENT ASSISTANCE

During the year, the Company received federal government assistance of \$53,013 [2005 - \$147,008] from a National Research Council Industrial Research Assistance Program ["IRAP"] grant to cover salaries related to the development of the Company's assay for the detection and staging of osteoarthritis and received. In addition, the Company recognized and received \$30,000 under a fellowship program of the National Research Council of Canada. These amounts were accounted for as a reduction of research and development expenses.

11. INCOME TAXES

The differences between the income tax expense (recovery) and the amount that would be computed by using the applicable federal and provincial statutory tax rate of 36.1% [2005 - 36.1%] are as follows:

	2006 \$	2005 \$
Loss for accounting purposes	8,935,673	3,075,107
Income tax recovery computed at statutory tax rate	(3,227,565)	(1,110,700)
Decrease (increase) in income tax recovery resulting from		
Non-deductible expenses	8,452	6,600
Stock option expense	263,092	216,400
Income tax recovery	(2,956,021)	(887,700)
Future tax assets not tax benefited	2,956,021	887,700
Net income tax recovery	—	—

GeneNews Limited
[formerly ChondroGene Limited]

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
[Expressed in Canadian dollars unless otherwise noted]

December 31, 2006

The tax effects of the loss carryforwards and temporary differences that give rise to future tax assets and future tax liabilities are presented below:

	2006	2005
	\$	\$
Future tax assets		
Non-capital loss carryforwards	3,868,200	2,402,100
Research and development expenditures	3,764,500	2,418,700
Unamortized share issue costs	417,300	196,700
Deferred revenue	—	763,000
Federal investment tax credits carried forward expiring between 2009 and 2026	2,401,000	1,401,500
Total future tax assets	10,451,000	7,182,000
Less valuation allowance	(10,018,300)	(6,500,200)
	432,700	681,800
Future tax liabilities		
Property, plant and equipment	174,700	263,900
Intellectual property	258,000	417,900
Total future tax liabilities	432,700	681,800
Net future tax assets	—	—

The valuation allowance for future tax assets as at December 31, 2006 is \$10,018,300 [2005 - \$6,500,200]. The valuation allowance increased by \$3,518,100 [2005 - \$1,491,100] during the year mainly due to additional scientific research and experimental development ["SRED"] expenditures incurred during the year and the increase in investment tax credits available for carryforward. The ultimate realization of the future tax assets is dependent upon the generation of future taxable income during the periods in which the temporary differences become deductible. Based on the fact that the Company is an early stage biotechnology company dependent on raising future capital to fund its activities, it cannot be reasonably estimated at this time if it is more likely than not the Company will realize the benefits of these future tax assets. Consequently, the future tax assets have been reduced by a valuation allowance such that the net future tax assets balance is nil.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
[Expressed in Canadian dollars unless otherwise noted]

December 31, 2006

As at December 31, 2006, the Company and its subsidiary have \$11,611,600 [2005 - \$6,650,400] of federal non-capital losses and \$12,836,500 [2005 - \$8,410,800] of Ontario non-capital losses available for carry forward, as well as \$2,966,900 [2005 - \$1,799,500] of federal investment tax credits available to reduce future federal taxes payable. These will expire as follows:

	Investment tax credits	Ontario loss carryforwards	Federal loss carryforwards
	\$	\$	\$
2007	—	695,900	526,000
2008	—	2,524,200	2,037,600
2009	108,800	1,911,800	1,343,300
2010	94,500	367,600	367,600
2011	47,400	1,885,800	1,885,800
2012	18,600	178,700	178,700
2013	66,400	5,218,600	5,218,600
2014	658,600	—	—
2015	805,200	—	—
2026	1,167,400	—	—
	2,966,900	12,782,600	11,557,600

In addition to the non-capital losses outlined above, the Company and its subsidiaries have \$6,696,400 in SRED expenditures that are available to reduce future taxable income in future years and have an unlimited carryforward period. The benefit of this carryforward amount has not been reflected in these consolidated financial statements.

12. COMMITMENTS AND CONTINGENCIES

[a] Aggregate future minimum annual lease payments for the rental of the Company's premises and obligations under its various collaborative research agreements are as follows:

	\$
2007	321,822
2008	330,160
2009	330,160
2010	330,160
2011 and thereafter	906,265
	2,218,567

Included in the above amount for 2007 is \$28,224 payable to a related party [note 9[b]].

GeneNews Limited
[formerly ChondroGene Limited]

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
[Expressed in Canadian dollars unless otherwise noted]

December 31, 2006

At December 31, 2006, the Company's obligation for the next year under collaborative research agreements amounts to \$216,000 [2005 - \$193,000]. These amounts represent the Company's ongoing commitments under various research collaboration agreements.

In addition, the Company is committed to paying \$250,000 to one of the founders in 2007 under a consulting contract *[note 9[a]]*.

- [b] During the ordinary course of business activities, the Company may be contingently liable for litigation and a party to claims. Management believes that adequate provisions have been made in the accounts where required. Although it is not possible to estimate the extent of potential costs and losses, if any, management believes that the ultimate resolution of such contingencies will not have a material adverse effect on the financial position of the Company.

13. COMPARATIVE CONSOLIDATED FINANCIAL STATEMENTS

The comparative consolidated financial statements have been reclassified from statements previously presented to conform to the presentation of the 2006 consolidated financial statements.