



ChondroGene

UNLOCKING THE SECRETS OF ARTHRITIS

2002 Annual Report

ChondroGene is a functional genomics company that was founded in 1998 with a mission to use genomics-based approaches to develop novel therapeutics and diagnostics for osteoarthritis - the most common form of arthritis.

Osteoarthritis, which is usually associated with aging, is a chronic disease of the joints where cartilage gradually degenerates over time. Patients suffering from osteoarthritis experience pain, swelling, weakness and loss of functional ability in the afflicted joints. These symptoms frequently progress to the point that they have a significant impact in terms of lost productivity and/or quality of life consequences for the patient.



Report to the Shareholders

The past year has been one of significant activity and dramatic progress for the Company. In a milestone event, ChondroGene entered into a two-year collaborative agreement with Pfizer Inc, the world's largest pharmaceutical company in October 2002. This collaboration is valued at up to \$7.5 million, and is focused on the identification and development of novel biomarkers and therapeutic targets for osteoarthritis (OA). This agreement greatly strengthens the financial foundation of the Company. In addition, the resources and critical mass generated by the Pfizer collaboration have enabled an acceleration of our therapeutic target and biomarker programs. Most importantly, the Pfizer deal serves as a strong external validation of the quality of ChondroGene's science and the soundness of its scientific vision.

In addition to the Pfizer collaboration, the Company achieved further progress in implementing its business development strategy of forging mutually beneficial collaborative relationships with pharmaceutical, biotech and academic partners. To this end, arrangements were formalized with the University Health Network for continued access to important clinically-based information.

The scientific plan has progressed rapidly and accelerated during the past year. The Company's sequencing program has currently generated over 100,000 chondrocyte-specific cDNA clones. These clones have been used to generate a cDNA-based 15,000 gene microarray (ChondroChip™). The ChondroChip is a key platform tool for the identification of biomarkers and therapeutic targets for OA. Our experience with ChondroChip has enabled the development of a smaller OA-specific 2,000 gene microarray (OA-Chip™). ChondroGene is continuing to refine the OA-chip to develop a tool for use in routine research and clinical applications. The development and use of these key platform tools have led to the identification of a number of novel biomarkers and targets for osteoarthritis. Efforts are accelerating to further validate these targets and to generate a strong intellectual property portfolio around them.

The past year has also seen substantive increase in the breadth and strength of management in the Company, beginning with my appointment as President & CEO in January of 2002. This was followed by the appointment of Mr. Rory Riggs as Chairman of the Board, Ms. Gailina Liew as Vice President and General Counsel, Mr. Lenny Liscio as Chief Financial Officer, and Dr. Choong-Chin Liew as Chairman of the Scientific Advisory Board (SAB). We have also recently appointed Dr. Frank Barry to the SAB and added Mr. Bruno Maruzzo as Director, Corporate Development and Dr. Thomas Yager as Director, Product Development & Quality Assurance. These changes strengthen our operating, scientific and general management capabilities and reflect the steady maturation of the Company.

The Pfizer agreement has generated a great deal of public awareness of the Company. However, we recognize the need to further improve our liquidity and broaden our shareholder base. To this end, we have enhanced ChondroGene's visibility by unveiling a new corporate logo. We have also allocated increased resources to deliver the message that ChondroGene is an exciting, rapidly emerging biotech company that has already achieved remarkable successes and is poised for exceptional growth and development.

During 2002, as a result of the acquisition of the Canadian Venture Exchange being acquired by the Toronto Stock Exchange, we became listed on the TSX Venture Exchange with a new stock symbol of "YDG". Also during the year, we elected to change our fiscal year end from May 31 to December 31 to be in line with other biotech companies.

From a financial standpoint, I am pleased to inform you that ChondroGene has the financial resources in place to withstand the current uncertainty in the financial markets. In 2002, we successfully completed a rights offering and a subsequent private placement, which generated a total of \$2.3 million. These funds in conjunction with the revenue generated by the Pfizer agreement, will allow the Company to operate and execute its development plans for the next two years. In addition, ChondroGene recently announced a \$3 million private placement which will provide additional cash to enable the Company to greatly accelerate its scientific programs and to strengthen its intellectual property position.

In summary, the past year has been full of exciting achievements and dramatic change. These successes are a direct reflection of the passionate commitment and innovative approaches generated by the group of talented individuals who make up the ChondroGene team. The timely and sharply focused contributions of our Board have also been invaluable. Above all, we recognize that ChondroGene's remarkable progress would not be possible without the tremendous support we have received from our loyal shareholder base. We pledge to continue to work hard and effectively to maintain your confidence.

A handwritten signature in black ink that reads "K. Wayne Marshall". The signature is written in a cursive, flowing style.

K. Wayne Marshall
President and CEO
May 12, 2003

Consolidated Financial Statements of

CHONDROGENE LIMITED
(A DEVELOPMENT STAGE COMPANY)

Seven month period ended December 31, 2002
Year ended May 31, 2002



ChondroGene Limited
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MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL STATEMENTS

Management prepares the financial statements of ChondroGene Limited, and is responsible for their fairness, integrity and objectivity. The financial statements have been prepared in accordance with Canadian generally accepted accounting principles. Preparation of the financial statements necessarily requires some estimates, and these reflect management's best judgment. Management has established systems of internal control designed to provide reasonable assurance that assets are safeguarded from loss or unauthorized use and to produce reliable accounting records for the preparation of financial information.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal control. The Audit Committee of the Board meets with management and representatives of the external auditors to satisfy itself that responsibilities are properly discharged and to review the financial statements. The Audit Committee is also responsible for, after completing its review, recommending the financial statements to the Board of Directors for approval and recommending the appointment of external auditors.

The financial statements are examined by the external auditors in accordance with Canadian generally accepted auditing standards. These standards provide for the review of internal accounting control systems and the testing of transactions to the extent the auditors deem appropriate. The external auditors have full and free access to the Audit Committee of the Board. Management recognizes its responsibility for conducting the Corporation's affairs in compliance with established financial standards and applicable laws and the maintenance of proper standards of conduct in its activities.

"K.Wayne Marshall"

"Lenny Liscio"

K. Wayne Marshall

Lenny Liscio

President and Chief
Executive Officer

Treasurer and Chief
Financial Officer

March 28, 2003



KPMG LLP
Chartered Accountants
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AUDITORS' REPORT TO THE SHAREHOLDERS

We have audited the consolidated balance sheets of ChondroGene Limited (a development stage company) as at December 31, 2002 and May 31, 2002 and the consolidated statements of operations and deficit and cash flows for the seven month period ended December 31, 2002 and for the year ended May 31, 2002. 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, 2002 and May 31, 2002 and the results of its operations and its cash flows for the seven month period ended December 31, 2002 and the year ended May 31, 2002 in accordance with Canadian generally accepted accounting principles.

A handwritten signature in black ink that reads 'KPMG LLP'. The signature is written in a cursive, slightly slanted style. Below the signature is a horizontal line that starts under the 'K' and ends under the 'P'.

Chartered Accountants
Toronto, Canada
March 28, 2003

CHONDROGENE LIMITED

(A DEVELOPMENT STAGE COMPANY)

Consolidated Balance Sheets

	December 31, 2002	May 31, 2002
Assets		
Current assets:		
Cash and cash equivalents	\$ 816,548	\$ 1,685,645
Receivables	25,553	13,790
Investment tax credits recoverable (note 1)	1,173,798	787,001
Prepaid expenses and deposits	68,823	57,813
	<u>2,084,722</u>	<u>2,544,249</u>
Capital assets (note 2)	1,048,627	1,061,326
Intellectual property (note 3)	116,498	139,150
	<u>\$ 3,249,847</u>	<u>\$ 3,744,725</u>
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 251,668	\$ 244,766
Deferred revenue	298,425	-
	<u>550,093</u>	<u>244,766</u>
Shareholders' equity:		
Capital stock (note 4)	8,443,110	7,876,574
Deficit	<u>(5,743,356)</u>	<u>(4,376,615)</u>
	2,699,754	3,499,959
Commitments (note 11)		
	<u>\$ 3,249,847</u>	<u>\$ 3,744,725</u>

See accompanying notes to consolidated financial statements.

On behalf of the Board:

"Garth MacRae" Director

"K. Wayne Marshall" Director

CHONDROGENE LIMITED

(A DEVELOPMENT STAGE COMPANY)

Consolidated Statements of Operations and Deficit

	Seven month Period ended December 31, 2002	Year ended May 31, 2002	Cumulative from inception September 8, 1998
Revenue	\$ 238,740	–	\$ 238,740
Expenses:			
Research and development	1,703,784	2,034,197	6,203,888
Less investment tax credits recoverable	(516,323)	(691,403)	(1,899,716)
	1,187,461	1,342,794	4,304,172
General and administrative	439,146	817,824	1,980,129
	1,626,607	2,160,618	6,284,301
Interest income	(21,126)	(79,316)	(302,205)
Loss for the period	1,366,741	2,081,302	5,743,356
Deficit, beginning of period	4,376,615	2,295,313	–
Deficit, end of period	\$ 5,743,356	\$ 4,376,615	\$ 5,743,356
Loss per common share – basic and diluted (note 6)	0.06	0.12	
Weighted average number of common shares outstanding – basic and diluted	22,364,417	17,142,484	

See accompanying notes to consolidated financial statements.

CHONDROGENE LIMITED

(A DEVELOPMENT STAGE COMPANY)

Consolidated Statements of Cash Flows

	Seven month period ended December 31, 2002	Year ended May 31, 2002	Cumulative from inception September 8, 1998
Cash flows provided by (used in):			
Operations:			
Loss for the period	\$ (1,366,741)	\$ (2,081,302)	\$ (5,743,356)
Items not involving cash:			
Investment tax credits recoverable	(516,323)	(691,403)	(1,899,716)
On going clinical access rights in exchange for common shares	186,000	-	186,000
Amortization of capital assets	148,531	257,879	608,254
Amortization of intellectual property	22,652	38,832	77,664
	(1,525,881)	(2,475,994)	(6,771,154)
Changes in non-cash operating working capital:			
Receivables	(11,763)	16,912	(20,307)
Investment tax credit recoverable	129,526	764,633	898,604
Prepaid expenses and deposits	(11,010)	(21,819)	(65,823)
Accounts payable and accrued liabilities	6,902	120,800	251,668
Deferred revenue	298,425	-	298,425
	(1,113,801)	(1,595,468)	(5,408,587)
Financing:			
Net proceeds from share issue	380,536	2,015,916	8,094,979
Investments:			
Additions to capital assets	(135,832)	(264,366)	(1,829,567)
Amounts expended on intellectual property	-	-	(41,159)
Acquisition of cash	-	-	883
	(135,832)	(264,366)	(1,869,844)
Increase (decrease) in cash and cash equivalents	(869,097)	156,082	816,548
Cash and cash equivalents, beginning of period	1,685,645	1,529,563	-
Cash and cash equivalents, end of period	\$ 816,548	\$ 1,685,645	\$ 816,548
Supplemental cash flow information:			
Interest received	\$ 21,126	\$ 79,316	\$ 302,205
Interest paid	-	-	-
Income taxes paid	-	-	-
Supplemental non cash financing activity:			
Shares issued for:			
Intellectual property	\$ -	\$ -	\$ 153,000
On going clinical access rights	186,000	-	186,000

See accompanying notes to consolidated financial statements.

CHONDROGENE LIMITED

(A DEVELOPMENT STAGE COMPANY)

Notes to Consolidated Financial Statements

Seven month period ended December 31, 2002 and year ended May 31, 2002

ChondroGene Limited, (the "Company") is incorporated under the laws of the Province of Ontario. The Company is a development stage and research-based biomedical company whose focus is to develop new therapeutics and diagnostics for the treatment of osteoarthritis ("OA") and cartilage repair through the use of functional genomic technologies.

1. Investment tax credits recoverable:

Due to the Company carrying out qualifying research activities, it is eligible for both federal and provincial investment tax credits. These credits, for most public companies, are available to reduce income taxes otherwise payable. As a Tier 3 Issuer on the TSX Venture Exchange, the Company is able to receive a large portion of its investment tax credits as a cash refund, notwithstanding that it is not currently in a taxable position. These investment tax credits are recorded as assets in the period in which the related expenditures are incurred, with credits to research expense for the portion arising from qualifying expenses, and to capital assets for the portion related to qualifying capital expenditures.

2. Capital assets:

The following table summarizes capital assets at the respective balance sheet dates:

December 31, 2002			
	Cost	Accumulated amortization	Net book value
Laboratory equipment (net of investment tax credits of \$232,091)	\$ 1,170,556	\$ 416,105	\$ 754,451
Office furniture and equipment	293,988	99,532	194,456
Leasehold improvements	192,337	92,617	99,720
	<u>\$ 1,656,881</u>	<u>\$ 608,254</u>	<u>\$ 1,048,627</u>
May 31, 2002			
	Cost	Accumulated amortization	Net book value
Laboratory equipment (net of investment tax credits of \$212,091)	\$ 1,106,318	\$ 320,703	\$ 785,615
Office furniture and equipment	226,360	70,474	155,886
Leasehold improvements	188,371	68,546	119,825
	<u>\$ 1,521,049</u>	<u>\$ 201,844</u>	<u>\$ 1,061,326</u>

CHONDROGENE LIMITED

(A DEVELOPMENT STAGE COMPANY)

Notes to Consolidated Financial Statements (continued)

Seven month period ended December 31, 2002 and year ended May 31, 2002

3. Intellectual property:

Intellectual property consists of the following:

- (a) Licensing agreement for the exclusive rights, in perpetuity, to use a blood-based methodology for the detection of osteoarthritis and traumatic joint injury. This licensing agreement was acquired in December 2000 for \$153,000 being the market value of the consideration of the 300,000 common shares at date of purchase. In addition, legal costs of \$41,159 were capitalized. The majority shareholder of the licensor company is one of the founders and a director of the Company.
- (b) Technical findings, expertise and related material in disease gene discovery, in vivo research and human clinical trial skill in OA, ("Expertise"). This Expertise was previously developed by the founders and acquired by the Company in September 1998 at an ascribed value of \$3 for 6,000,000 common shares.

December 31, 2002

	Cost	Accumulated amortization	Net book value
Intellectual property	\$ 194,162	\$ 77,664	\$ 116,498

May 31, 2002

	Cost	Accumulated amortization	Net book value
Intellectual property	\$ 194,162	\$ 55,012	\$ 139,150

CHONDROGENE LIMITED

(A DEVELOPMENT STAGE COMPANY)

Notes to Consolidated Financial Statements (continued)

Seven month period ended December 31, 2002 and year ended May 31, 2002

4. Capital stock:

Authorized:

Unlimited number of non-voting preference shares;
issuable in one or more series.

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

Unlimited number of voting common shares.

Issued and outstanding:

	Number of common shares	Amount
Balance at May 31, 2001	15,176,503	\$ 5,860,658
Issue of shares:		
Rights offering, net of shares issue costs of \$303,310	3,891,625	1,019,842
Warrants exercised	100,000	41,600
Private placement, net of share issue costs of \$52,182	2,000,000	947,818
Options exercised	16,000	6,656
Balance at May 31, 2002	21,574,128	7,876,574
Issue of shares:		
Shares issued in exchange for on going clinical access rights from an arm's length party, net of share issue costs of \$2,567	600,000	183,433
Private placement, net of share issue costs of \$500	1,162,462	383,103
Balance at December 31, 2002	23,336,590	\$ 8,443,110

During the period ended December 31, 2002, the Company issued 600,000 common shares in exchange for on going clinical access rights from an arm's length party. The shares were issued for an ascribed value of \$0.31 per share being the market value at the time of issue.

On July 25, 2002, warrants totaling 2,935,625 expired.

At December 31, 2002, 1,331,334 common shares of two founders are held in escrow and will be released on May 31, 2003.

During the year ended May 31, 2002, the Company granted its brokers 50,000 non-assignable and non-transferable warrants each convertible into one common share, exercisable until November 10, 2003 upon payment of \$0.50 per warrant.

CHONDROGENE LIMITED

(A DEVELOPMENT STAGE COMPANY)

Notes to Consolidated Financial Statements (continued)

Seven month period ended December 31, 2002 and year ended May 31, 2002

5. Stock-based compensation:

(a) Stock options

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 not exceeding 4,667,318. 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 5 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 below the closing stock price on the TSX Venture Exchange for the day immediately preceding the date of Board approval for the issuance of options. As of the December 31, 2002, there were 1,067,404 options outstanding and a cumulative number of 106,000 options that had been exercised for a total of 1,173,404, leaving a balance of 3,493,914 options available for issuance under the Plan.

A summary of the status of the Company's stock option plan as of December 31, 2002 and May 31, 2002 and changes during the periods then ended is presented below:

	December 31, 2002		May 31, 2002	
	Shares	Weighted-average exercise price	Shares	Weighted-average exercise price
Outstanding, beginning of year	1,164,112	\$ 0.468	900,506	\$ 0.605
Granted	120,000	1.479	329,606	0.539
Excercised	-	-	(16,000)	0.416
Forfeited	(216,708)	0.714	(50,000)	0.750
Outstanding, end of year	1,067,404	\$ 0.525	1,164,112	\$ 0.605
Options exercisable, end of year	726,508	\$ 0.583	670,550	\$ 0.534

CHONDROGENE LIMITED

(A DEVELOPMENT STAGE COMPANY)

Notes to Consolidated Financial Statements (continued)

Seven month period ended December 31, 2002 and year ended May 31, 2002

5. Stock option plan (continued):

The following table summarizes information about stock options outstanding at December 31, 2002:

Exercise price per share	Number outstanding	Weighted-average remaining contractual life	Options exercisable
\$ 0.400	25,000	3.39	8,333
\$ 0.416	343,170	7.48	319,837
\$ 0.450	120,000	4.99	15,000
\$ 0.500	38,574	4.18	6,429
\$ 0.610	120,000	4.48	40,000
\$ 0.750	420,660	5.97	336,909
	1,067,404		726,508

(b) Pro forma net loss and net loss per share:

CICA Handbook Section 3870 requires the disclosure of pro forma net earnings (loss) and net earnings (loss) per share as if the Company had accounted for employee stock options under the fair value based method. The Company has applied the pro forma disclosure provisions of the new standard to awards granted on or after June 1, 2002.

The fair value of each employee option is estimated on the date of grant using the Black-Scholes option-pricing model. For the seven month period, the weighted average assumptions were: dividend yield of nil; expected volatility of 71%; risk-free interest rate of 4.5%; and expected life of five years.

CHONDROGENE LIMITED

(A DEVELOPMENT STAGE COMPANY)

Notes to Consolidated Financial Statements (continued)

Seven month period ended December 31, 2002 and year ended May 31, 2002

5. Stock option plan (continued):

For the purposes of pro forma disclosures, the estimated fair value of the options is amortized over the vesting period. Had the fair value based method been applied to all employee options granted during the period, the Company's pro forma loss would be increased by stock based compensation cost of \$4,170 for a total pro forma loss of \$1,370,911. The basic and diluted loss per common share remains at \$0.06 per common share.

6. Loss per common share:

Loss per common share has been calculated using the weighted average number of shares outstanding during the period. The maximum dilutive number of shares outstanding during the period will have an anti-dilutive impact on loss per share. Therefore no dilutive loss per share is disclosed. The potentially dilutive items consist of stock options and warrants.

7. Fair value of financial assets and financial liabilities:

The carrying values of cash and cash equivalents, receivables, accounts payable and accrued liabilities and deferred revenue approximate their fair values due to the short-term nature of these instruments.

8. Segmented information:

The Company considers that its current operations fall principally into one industry segment, biomedical research. All of its identifiable assets at December 31, 2002 and May 31, 2002 are located in Canada.

CHONDROGENE LIMITED

(A DEVELOPMENT STAGE COMPANY)

Notes to Consolidated Financial Statements (continued)

Seven month period ended December 31, 2002 and year ended May 31, 2002

9. Related party transactions and commitments:

The following transactions, in which one or more of the founders has an interest, have occurred:

	Seven month Period ended December 31, 2002	Year ended May 31, 2002
a) Consulting fees were paid to two of the founders pursuant to agreements having one year terms, renewable annually in January	\$ 58,333	\$ 200,000
b) The Company paid rent for a portion of its premises pursuant to a three year lease agreement with the spouse of one of the founders	\$ 31,609	\$ 57,743
c) The Company paid fees for research performed by laboratories run by two of the founders	\$ 45,000	\$ 102,000
d) Materials purchased from a company controlled by a relative of one of the founders	\$ 285,281	\$ 547,378

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

CHONDROGENE LIMITED

(A DEVELOPMENT STAGE COMPANY)

Notes to Consolidated Financial Statements (continued)

Seven month period ended December 31, 2002 and year ended May 31, 2002

10. Income taxes:

The income tax recovery differs from the amount that would be computed by applying the applicable federal and provincial statutory rates 36.6% (May 2002 – 40%) to income before the tax recovery. The reasons for the differences are as follows:

	December 31, 2002	May 31, 2002
Income tax recovery computed at statutory rate	\$ (500,000)	\$ (854,000)
Decrease in income tax recovery resulting from non-deductible expenses	3,000	5,900
Income tax recovery	(497,000)	(848,100)
Amounts not tax benefited	497,000	848,100
Net income tax recovery	\$ –	\$ –

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

	December 31, 2002	May 31, 2002
Future tax assets:		
Net operating loss carryforwards, including scientific research expenditures	\$ 2,694,900	\$ 2,454,300
Unamortized share issue costs	247,600	342,600
Intellectual property	12,200	8,800
Federal investment tax credit carried forward expiring between 2011 and 2013	277,200	260,000
Total future tax assets	3,231,900	3,065,700
Less valuation allowance	(2,838,700)	(2,577,300)
Net future tax assets	393,200	488,400
Less future tax liabilities:		
Capital assets	279,600	303,200
Investment tax credits recoverable	113,600	185,200
Total future tax liabilities	393,200	488,400
Net future tax asset	\$ –	\$ –

CHONDROGENE LIMITED

(A DEVELOPMENT STAGE COMPANY)

Notes to Consolidated Financial Statements (continued)

Seven month period ended December 31, 2002 and year ended May 31, 2002

10. Income taxes (continued):

The valuation allowance for future tax assets as at December 31, 2002 and May 31, 2002 is \$2,838,700 and \$2,577,300, respectively. The net changes in the total valuation allowance for the seven month period December 31, 2002 and for the year ended May 31, 2002 was an increase of \$261,400 and \$1,057,900, respectively. 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 the future tax assets. Consequently, the future tax assets have been reduced by an equivalent valuation allowance. The valuation allowance will be adjusted in the period that it is determined with reasonable certainty that it is more likely than not that some portion or all of the future tax assets will be realized.

At December 31, 2002 the Company has the following non-capital losses and other timing differences that will impact future years' income for tax purposes:

Non-capital losses available on a tax filing basis until:	
2004	\$ 3,200
2005	274,900
2006	985,000
2007	2,515,000
2008	2,410,000
2009	1,211,000
	<hr/>
	7,399,100
Investment tax credits taxable in subsequent period	(334,000)
Unamortized share issue costs	677,000
Excess of net book value over undepreciated cost of capital assets	(763,000)
Cumulative eligible capital deductible in future periods	33,000
	<hr/>
	\$ 7,012,100

CHONDROGENE LIMITED

(A DEVELOPMENT STAGE COMPANY)

Notes to Consolidated Financial Statements (continued)

Seven month period ended December 31, 2002 and year ended May 31, 2002

11. Commitments:

Aggregate future minimum lease payments for the rental of the Company's premises are as follows:

2003	\$	94,000
2004		96,000
2005		48,000
	\$	238,000

Included in the above amounts are \$56,000 for 2003, \$60,000 for 2004 and \$30,000 for 2005 payable to a related party (See note 9(b)).

12. Operations:

These 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 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.

CHONDROGENE LIMITED

(A DEVELOPMENT STAGE COMPANY)

Notes to Consolidated Financial Statements (continued)

Seven month period ended December 31, 2002 and year ended May 31, 2002

13. Significant accounting policies:

(a) Basis of consolidation:

These consolidated financial statements are expressed in Canadian dollars and include the accounts of the Company and its wholly-owned subsidiary company, ChondroGene Inc.

(b) Cumulative information from inception:

In accordance with the Canadian Institute of Chartered Accountants Accounting Guideline 11, "Enterprises in Development Stage," the Company qualifies as a development stage company. Accordingly, certain cumulative information from inception has been disclosed in accordance with the Accounting Guideline.

(c) Cash and cash equivalents:

Cash and cash equivalents include cash in bank and investments in money market instruments with term to maturity of less than 90 days at date of acquisition.

(d) Intellectual property:

Intellectual property is being amortized over a five-year period on a straight-line basis. Intellectual property is regularly evaluated by management and any permanent impairment would be written off in the year in which it occurs.

(e) Capital assets:

Capital assets are recorded at cost less investment tax credits recoverable and are amortized over their estimated useful lives using the following rates and methods.

	Method	Rate
Laboratory equipment	Declining balance	20 – 30%
Office furniture and equipment	Declining balance	20 – 30%
Leasehold improvements	Straight line	20%

CHONDROGENE LIMITED

(A DEVELOPMENT STAGE COMPANY)

Notes to Consolidated Financial Statements (continued)

Seven month period ended December 31, 2002 and year ended May 31, 2002

13. Significant accounting policies (continued):

(f) Revenue recognition:

Revenue is recognized as services are performed. Payments received for future services are deferred until the service is provided.

(g) Research and development expenses:

Research costs 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 the criteria under Canadian generally accepted accounting principles for deferral and amortization. To December 31, 2002, the Company has not deferred any development costs.

(h) 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 substantially 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 recovered.

(i) Stock based compensation:

The Company accounts for stock-based compensation using the intrinsic value method for stock options granted to employees and a fair value based method for all other stock options and awards.

CHONDROGENE LIMITED

(A DEVELOPMENT STAGE COMPANY)

Notes to Consolidated Financial Statements (continued)

Seven month period ended December 31, 2002 and year ended May 31, 2002

13. Significant accounting policies (continued):

(j) Use of estimates:

The preparation of 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 financial statements and the reported amounts of revenues and expenses during the period. Actual results could differ from those estimates.

14. Change in accounting policy:

Effective June 1, 2002, the Company adopted the new Canadian Institute of Chartered Accountants ("CICA") Handbook Section 3780, "Stock-Based Compensation and Other Stock-Based Payments", which requires that a fair value based method of accounting be applied to all stock-based payments to non-employees, and employee awards that are direct awards of stock, call for settlement in cash or other assets or are stock appreciation rights that call for settlement by the issuing of equity instruments, granted on or after June 1, 2002.

Under the fair value based method, stock-based payments to non-employees are measured at the fair value of the consideration received, of 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 re-measured 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.

While the new standard encourages the use of a fair value based method for all other direct awards of stock, stock appreciation rights, and awards that call for settlement in cash or other assets granted to employees, it however permits the Company to continue its existing policy of recording no compensation cost on the grant of stock options to employees. Accordingly, no compensation cost is recorded in the fiscal period ended on or before December 31, 2002 for all stock options granted to employees. Proceeds received on the exercise of employee stock options are credited to capital stock. The Company discloses the pro forma effect of accounting for these employee stock options awards under the fair value based method.

ChondroGene Limited
Management Discussion and Analysis
For the seven month period ended December 31, 2002

The following discussion and analysis should be read in conjunction with the audited consolidated financial statements as at and for the period ended December 31, 2002, and notes thereto, to which these comments are attached. The Company changed its fiscal year end from May 31 to December 31 during the current period such that all comparatives described herein refer to the seven months from June 1 to December 31, 2002 relative to the prior fiscal year end for the twelve months from June 1, 2001 to May 31, 2002.

NATURE OF OPERATIONS:

ChondroGene Limited ("the Company") is an early stage genomics-based company focused on the discovery and development of disease-specific therapeutic and diagnostic approaches, specializing in osteoarthritis ("OA"). From inception to the current period ended December 31, 2002, the Company had no independent sources of income, except for proceeds from a recently signed business collaboration described herein, and, to December 31, 2002 it had accumulated losses of about \$5.8 million. Its operations to date, which are conducted through its wholly owned subsidiary, ChondroGene Inc., have been and will continue to be financed in the foreseeable future from the proceeds of equity financings along with proceeds from business collaborations.

To December 31, 2002, the Company had raised a total of \$9.4 million (gross proceeds) through private placements of its capital stock and the issuance of common shares pursuant to a Rights Offering, of which about \$800,000 was still on hand at the end of the current period.

OPERATIONS:

Scientific Discussion:

In the current year, the Company advanced its scientific plan as described below.

Efforts to identify novel therapeutic targets and biomarkers for the diagnosis of early OA are ongoing and remain the central focus of the Company's scientific plan. These efforts have been accelerated by virtue of the collaborative research agreement with Pfizer Inc. Progress in the biomarker program has been significant and preliminary results are promising.

The ChondroChip™ continues to be utilized as a key platform technology and validation of the results from its use through the application of real-time RT-PCR has been standardized.

The bioinformatics infrastructure has been strengthened by the completion of the first phase of a relational database. Work on a second phase has commenced.

ChondroGene Limited
Management Discussion and Analysis
For the seven month period ended December 31, 2002

This work will continue in the next fiscal quarter. The Company will also continue its sequencing efforts and its work in cell and tissue culture.

Business collaboration revenues:

On October 10, 2002, the Company announced a business collaboration with Pfizer Inc., a major pharmaceutical company. The collaboration is valued at up to \$7.5 million over the next two years, and involves both an equity component and funding for collaborative research activities.

Revenues from the collaborative research activities are comprised of both contract payments and service fees.

There were no contract related revenues recorded in the current period ended December 31, 2002. Subsequent to December 31, 2002, the Company fulfilled its deliverables pertaining to the first contract payment requirement and received proceeds of \$1,479,000, to be recorded as revenue in the first fiscal quarter of 2003, ending March 31.

Service fees are billed in advance, then deferred and recognized as revenue on a straight-line basis as the work is performed. The total of \$239,000 revenue for the current period represents the proportionate amount of the first advance payment (\$537,000, less \$298,000 reflected as deferred revenue on the balance sheet) applicable to the period from contract inception, October 10, 2002, to the end of the current period.

Research and development expenses:

Of the total \$1,703,000 in this category, \$509,000 (30%) represents the cost of salaries, fringe benefits, travel and communications; \$766,000 (45%) represents the cost of supplies, equipment and premises; the remaining \$428,000 (25%) is the cost of consultants, professional advisors and other third parties whose efforts have been enlisted in direct support of the research and development activities. Average monthly expenses of \$245,000 over the 7 month period ended December 31, 2002, were higher than the prior year monthly average of \$170,000 over the 12 month fiscal year ended May 31, 2002, (total \$2,034,000 for the year) due primarily to increased consumption of lab supplies and reagents as research phases progress, fees paid (\$186,000, by way of a share issuance) to the University Health Network ("UHN") for ongoing access to clinical information, and labour costs from increased head count.

General and administrative expenses:

Of the total \$439,000 in this category, \$214,000 (49%) is the administrative portion of the salary, fringe benefits and travel costs of the senior management and administrative group comprised of the president, vice president, chief financial officer and two support persons. Approximately \$68,000 (15%) represents expenses for premises, office

ChondroGene Limited
Management Discussion and Analysis
For the seven month period ended December 31, 2002

supplies and equipment. The remaining \$ 157,000 (36%) of the total includes professional fees (legal, accounting and audit, investor relations), consultants, and specialized corporate service costs. Average monthly expenses of \$63,000 over the 7 month period ended December 31, 2002, were comparable to the prior year monthly average of \$68,000 over the 12 month fiscal year ended May 31, 2002, (total \$818,000 for the year).

Interest and sundry income:

Interest of \$21,000 was earned through investment of surplus funds in a short term money market facility managed by the Company's bankers, and from investment tax credit refunds. The prior year total of \$79,000 included higher interest on cash balances invested in the short term money market facility, and from investment tax credit refunds, and \$16,000 incidental income from a research collaboration.

BALANCE SHEET COMPARISONS:

Investment tax credit refunds ("ITC refunds"):

The balance of \$787,000 from May 31, 2002 included an Ontario refund of \$146,000 pertaining to fiscal 2001, received in September 2002, and an estimate of \$641,000 for refunds arising from qualifying expenditures for the fiscal year ended May 31, 2002.

During the current period ended December 31, 2002, this total was increased to \$1,174,000 with an increase of \$104,000 to the May 31, 2002, estimate based on the actual claim filed of \$745,000, and an additional estimate of \$429,000 (\$409,000 operating / \$20,000 capital items) for refunds that will arise from qualifying expenditures during the period ended December 31, 2002.

Capital assets:

During the current period, the Company spent \$136,000 on capital asset additions (net of a \$20,000 reduction to the cost of laboratory equipment for anticipated ITC refunds), the majority of which was for assets used directly in the research program. The carrying value of capital assets was further reduced by amortization charges for the current period of \$149,000.

Accounts payable and accrued liabilities:

The balance of \$252,000 as at December 31, 2002 is comparable to the \$245,000 balance from May 31, 2002.

ChondroGene Limited
Management Discussion and Analysis
For the seven month period ended December 31, 2002

Capital stock:

The issued and outstanding share capital increased from \$7.88 million to \$8.44 million (7.1%). The increase during the current year is the result of the issuance of 1.76 million shares (with net value of \$567,000) pursuant to private placements.

There were 2,935,625 warrants outstanding at May 31, 2002, which expired on July 25, 2002. Another 50,000 broker's warrants issued on May 10, 2002, pursuant to a private placement, remain outstanding and are exercisable until November 10, 2003, at \$0.50 per warrant.

Recently Issued Accounting Standards:

The Company has adopted the accounting standard ("the treasury stock method") for calculating dilutive earnings per share. Since there was a loss per share, the maximum dilutive number of shares outstanding during the period would have an anti-dilutive impact on loss per share, such that no dilutive loss per share is disclosed, and consequently, there was no impact to the Company of applying the new standard to the current period results.

In December 2001, the Accounting Standards Board of the CICA issued Handbook Section 3870. Section 3870 establishes standards for the recognition, measurement, and disclosure of stock-based compensation and other stock-based payments made in exchange for goods and services provided by employees and non-employees. It applies to transactions in which shares of common stock, stock options, or other equity instruments are granted or liabilities incurred based on the price of common stock or other equity instruments.

As of June 1, 2002, the Company is required to comply with the new accounting standards pertaining to Stock-Based Compensation. During this period, there were no non-employee stock options that met the requirement of measurement under the new standard. Therefore, only pro-forma disclosure was made for employee stock options.

LIQUIDITY:

The Company had \$817,000 in cash at December 31, 2002, and working capital (excluding deferred revenue balances) of \$ 1.8 million. These resources will permit the Company to execute its business plan and maintain all efforts to advance its research activities.

ChondroGene Limited
Management Discussion and Analysis
For the seven month period ended December 31, 2002

During the current period ended December 31, 2002, the movements in cash resources were as follows:

	<u>(000's)</u>
Balance, beginning of period	\$1,686
Add: Proceeds from equity issuance	383
Cash receipts from business collaboration	537
ITC refunds received	146
Deduct net cash burn from operations	<u>(1,935)</u>
Balance, end of period	<u>\$817</u>

The Company expects to raise funds by private placements or other issuances of stock from treasury and through strategic collaborations, including additional contract and service payments from its existing collaboration with Pfizer Inc., and is optimistic that the necessary funds to extend operations will be in place before they are required.

Subsequent to the period ended December 31, 2002, the Company received ITC refunds totalling \$745,000, and a \$1.479 million contract payment from the Pfizer collaboration. Cash balances at the end of the first fiscal quarter ended March 31, 2003, were approximately \$2.4 million.

On April 29, 2003, the Company announced its intention to raise up to \$3 million by way of a private placement to close on or about June 16, 2003.

At forecast rates of expenditure, and taking into account capital and operating items, as well as anticipated payments from collaborations, the Company's funds will carry operations for the next fiscal year.

PRINCIPAL RISK FACTORS:

Given the Company's stage of development, there are four major risks to be faced:

1. Invalid scientific premises:

The Company's core belief is that it will discover the relationship between abnormal cartilage function and altered gene expression in blood and the chondrocyte (the basic cell found in cartilage), and will use this knowledge to develop new diagnostics and therapeutics for OA. This premise may prove incorrect.

ChondroGene Limited
Management Discussion and Analysis
For the seven month period ended December 31, 2002

2. Competition and Markets:

The biotechnology and genomic research field is filled with many large and sophisticated companies whose financial and human resources far outweigh those of the Company. Any one or several of these entities could announce findings at any time that could diminish or even eliminate any of the Company's competitive advantages.

The Company believes that its efforts will lead to commercially viable products or processes for the diagnosis and/or treatment of OA. Such successful commercialization will depend, in part, on future market conditions that are impossible to predict.

3. Financing:

While the Company has successfully raised \$9.4 million (gross proceeds) in capital to the end of December 2002, had cash resources of about \$800,000 on hand at the end of the period, and recently signed a collaboration agreement with proceeds of up to \$7.5 million over the next two years, additional funds will be required to fund future operations. Efforts will be required to obtain these additional funds, but there is no assurance that these efforts will generate sufficient funds on time.

4. Scientific skills and know-how:

The Company needs to attract and retain skilled employees in order to execute its business plan. Many of these people will demand high levels of remuneration, and will have many alternative potential employers. Accordingly there exists the risk that required personnel would not be available when needed.

FORWARD LOOKING STATEMENTS:

ChondroGene and its representatives periodically make written and spoken forward looking statements and projections, including those contained in the annual and quarterly reports to shareholders. Substantial risks and uncertainties exist with respect to such factors as the outcome of the Company's scientific research, the actions of the competition, the economics of the marketplace, the obtaining of adequate financing in a timely manner, the hiring and retention of necessary skilled staff, as well as various other risk factors that will be listed from time to time in the Company's reports or other forms of public disclosure whether written or oral. Because of these risks and uncertainties, actual results could differ materially from those contained in the Company's projections or other forward looking statements. Readers are cautioned when making decisions to consider the risks and uncertainties inherent in relying on forward looking statements made by the Company and its representatives at this or any other time.

MANAGEMENT

K. Wayne Marshall, MD, FRCS(C), PhD
President & CEO

Choong-Chin Liew, PhD
Chief Scientist

Gailina J. Liew, BSc, LLB
VP & General Counsel

Lenny Liscio, BComm, CA
Chief Financial Officer

STOCK INFORMATION

Trading Symbol: YDG: TSX Venture Exchange
CUSIP number: 170396105
Transfer Agent: Equity Transfer Services Inc.

Accountants: Ernst & Young
Legal Counsel: Aird & Berlis
Patent Counsel: Palmer & Dodge
Torys

BOARD OF DIRECTORS

Rory Riggs, Chairman
Managing Member of Balfour LLC.

James Howard-Tripp
President and CEO, Labopharm Inc.

Choong-Chin Liew
Chief Scientist, ChondroGene Limited

Garth MacRae
Vice Chairman, Dundee Bancorp Inc.

K. Wayne Marshall
President & CEO, ChondroGene Limited

ANNUAL MEETING

The 2002 ChondroGene Limited Annual General Meeting will be held at 4:00 PM on Monday June 16, 2003 in the Ketchum Room at the Toronto Board of Trade, 1 First Canadian Place, Toronto, Ontario.

SCIENTIFIC ADVISORY BOARD

Choong-Chin Liew, PhD
Chairman of SAB
Director, Cardiovascular Genome Unit,
Brigham & Women's Hospital, Boston

Phil Band, PhD
Consultant

Frank Barry, PhD
Consultant

Dan Grande, PhD
Director, Orthopaedic Research,
North Shore University Hospital

K. Wayne Marshall, MD, FRCS(C), PhD
President & CEO, ChondroGene Limited

Robin Poole, PhD
Program Director, Canadian Arthritis Network

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