



ChondroGene

Growing,

Advancing,

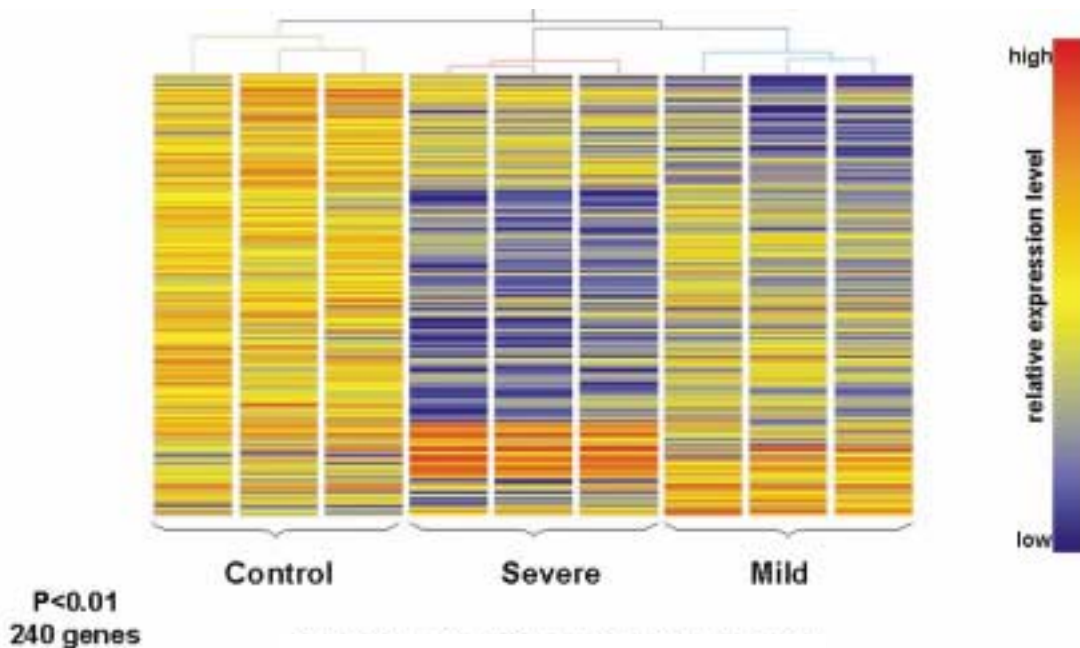
Evolving...

2003 Annual Report

CHONDROGENE Mission

ChondroGene is focused on the application of functional genomics to enable early diagnosis and personalized therapeutic intervention based on disease-specific biomarkers.

ChondroGene OA Blood Biomarker Data



The dendrogram above, based on data derived from ChondroGene's proprietary osteoarthritis clinical database, clearly shows the difference between normal patients and those with mild and severe osteoarthritis.

President's Message to Shareholders

We are extremely pleased with our accomplishments of the past year, highlighted by continued progress in our osteoarthritis collaboration with Pfizer. The first two research milestones in the joint target identification program were achieved on time and each triggered \$1 million U.S. payments. Important progress was also achieved in our blood biomarker program for osteoarthritis.



In order to leverage the successes achieved in identifying osteoarthritis biomarkers, ChondroGene acquired GeneNews and its novel blood biomarker technology. This has enabled ChondroGene to expand its application of novel blood biomarker technology to disease areas beyond arthritis and traumatic joint injury. Progress to date in these other disease areas has generated important new academic collaborations and strong interest from potential commercial partners.

In June, the company raised \$3 million of additional capital by way of a private placement with existing and new shareholders. The support shown by our existing investors and the interest demonstrated by new investors is a reflection of the progress and success we have achieved in the past year and we are excited about our prospects for the future.

The path to commercialization has been accelerated in the past year through the acquisition and implementation of several important technologies as well as the hiring of a number of key individuals. The company has also aggressively expanded the depth and breadth of its intellectual property portfolio. We believe the company's rapid scientific progress in conjunction with a commercialization strategy that is focused on major areas of clinical need will reward the confidence you have placed in us. Your ongoing support is valued and appreciated.

A handwritten signature in black ink that reads "K W Marshall". The signature is written in a cursive, slightly stylized font.

Dr. K. Wayne Marshall
MD, PhD, FRCS(C)
President and CEO
April 8, 2004

Company History

ChondroGene was formed in 1998 with the bringing together of its two key founders; Dr. K Wayne Marshall, a noted orthopaedic surgeon and knee specialist and Dr. C.C. Liew, an internationally recognized leader in the area of tissue specific functional genomics. Their respective expertise was combined to focus on developing new drugs and tests for osteoarthritis (OA), a chronic condition which affects the joints of millions of individuals worldwide, resulting in diminished quality of life for patients and severe economic burdens on healthcare systems.

The Company initially focussed on the use of functional genomics to characterize the molecular activity in tissues that make up the joints in the human body - cartilage, synovium and synovial fluid. The goal was to examine how the tissues of the joint function in different stages of osteoarthritis; from normal joints, to moderately diseased joints, all the way to severe osteoarthritis which could only be treated by total joint replacement. This work culminated in 2001 with the substantial completion of the identification and characterization of the chondrocyte genome (genes expressed in healthy and diseased human cartilage cells). The Company then produced the first known cDNA microarray specifically targeted at human cartilage gene expression, the ChondroChip™, an important platform tool which the Company is using to advance its research efforts in osteoarthritis.

Following on these achievements, the Company entered into a research collaboration with Pfizer Inc in October 2002. The objectives of the collaboration are to identify novel biomarkers to detect and stage the severity of OA, and to use ChondroGene's proprietary data and ChondroChip™ to identify potential new drug targets to treat OA. The Company has made great progress in its collaboration with Pfizer, achieving the first two of three research milestones in 2003. ChondroGene also demonstrated the application of a novel blood-based diagnostic approach and methodology in OA and is focussing on application of this approach in additional disease areas with significant healthcare and commercial potential.

Progress in Osteoarthritis

ChondroGene's initial focus has been in osteoarthritis, a chronic progressive disease of the joints that affects between twenty to thirty percent of the adult population to varying degrees. As the population ages, these numbers will only increase. Many people cope with the early symptoms of pain, joint stiffness and reduced mobility through the use of drugs and by limiting activities. But in many cases, the disease progresses to the point where surgery is required to 'clean out the joint', or in the most severe cases, a joint replacement is required.

All of the current treatments - drugs, injections into the joint and surgery - target the symptoms, not the underlying disease processes. ChondroGene's research and development programs are aimed at developing tests that can pick up the disease early, even before symptoms appear. Today, because there are no drugs that can retard or stop the progress of the disease, an early diagnosis of OA might lead to lifestyle changes, such as losing weight, avoiding high impact activities and taking dietary supplements, in order to retard the progress of the disease. In addition, a test that could detect early stage, asymptomatic OA patients is essential in developing new drugs to treat the disease. The other component of ChondroGene's OA research involves the use of its genomic techniques to identify potential drug targets for developing drugs to affect the course of the disease, that is, to retard or stop the progress of disease, or in the ideal scenario, reverse the disease process thereby returning the joint to normal.

ChondroGene entered into a research collaboration with Pfizer having two main objectives: (1) to identify unique biomarkers for OA that can be used in a diagnostic test to detect early stage disease and stage the severity of disease, and (2) to identify drug targets that can be used to develop new drugs that will modify the disease process and not merely treat the symptoms. The Company has been successful in meeting these two objectives. To date, a number of biomarkers have been identified and characterized for the early detection and staging of OA. In addition, ChondroGene has achieved the first two of three research milestones in the target identification program, with the third expected to be achieved before the end of the collaboration.

The Sentinel Principle

The unique blood biomarker approach used in the Company's osteoarthritis work is based on the work of Dr. C.C. Liew with GeneNews Inc., which demonstrates that circulating blood reflects what is happening in the different tissues of the body. The application of this approach, the Sentinel Principle, led to the development of a novel method to diagnose disease through the identification of disease-specific biomarkers from blood. The Company had an exclusive license to use this method and has been successful in applying it to osteoarthritis. ChondroGene has demonstrated the power of the method in OA and has developed the first known assay to detect and stage OA from a blood test. The Company acquired GeneNews Inc. and ownership of the method in late 2003.

Applications to Other Diseases

ChondroGene is rapidly applying the Sentinel Principle to identify disease-specific biomarkers in a number of other diseases. Results to date have been very encouraging.

Diseases that are either difficult or impossible to diagnose with conventional approaches, and diseases that require invasive or expensive procedures, have been differentiated using this blood-based approach.

The Future

ChondroGene is focussing its efforts on the application of the Sentinel Principle in the development of blood-based molecular diagnostic assays to detect and diagnose disease and other medical conditions, and to use this information for appropriate therapeutic selection and monitoring.

Going forward, osteoarthritis will continue to be an important disease focus for the Company and its partners. ChondroGene will seek additional partners in other disease areas in order to utilize their expertise and to accelerate development of new diagnostics and therapeutics in these new disease areas.

The Company's goal is to develop novel diagnostic assays for major disease areas using its proprietary molecular diagnostic approach in the coming 18 to 24 months. We believe the application of this approach will facilitate the ability of healthcare practitioners to quickly and easily;

- Diagnose disease at an early stage,
- Predict the risk of disease,
- Determine the stage of a disease,
- Identify responders/non-responders to certain treatments, and
- Monitor progression of disease and the effects of treatment.

Meeting these needs will lead to the practice of personalized medicine, eventually enabling healthcare practitioners to select the appropriate treatment for a specific individual's genetic makeup and specific condition.

Notes



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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

President and Chief
Executive Officer

Lenny Liscio

Treasurer and Chief
Financial Officer

March 15, 2004

Consolidated Financial Statements

ChondroGene Limited

[A Development Stage Company]

December 31, 2003

AUDITORS' REPORT

To the Shareholders of
ChondroGene Limited

We have audited the consolidated balance sheet of **ChondroGene Limited** [a development stage company] as at December 31, 2003 and the consolidated statements of operations and deficit and cash flows for the year 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 audit.

We conducted our audit 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, 2003 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

The consolidated financial statements for the preceding periods were audited by other auditors who expressed an opinion without reservation on those statements in their report dated March 28, 2003.

Toronto, Canada,
March 15, 2004.

Ernst & Young LLP

Chartered Accountants

ChondroGene Limited
[A Development Stage Company]

CONSOLIDATED BALANCE SHEETS

[See note 1 - Basis of Presentation]

As at December 31

	2003	2002
	\$	\$
ASSETS		
Current		
Cash and cash equivalents	2,564,349	816,548
Accounts receivable	1,445,596	25,553
Investment tax credits recoverable [note 5]	600,000	1,173,798
Prepaid expenses and deposits	217,202	68,823
Total current assets	4,827,147	2,084,722
Property, plant and equipment, net [note 6]	1,144,726	1,048,627
Intellectual property [notes 4 and 7]	2,168,977	116,498
	8,140,850	3,249,847
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Accounts payable and accrued liabilities	672,289	251,668
Deferred revenue	25,127	298,425
Total current liabilities	697,416	550,093
Commitments and contingencies [note 11]		
Shareholders' equity		
Capital stock [notes 8[a] and [b]]	13,315,713	8,443,110
Contributed surplus [notes 3[a] and 8[c]]	213,880	—
Deficit	(6,086,159)	(5,743,356)
Total shareholders' equity	7,443,434	2,699,754
	8,140,850	3,249,847

See accompanying notes

On behalf of the Board:

"Garth MacRae"
Director

"K. Wayne Marshall"
Director

ChondroGene Limited
[A Development Stage Company]

**CONSOLIDATED STATEMENTS OF OPERATIONS
AND DEFICIT**

	Year ended December 31, 2003 \$	Seven-month period ended December 31, 2002 \$	Year ended May 31, 2002 \$	Cumulative from inception on September 8, 1998 \$
Revenue				
Milestone revenue	2,788,000	—	—	2,788,000
Fees for service	979,129	238,740	—	1,217,869
	3,767,129	238,740	—	4,005,869
Expenses				
Research and development <i>[note 9]</i>	3,988,226	1,703,784	2,034,197	10,192,114
Less investment tax credits recoverable <i>[note 5]</i>	(647,585)	(516,323)	(691,403)	(2,547,301)
	3,340,641	1,187,461	1,342,794	7,644,813
General and administrative <i>[note 9]</i>	862,083	439,146	817,824	2,842,212
	4,202,724	1,626,607	2,160,618	10,487,025
Interest income	92,792	21,126	79,316	394,997
Net loss for the period	(342,803)	(1,366,741)	(2,081,302)	(6,086,159)
Deficit, beginning of period	(5,743,356)	(4,376,615)	(2,295,313)	—
Deficit, end of period	(6,086,159)	(5,743,356)	(4,376,615)	(6,086,159)
Net loss per common share				
Basic and fully diluted	\$(0.01)	\$(0.06)	\$(0.12)	—
Weighted average number of common shares outstanding				
Basic and fully diluted	27,254,398	22,364,417	17,142,484	—

See accompanying notes

ChondroGene Limited
[A Development Stage Company]

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year ended December 31, 2003 \$	Seven-month period ended December 31, 2002 \$	Year ended May 31, 2002 \$	Cumulative from inception on September 8, 1998 \$
OPERATING ACTIVITIES				
Net loss for the period	(342,803)	(1,366,741)	(2,081,302)	(6,086,159)
Add items not involving cash				
Stock-based compensation [notes 3[a] and 8[c]]	213,880	—	—	213,880
Amortization of property, plant and equipment	297,624	148,531	257,879	905,878
Amortization of intellectual property	77,374	22,652	38,832	155,038
Ongoing clinical access rights in exchange for common shares	—	186,000	—	186,000
	246,075	(1,009,558)	(1,784,591)	(4,625,363)
Changes in non-cash operating working capital				
Accounts receivable	(1,420,043)	(11,763)	16,912	(1,440,350)
Investment tax credits recoverable	573,798	(386,797)	73,230	(427,314)
Prepaid expenses and deposits	(148,379)	(11,010)	(21,819)	(214,202)
Accounts payable and accrued liabilities	412,620	6,902	120,800	664,288
Deferred revenue	(273,298)	298,425	—	25,127
Cash used in operating activities	(609,227)	(1,113,801)	(1,595,468)	(6,017,814)
FINANCING ACTIVITIES				
Net proceeds from share issuance	2,872,603	380,536	2,015,916	10,967,582
Cash provided by financing activities	2,872,603	380,536	2,015,916	10,967,582
INVESTING ACTIVITIES				
Additions to property, plant and equipment	(393,723)	(135,832)	(264,366)	(2,223,291)
Repayment of shareholder advance	(100,000)	—	—	(100,000)
Acquisition costs	(21,852)	—	—	(21,852)
Amounts expended on intellectual property	—	—	—	(41,159)
Acquisition of cash	—	—	—	883
Cash used in investing activities	(515,575)	(135,832)	(264,366)	(2,385,419)
Net increase (decrease) in cash and cash equivalents during the period	1,747,801	(869,097)	156,082	2,564,349
Cash and cash equivalents, beginning of period	816,548	1,685,645	1,529,563	—
Cash and cash equivalents, end of period	2,564,349	816,548	1,685,645	2,564,349
Supplemental cash flow information				
Interest received	92,792	21,126	79,316	394,997
Supplemental non-cash transactions				
Shares issued for acquisition [note 4]	2,000,000	—	—	2,000,000
Intellectual property	—	—	—	153,000
Ongoing clinical access rights	—	186,000	—	186,000

See accompanying notes

ChondroGene Limited
[A Development Stage Company]

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2003

1. NATURE OF OPERATIONS AND BASIS OF PRESENTATION

ChondroGene Limited [the "Company"] is incorporated under the laws of the Province of Ontario. The Company is a development stage company 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. All of its identifiable assets as at December 31, 2003 and 2002 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 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. ["GeneNews"]. All significant intercompany balances and transactions have been eliminated.

ChondroGene Limited
[A Development Stage Company]

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2003

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 consolidated financial statements and the reported amounts of revenues 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.

Cumulative information from inception

In accordance with the Canadian Institute of Chartered Accountants' ["CICA"] 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.

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 their economic lives, 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.

ChondroGene Limited
[A Development Stage Company]

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2003

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

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, comprised of two components.

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 balance sheet. 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.

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 Canadian generally accepted accounting criteria for deferral and amortization. No development costs have been deferred to date.

ChondroGene Limited
[A Development Stage Company]

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2003

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

The Company accounts for stock options awarded to non-employees on or after January 1, 2002 using the fair value method. Stock options awarded to employees on or after January 1, 2003 are accounted for using the fair value method [note 3]. For stock options awarded to employees prior to January 1, 2003, pro forma disclosure of net loss and net 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 share capital.

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.

Loss per share

Diluted 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 loss per share would have an anti-dilutive effect on loss per share and therefore options and warrants are excluded from the computation.

ChondroGene Limited
[A Development Stage Company]

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2003

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 and deferred revenue. The carrying values of these financial instruments approximate their fair values due to their short-term nature.

The Company is exposed to foreign currency fluctuations to the extent that purchases are denominated in foreign currencies. The Company currently does not use financial instruments to hedge these risks.

3. CHANGE IN ACCOUNTING POLICIES

[a] 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 CICA Section 3870, "*Stock-Based Compensation and Other Stock-Based Payments*". Previously, no compensation expense was recognized for stock options granted to employees. Under the new policy, compensation expense for employee stock options is accounted for using the fair value method as described in note 2. The impact to net loss during 2003 and contributed surplus at December 31, 2003 as a result of the change in accounting policy was \$213,880.

[b] Impairment of long-lived assets

On January 1, 2003, the Company adopted prospectively the recommendations of CICA Section 3063, "*Impairment of Long-Lived Assets*". Section 3063 requires that management review 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 amounts of a group of assets exceeds their fair value. The adoption of this accounting standard as of January 1, 2003 had no material impact on the Company's financial position, results of operations or cash flows.

ChondroGene Limited
[A Development Stage Company]

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2003

4. BUSINESS ACQUISITION

On November 26, 2003, the Company acquired 100% of the outstanding common shares of GeneNews in exchange for 4,000,000 common shares of the Company. The total fair value of the 4,000,000 common shares was \$2,000,000 based on the estimated average stock market trading price of \$0.50 per share between April 16, 2003 and May 7, 2003, the time of signing an agreement to purchase. The majority shareholder of GeneNews prior to its acquisition was a corporation controlled by one of the founders and a director of ChondroGene Limited.

This acquisition was accounted for under the purchase method of accounting and included in the consolidated statements of operations and deficit from the date of acquisition. Total consideration, including costs of acquisition, was allocated based on the estimated fair values on the date of acquisition as follows:

	\$
Intellectual property	2,129,853
Less liabilities assumed	
Current liabilities	8,001
Shareholder advance	100,000
Net assets acquired at fair value	2,021,852
Consideration	
4,000,000 common shares issued	2,000,000
Acquisition costs	21,852
	2,021,852

The shareholder advance was non-interest bearing and was repaid prior to December 31, 2003. The excess of consideration given over the net tangible assets of GeneNews was allocated to intellectual property, representing patent applications filed related to GeneNews' proprietary blood-based methodology for the detection of various diseases.

ChondroGene Limited
[A Development Stage Company]

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2003

5. INVESTMENT TAX CREDITS RECOVERABLE

Due to the Company carrying out qualifying research activities, it is eligible for both federal and provincial investment tax credits. The Company records investment tax credits when the qualifying expenditures are made and there is reasonable assurance of recovery. These credits, for most public companies, are available to reduce income taxes otherwise payable. For the fiscal year ended December 31, 2003, the Company had been listed as a Tier 3 Issuer on the TSX Venture Exchange, and as such, was able to receive a large portion of its investment tax credits to date 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 property, plant and equipment for the portion related to qualifying capital expenditures [2003 - \$50,000; 2002 – nil].

On January 2, 2004, the Company commenced its listing as a Tier 2 Issuer on the TSX Venture Exchange, such that future federal investment tax credits will only be available to reduce income taxes otherwise payable.

6. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment consists of the following:

	2003		Net
	Cost	Accumulated	book
	\$	amortization	value
		\$	\$
Laboratory equipment [net of investment tax credits of \$282,091]	1,458,951	595,835	863,116
Office furniture and equipment	358,792	159,997	198,795
Leasehold improvements	232,861	150,046	82,815
	2,050,604	905,878	1,144,726

ChondroGene Limited
[A Development Stage Company]

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2003

	2002		Net book value
	Cost	Accumulated amortization	
	\$	\$	\$
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
	1,656,881	608,254	1,048,627

7. INTELLECTUAL PROPERTY

Intellectual property consists of the following:

	2003	2002
	\$	\$
Acquired technology [i]	2,324,012	194,159
Technical findings [ii]	3	3
Less accumulated amortization [iii]	(155,038)	(77,664)
	2,168,977	116,498

[i] The Company had previously recorded the costs of a licensing agreement with GeneNews for the exclusive rights, in perpetuity, to use this blood-based methodology in the areas of osteoarthritis, rheumatoid arthritis and traumatic joint injury. Following the acquisition of GeneNews [note 4], the remaining unamortized balance of \$80,899 has been included in acquired technology.

[ii] Technical findings, expertise and related material in disease gene discovery, in vivo research and human clinical trial skill in osteoarthritis 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.

[iii] Amortization of intellectual property for the year ended December 31, 2003 was \$77,374 [2002 - \$22,652].

ChondroGene Limited
[A Development Stage Company]

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2003

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; 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 May 31, 2002	21,574,128	7,876,574
Shares issued in exchange for ongoing 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
Shares issued in exchange for the common shares of GeneNews <i>[note 4]</i>	4,000,000	2,000,000
Private placement, net of share issue costs of \$165,397	6,000,000	2,834,603
Balance at December 31, 2003	33,336,590	13,277,713

On April 29, 2003, the Company announced its intention to raise up to \$3,000,000 by way of a private placement at a stated price of \$0.50 per share. The Company closed a portion of the private placement on May 23, 2003, issuing 4,000,000 common shares for gross proceeds of \$2,000,000. The Company's financial advisor and agent for the transaction received a fee of \$100,000 and warrants to purchase 200,000 common shares of the Company for a period of 24 months at a price of \$0.50 per share. On June 13, 2003, \$1,000,000 of proceeds were received through the issuance of 2,000,000 common shares to the Company's Chairman. There were no fees or commissions paid on this portion of the private placement.

As at December 31, 2002, 1,333,334 common shares previously issued to two founders were held in escrow. On May 31, 2003, pursuant to the terms of the escrow agreement, the balance of 1,333,334 common shares of two founders held in escrow were released.

ChondroGene Limited
[A Development Stage Company]

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2003

[b] Non-employee warrants and options

The changes in non-employee warrants and options are as follows:

	#	\$
Balance at December 31, 2002	50,000	—
Issued as share issue costs	200,000	38,000
Expired	(50,000)	—
Balance at December 31, 2003	200,000	38,000

In May 2003, the Company granted its brokers as payment for costs related to the private placement, 200,000 non-assignable and non-transferable warrants each convertible into one common share, exercisable until May 23, 2005 at an exercise price of \$0.50 per warrant.

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 at an exercise price of \$0.50 per warrant. On November 10, 2003, all 50,000 warrants expired unexercised.

[c] Contributed surplus

The balance in contributed surplus of \$213,880 consists of employee stock option expense for the year ended December 31, 2003 [note 3[a]]. The weighted average fair value of stock options granted during the year is \$0.44.

In compliance with current accounting standards, the fair value of each employee 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, 2003, the weighted average assumptions were: dividend yield of nil; expected volatility of 74%; risk-free interest rate of 4.0%; and expected life of four to five years.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2003

[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 November 25, 2002, increased the limit for stock option grants up to an amount 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 less than the "Discounted Market Price" [as defined in the TSX Venture Exchange Corporate Finance Manual]. As at December 31, 2003, there were 2,195,272 options outstanding and a cumulative number of 16,000 options that had been exercised for a total of 2,211,272, leaving a balance of 2,456,046 options available for issuance under the Plan.

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

	<u>2003</u>		<u>2002</u>	
	#	Weighted average exercise price \$	#	Weighted average exercise price \$
Outstanding, beginning of year	1,097,404	0.525	1,164,112	0.468
Granted	1,098,282	0.720	150,000	1.479
Forfeited	(414)	0.450	(216,708)	0.714
Outstanding, end of year	2,195,272	0.646	1,097,404	0.525
Options exercisable, end of year	1,169,468	0.607	726,508	0.583

ChondroGene Limited
[A Development Stage Company]

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2003

The following table summarizes information about stock options outstanding at December 31, 2003:

Exercise price per share \$	Number outstanding #	Weighted-average remaining contractual life [in years]	Options exercisable #
0.400	55,000	2.90	36,667
0.416	343,170	6.40	343,170
0.450	237,868	4.18	84,645
0.500	38,574	3.10	12,858
0.610	120,000	3.39	80,000
0.750	1,350,660	4.75	603,795
0.800	50,000	4.97	8,333
	2,195,272	4.71	1,169,468

[e] Pro forma net loss and net 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 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 is 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.

	Year ended December 31, 2003 \$	Seven-month period ended December 31, 2002 \$
Net loss as reported	342,803	1,366,741
Estimated stock-based compensation expense	8,820	4,170
Pro forma net loss	351,623	1,370,911
Pro forma basic and fully diluted loss per common share	\$(0.01)	\$(0.06)
Weighted average fair value of stock options granted	—	\$0.25

ChondroGene Limited
[A Development Stage Company]

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2003

9. RELATED PARTY TRANSACTIONS

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

	Year ended December 31, 2003 \$	Seven-month period ended December 31, 2002 \$	Year ended May 31, 2002 \$
[a] Consulting fees were paid to one [2002 – two] of the founders pursuant to an agreement having a one-year term, renewable annually in January	220,000	58,333	200,000
[b] The Company paid rent for a portion of its premises pursuant to a lease agreement with the spouse of one of the founders	56,344	31,609	57,743
[c] The Company incurred fees for research performed by laboratories run by one [2002 - two] of the founders. At December 31, 2003, \$6,500 [2002 - \$6,500] was unpaid	78,000	45,500	102,000
[d] The Company issued 2,115,385 common shares to a corporation controlled by one of the founders in consideration for the acquisition of a business in which this founder was a majority shareholder [note 4]	1,057,693	—	—
[e] Repayment of shareholder advance [note 4]	100,000	—	—

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

December 31, 2003

10. 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 36.62% [December 31, 2002 - 36.6%; May 31, 2002 - 40.0%] are as follows:

	Year ended December 31, 2003 \$	Seven-month period ended December 31, 2002 \$	Year ended May 31, 2002 \$
Loss for accounting purposes	342,803	1,366,741	2,081,302
Income tax expense (recovery) computed at statutory rate	(125,500)	(500,000)	(854,000)
Decrease in income tax expense (recovery) resulting from			
Non-deductible expenses	5,300	3,000	5,900
Amortization of intellectual property	14,800	—	—
Stock option expense	78,300	—	—
Income tax expense (recovery)	(27,100)	(497,000)	(848,100)
Future tax assets not tax benefited	27,100	497,000	848,100
Net income tax expense (recovery)	—	—	—

ChondroGene Limited
[A Development Stage Company]

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2003

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

	2003	2002
	\$	\$
Future tax assets		
Non-capital loss carryforwards, including		
scientific research and development expenditures	2,975,200	2,694,900
Unamortized share issue costs	205,600	247,600
Intellectual property	20,300	12,200
Federal investment tax credits carried forward expiring between 2011 and 2013	352,000	277,200
Total future tax assets	3,553,100	3,231,900
Less valuation allowance	(3,044,800)	(2,838,700)
	508,300	393,200
Future tax liabilities		
Property, plant and equipment	323,900	279,600
Investment tax credits recoverable	184,400	113,600
Total future tax liabilities	508,300	393,200
Net future tax assets	—	—

The valuation allowance for future tax assets as at December 31, 2003 is \$3,044,800 [2002 - \$2,838,700]. The valuation allowance increased by \$206,100 [2002 - \$261,400] during the year which was mainly due to additional tax losses incurred during the year. 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 are nil.

ChondroGene Limited
[A Development Stage Company]

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2003

At December 31, 2003, the Company and its subsidiary have \$8,232,700 of non-capital losses available for carryforward, which will expire as follows:

	\$
2004	23,100
2005	321,900
2006	985,300
2007	2,515,000
2008	2,410,000
2009	1,334,000
2010	643,400
	<hr/> 8,232,700 <hr/>

11. COMMITMENTS AND CONTINGENCIES

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

	\$
2004	96,000
2005 and thereafter	48,000
	<hr/> 144,000 <hr/>

Included in the above amounts are \$60,000 for 2004 and \$30,000 for 2005 payable to a related party [note 9[b]].

In addition, the Company is committed to paying \$220,000 to one of the founders in 2004 under a consulting contract [note 9[a]].

[b] During the ordinary course of business activities, the Company may be contingently liable for litigation and 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.

ChondroGene Limited
[A Development Stage Company]

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2003

12. CREDIT FACILITY

During the year, the Company entered into a capital equipment financing arrangement which provides a credit facility of up to \$600,000. The Company may draw on this facility up until the end of June 2004. Any amounts drawn under this arrangement are collateralized by the Company's property, plant and equipment and are repayable in equal blended monthly instalments over a 36-month period at 11.3%. As at December 31, 2003, no amounts were drawn under the arrangement.

13. COMPARATIVE CONSOLIDATED FINANCIAL STATEMENTS

The comparative consolidated financial statements have been reclassified from statements previously presented to conform to the presentation of the 2003 consolidated financial statements.

Notes

ChondroGene Limited
Management Discussion and Analysis
For the year ended December 31, 2003 ("current year")

The following discussion and analysis prepared as at April 6, 2004, should be read in conjunction with the interim consolidated financial statements as at and for the period ended December 31, 2003, and notes thereto, to which these comments are attached. The Company changed its fiscal year end from May 31 to December 31 in the year 2002, such that prior period comparatives described herein refer to the current period balance sheet as at December 31, 2003, relative to the balance sheet as at December 31, 2002, and to operations for the year from January 1, 2003 to December 31, 2003, relative to operations for the seven months from June 1, 2002 to December 31, 2002, and to operations for the year from June 1, 2001 to May 31, 2002.

NATURE OF OPERATIONS:

ChondroGene Limited ("the Company") is focused on the application of functional genomics to enable early diagnosis and personalized therapeutic invention based on disease specific biomarkers. From inception to the current period ended December 31, 2003, the Company had no significant independent sources of income, except for proceeds from a business collaboration with Pfizer Inc signed on October 10, 2002, and, to December 31, 2003 it had accumulated losses of about \$6.1 million. Its operations to date, which are conducted through one of its wholly owned subsidiaries, 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, 2003, the Company had received a total of \$15.1 million (gross proceeds) through private placements of its capital stock and its collaboration with Pfizer Inc, of which about \$2.6 million was still on hand at the end of the current year.

OPERATIONS:

Scientific Discussion:

The Company commenced development of a prototype early OA diagnostic assay based on progress made in its OA Biomarker Program and the application of quantitative RT-PCR technology. Efforts to identify novel therapeutic targets for the treatment of OA are ongoing.

The ChondroChip™ continues to be utilized as a key platform technology. The completion of the GeneNews acquisition also led to the development of a BodyChip™ and BloodChip™ for use as key platform technologies for the Company's ongoing research to complement the data generated from the Company's Affymetrix GeneChip® system.

The Company has enhanced its database infrastructure, is continuing to expand its clinical database and has also broadened its Biomarker Program to focus on additional disease areas. This work will continue in the next fiscal quarter.

ChondroGene Limited
Management Discussion and Analysis
For the year ended December 31, 2003 ("current year")

Business acquisition:

On November 26, 2003, the Company acquired 100% of the outstanding common shares of GeneNews Inc., in exchange for 4,000,000 of the Company's common shares (valued at \$2,000,000). The majority shareholder of GeneNews prior to its acquisition was a corporation controlled by one of the founders and a director of ChondroGene Limited.

The principal asset attributable to GeneNews is certain proprietary blood-based approaches to analyse gene expression for diagnostic, prognostic and pharmacogenomic applications across a broad range of disease; the patents pertaining to this technology were originally filed in 1999 and have not yet been issued; the Company has valued this portion of its Intellectual Property on the balance sheet at \$2,089,426 (net of current year amortization).

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 two years, and involves both an equity component and funding for collaborative research activities.

Revenues from the collaborative research activities are comprised of payments for the Company's provision of certain clinical data pertaining to the OA therapeutic target initiative in the collaboration (referred to as milestone payments on the statement of operations) and fees for services pertaining to the OA biomarker initiative.

In the current year ended December 31, 2003, the Company achieved acceptance and recorded as revenue, the first and second of three research payments pertaining to the therapeutic target initiative for amounts of \$1,478,800 and \$1,309,200 respectively, totalling \$2,788,000. The first research payment of \$1,478,800 was received in March 2003, and the second research payment of \$1,309,200 was reflected in Accounts Receivable at December 31, 2003, and subsequently received in January 2004. The Company recognizes revenue at the time of Pfizer's acceptance of the clinical data provided under the therapeutic target initiative, as the Company's obligations are fulfilled at this point and collection is reasonably assured.

Fees for service are billed in advance, then deferred and recognized as revenue on a straight-line basis as work is continuously performed during the term covered by the billing. A total of \$979,129 revenue for the current year represents the amortized portion of billings up to October 10, 2003. An amount of \$25,127 is reflected as deferred revenue on the balance sheet for the future period from January 1 to January 10, 2004, covered by the October 10, 2003 billing. In the previous fiscal period ended December 31, 2002, the Company recorded fee for service revenues of \$238,740, representing the period from the start of the collaboration on October 10, 2002 to December 31, 2002. Subsequent to December 31, 2003, the Company billed and collected proceeds of \$214,144 for service related revenues covering the period January 10, 2004 to April 10, 2004.

ChondroGene Limited
Management Discussion and Analysis
For the year ended December 31, 2003 ("current year")

Research and development expenses:

Of the total \$3,988,226 in this category, \$1,426,627 (36%) represents the cost of salaries, fringe benefits, travel and communications; \$1,608,945 (40%) represents the cost of supplies, equipment and premises; \$862,184 (22%) consists of the amortization of Intellectual Property, and the cost of consultants, professional advisors, and other third parties whose efforts have been enlisted in direct support of the research and development activities; the balance of \$90,470 (2%) represents the charge for stock based compensation.

Costs are higher by about \$2.3 million relative to the seven-month period ended December 31, 2002, and about \$2 million relative to the prior full year comparative ended May 31, 2002, due mainly to: increased personnel related costs for increased staff members (about \$665,000 and \$475,000 respectively), increased travel for business development initiatives (about \$175,000 and \$130,000 respectively), increases in materials and equipment costs, including amortization (about \$865,000 and \$790,000 respectively); legal and personnel related cost for Intellectual Property development (about \$355,000 and \$335,000 respectively); greater utilization of outside consultants (about \$75,000 and \$95,000 respectively), amortization of Intellectual Property in the GeneNews acquisition (\$40,427), and stock based compensation costs (\$90,470).

General and administrative expenses:

Of the total \$862,084 in this category, \$469,980 (55%) is the administrative portion of the salary, fringe benefits and travel costs of the senior management and administrative group; \$207,131 (24%) represents expenses for premises, office supplies and equipment; \$61,563 (7%) includes professional fees (legal, accounting and audit, investor relations), consultants, and specialized corporate service costs; and \$123,410 (14%) represents the charge for stock based compensation.

Costs are higher by \$422,938 relative to the seven-month period ended December 31, 2002, and \$44,258 relative to the prior full year comparative ended May 31, 2002, due mainly to: increased personnel related costs compared to the seven-month period ended December 31, 2002, (about \$255,000), lower personnel related costs compared to the prior year ended May 31, 2002 (about \$112,000 due to significant departure costs in the prior period relating to a former executive); increases in amortization of office and computer equipment and leasehold improvements (about \$29,000 and \$13,000 respectively); increases in office expenses (about \$41,000 and \$7,500 respectively); increases in legal and accounting costs (about \$38,000 and \$57,000 respectively); increases in public entity related costs (about \$18,500 for the seven-month period ended December 31, 2002); stock based compensation costs (\$123,410); less the favourable impact on foreign exchange translation of US\$ purchases (due to strengthening Canadian \$) in 2003 relative to the prior periods (about \$85,000 and \$46,000 respectively).

Interest and sundry income:

Interest of \$93,792 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 amount was higher than the comparative prior periods due to higher average cash balances on hand during the current year.

ChondroGene Limited
Management Discussion and Analysis
For the year ended December 31, 2003 ("current year")

BALANCE SHEET COMPARISONS:

Accounts receivable:

The prior period balance was comprised mainly of GST input tax credits due to the Company on its purchases. The current year balance includes a similar provision for GST input tax credits and the large trade receivable balance of about \$1.4 million for the second Pfizer therapeutic target initiative payment, described above, and received in January 2004.

Prepaid expenses and deposits:

The prior period balance was comprised mainly of unamortized portions of insurance premiums and equipment service contracts paid in advance. The current year includes similar balances and an additional balance for gene chip supplies on hand (\$134,886) at the end of the year, which are purchased periodically in large quantities then consumed (and expensed) over future periods.

Investment tax credit refunds ("ITC refunds"):

The balance of \$600,000 from December 31, 2003 represents an estimate for anticipated refunds arising from qualifying expenditures for the year ended December 31, 2003. The prior year balance of \$1,173,798 included federal and Ontario refunds of \$744,798 pertaining to the fiscal year ended May 31, 2002, and an estimate of \$429,000 pertaining to the seven-month fiscal period ended December 31, 2002. All refunds applicable to the prior fiscal periods were received in the year.

The Company's estimate of anticipated refunds is lower than for the full year ended May 31, 2002, and only \$171,000 higher than for the seven-month period ended December 31, 2002, due to contract payments received in the current year under the Pfizer collaboration to be included as a reduction in the calculation of tax claims to be filed.

An amount of \$647,585 was recorded as an offset to research expenditures during the year reflecting the accrual of \$600,000 for the current year, less \$50,000 of this accrual applied as an offset to lab equipment expenditures, and an additional amount of \$97,585 for the excess of refunds received during the year over amounts previously accrued.

Property, plant and equipment:

During the current year, the carrying value of property, plant and equipment was increased by \$96,099, from \$1,048,627 to \$1,144,726, representing \$393,724 of additions for predominantly lab and computing equipment, less amortization charges of \$297,625.

ChondroGene Limited
Management Discussion and Analysis
For the year ended December 31, 2003 ("current year")

Intellectual Property:

Intellectual property of \$116,498 from the prior period was increased by \$2,052,479 to \$2,168,977, representing the portion of the purchase cost of GeneNews designated as "Acquired Technology" (\$2,129,853), less amortization of \$77,374 for the year.

The Company is amortizing Intellectual Property on a straight-line basis over 5 years, and reviews the balance each year to assess whether there has been any impairment in value.

Accounts payable and accrued liabilities:

The balance of \$672,289 as at December 31, 2003 is \$420,621 (167%) higher than the \$251,668 balance from December 31, 2002 due primarily to the accrual of legal fees on mainly patent related activities (about \$140,000), a trade payable for a large quantity of gene chip supplies purchased in December and accruals for other material purchases (about \$231,500), accruals for expense reports pertaining to overseas travel in late 2003 (about \$23,000); GST payable (about \$92,000) on a Pfizer billing in December; and a reversal of prior over accrued legal fees (about \$71,000) for financing activities in prior periods.

Capital stock:

The issued and outstanding share capital increased from \$8.44 million to \$13.31 million (58%). The increase during the year is the result of the issuance of 10 million shares (with net value of \$4.87 million) pursuant to a private placement (6 million shares, net value of \$2.87 million) and the issuance of 4 million shares (valued at \$2 million) upon the acquisition of all the outstanding shares of GeneNews Inc.

There were 50,000 broker's warrants outstanding at December 31, 2002, issued on May 10, 2002, at \$0.50 per warrant, pursuant to a private placement. These warrants, exercisable until November 10, 2003, remained unexercised and expired on that date. An additional 200,000 broker's warrants were issued on the current year private placement, exercisable until May 23, 2005, at \$0.50 per warrant.

During the year, the Company was listed as a "Tier 3" issuer on the TSX Venture Exchange, which was not a "prescribed stock exchange" for the purposes of the Canadian Income Tax Act ("ITA"). A TSX Venture Bulletin dated October 2, 2003 announced that the TSX Venture Exchange would wind up and discontinue Tier 3 on January 2, 2004. The Company became a Tier 2 issuer at that time, which is considered to be a prescribed stock exchange for the purposes of the ITA.

ChondroGene Limited
Management Discussion and Analysis
For the year ended December 31, 2003 ("current year")

RELATED PARTY TRANSACTIONS:

A founder of the Company provides consulting services at a rate of \$220,000 per year pursuant to the terms of a consulting agreement originally signed in May 2000 at an agreed upon rate of \$100,000 per annum, subsequently amended, effective January 2003 to reflect the current rate. For the seven-month period ended December 31, 2002, an amount of \$58,333 was paid, representing the seven-month portion of the annual rate of \$100,000. For the year ended May 31, 2002, the amount of \$200,000 represents payments to two of the founders at the annual rate of \$100,000. The other founder had signed a similar agreement as above in May 2000, which was subsequently replaced by employment terms, finalized during the seven-month period ended December 31, 2002.

The Company makes payments of \$6,500 per month, (\$78,000 for the years ended December 31, 2003 and May 31, 2002, and \$45,500 for the seven-month period ended December 31, 2002) to a research lab run by one of the founders of the Company at Toronto Western Hospital, principally for resources employed in procuring clinical samples used by the Company. For the year ended May 31, 2002, additional payments of \$24,000 were made for services provided by the laboratory of another founder located at the University of Toronto.

The Company occupies two adjoining units in an industrial building located in northwest Toronto. The spouse of a founder owns one of the units. Rental rate on the office portion of this unit is at the same rate as negotiated with the unrelated third party owner of the other unit. Rental rate for lab space in this unit was set at the prevailing market rates in effect when the lease was negotiated, plus an amount for amortization of leasehold improvements paid for by the owner. Payments made directly to the related party owner of one of the units totalled \$56,344 during the year (\$31,609 for the seven-month period ended December 31, 2002, and \$57,743 for the year ended May 31, 2002).

As referenced in the "Business Acquisition" section, the majority shareholder of GeneNews prior to its acquisition was a corporation controlled by a founder of the Company. The Company issued 2,115,385 of its common shares to this corporation (from the total of 4,000,000 common shares issued) for the acquisition of the business, and repaid the founder \$100,000 for shareholder advances the founder had previously made to GeneNews.

ChondroGene Limited
Management Discussion and Analysis
For the year ended December 31, 2003 ("current year")

CHANGES IN ACCOUNTING POLICIES:

Stock based compensation

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.

During the current year, there were 1,098,282 stock options issued that met the requirement of measurement under the new standard, resulting in a total stock based compensation cost of \$213,880, reflected in the Company's statement of operations as charges to research expenses (\$90,470) and administration charges (\$123,410), with a corresponding offset to Contributed surplus on the balance sheet.

In the prior period, there were no awards that met the requirement of measurement under the new standard, however, the Company is required to disclose 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.

For options granted to employees during the prior year, starting on or after June 1, 2002, the Company applied the pro forma disclosure provisions of the new standards. 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 from June 1, 2002 to December 31, 2002, the Company's pro forma loss during the current period would be increased by stock based compensation cost of \$8,820 (\$4,170 for 2002) for a net pro forma loss of \$351,623 (\$1,370,911 for 2002). Basic and fully diluted earnings (loss) per share remain at (\$0.01) per common share (\$0.06 for 2002).

Impairment of long-lived assets

On January 1, 2003, the Company adopted prospectively the recommendations of CICA Section 3063, requiring that management review 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. The adoption of this policy did not impact on the Company's results for the current year.

ChondroGene Limited
Management Discussion and Analysis
For the year ended December 31, 2003 ("current year")

LIQUIDITY:

The Company had \$2.6 million in cash on December 31, 2003, and working capital (excluding deferred revenue balances) of \$4.2 million. These resources will permit the Company to execute its business plan and maintain all efforts to advance its research activities.

During the current year ended December 31, 2003, the movements in cash resources were as follows:

Balance, beginning of year	<u>(000's)</u> \$817
Add: Net proceeds from equity issuance	2,874
Cash receipts from business collaboration	2,220
ITC refunds received	1,271
Deduct cash burn from operations	<u>(4,618)</u>
Balance, end of year	<u>\$2,564</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.

During the year, the Company also entered into an equipment financing agreement providing a credit facility of up to \$600,000. To date, the Company has not drawn on this facility. Drawdown on the facility is available up to the end of June 2004, with repayments in equal monthly amounts of blended principal and interest over a 36-month term, secured by the Company's capital assets.

Subsequent to the year ended December 31, 2003, the Company has received proceeds totalling \$1,523,343 from its collaboration with Pfizer Inc.

As of April 6, 2004 at forecasted 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 13 months.

ChondroGene Limited
Management Discussion and Analysis
For the year ended December 31, 2003 ("current 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 be able to apply functional genomics to enable early diagnosis and personalized therapeutic intervention based on disease specific biomarkers. This premise may prove incorrect.

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 and other diseases. Such successful commercialization will depend, in part, on future market conditions that are impossible to predict.

3. Financing:

While the Company has successfully raised \$15.1 million (gross proceeds) in capital and through business collaborations, to the end of December 2003, and had cash resources of about \$2.6 million on hand at the end of the year, and has received additional collaboration proceeds of \$1.5 million since the end of the year, 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.

ChondroGene Limited
Management Discussion and Analysis
For the year ended December 31, 2003 ("current year")

5. **Foreign exchange risk:**

The Company has exposure to exchange rate fluctuations with respect to its US \$ revenues from Pfizer earned in Canada and billed in the equivalent Canadian dollars.

FORWARD 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
Vice President

Lenny Liscio, BComm, CA
Chief Financial Officer

SCIENTIFIC & CLINICAL ADVISORS

Choong-Chin Liew, PhD
Chief Scientist, ChondroGene Limited;
Director, Cardiovascular Genome Center,
Brigham & Women's Hospital; Visiting
Professor, Harvard Medical School

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Frank Barry, PhD
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Brigham & Women's Hospital;
Professor, Harvard Medical School

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North Shore University Hospital

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President & CEO, ChondroGene Limited

Robin Poole, PhD
Director, Joint Diseases Laboratory,
Shriner's Hospitals for Children (Canada);
Program Director, Canadian Arthritis
Network

BOARD OF DIRECTORS

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Chief Scientist, ChondroGene Limited

Garth MacRae
Vice Chairman, Dundee Bancorp Inc.

K. Wayne Marshall
President & CEO, ChondroGene Limited

STOCK INFORMATION

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

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

ANNUAL MEETING

The 2003 ChondroGene Limited Annual General Meeting will be held at 4:30 PM on Monday May 17, 2004, in the Ketchum Room at the Toronto Board of Trade, 1 First Canadian Place, Toronto, Ontario.

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