

Bioniche Life Sciences Inc.
Amalgamated under the laws of Ontario

CONSOLIDATED BALANCE SHEETS

As at June 30	2003 \$	2002 \$
		<i>[restated]</i>
ASSETS		
Current		
Cash and cash equivalents	9,848,410	11,145,848
Accounts receivable <i>[note 4]</i>	12,988,929	8,454,902
Inventories <i>[note 5]</i>	8,683,730	7,047,292
Prepaid expenses and deposits	614,080	537,043
	32,135,149	27,185,085
Long-term		
Capital assets <i>[note 6]</i>	15,534,329	14,877,927
Goodwill	5,553,798	5,553,798
Other assets <i>[note 7]</i>	12,987,256	12,517,390
	66,210,532	60,134,200
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Accounts payable and accrued liabilities	11,103,499	8,757,952
Deferred revenue	—	374,300
Income taxes payable	550,812	434,054
Current portion of long-term debt <i>[note 8]</i>	1,073,704	568,763
	12,728,015	10,135,069
Long-term		
Long-term debt <i>[note 8]</i>	21,644,898	16,505,098
Other long-term debt <i>[note 15]</i>	333,164	—
Deferred government incentives <i>[note 9]</i>	2,548,123	1,636,978
Future income taxes <i>[note 14]</i>	399,000	—
	37,653,200	28,277,145
Non-controlling interest <i>[note 10]</i>	3,868,254	3,680,662
Shareholders' equity		
Share capital <i>[note 11]</i>	49,050,151	45,543,807
Other paid-in capital <i>[note 8(a)]</i>	5,748,240	6,343,728
Deficit	(30,936,563)	(24,487,100)
Cumulative translation amount	827,250	775,958
	24,689,078	28,176,393
	66,210,532	60,134,200

See accompanying notes

On behalf of the Board



Director



Director

Bioniche Life Sciences Inc.

CONSOLIDATED STATEMENTS OF LOSS

Year ended June 30	2003 \$	2002 \$
		<i>[restated]</i>
REVENUE		
Sales	51,559,268	40,538,337
Cost of sales	19,603,067	15,300,839
Gross profit	31,956,201	25,237,498
OPERATING EXPENSES		
Administration and marketing	15,195,463	13,104,042
Quality assurance	2,832,153	1,846,766
Interest	1,689,706	1,359,458
Non-cash accounting elements		
Share ownership and bonus	456,974	353,700
Amortization	2,489,902	1,733,892
Imputed interest expense on convertible debentures	2,208,687	1,684,642
Foreign exchange (gain) loss	(1,107,462)	105,291
	23,765,423	20,187,791
Income before research and development and other item	8,190,778	5,049,707
Research and development expenses, gross	(14,686,701)	(11,819,514)
Less government incentives <i>[note 9]</i>	1,823,096	1,074,545
Settlement of litigation <i>[note 15]</i>	(975,533)	—
Loss before income taxes	(5,648,360)	(5,695,262)
Income tax recovery (expense) <i>[note 14]</i>		
Current	(290,347)	(296,400)
Future	(399,000)	1,174,000
	(689,347)	877,600
	(6,337,707)	(4,817,662)
Non-controlling interest	(111,756)	—
Net loss for the year	(6,449,463)	(4,817,662)
Basic and fully diluted net loss per share	(0.23)	(0.17)

See accompanying notes

CONSOLIDATED STATEMENTS OF DEFICIT

Year ended June 30	2003 \$	2002 \$
		<i>[restated]</i>
Balance, beginning of year	(24,487,100)	(19,532,984)
Net loss for the year	(6,449,463)	(4,817,662)
Change in accounting policy <i>[note 3]</i>	—	(136,454)
Balance, end of year	(30,936,563)	(24,487,100)

See accompanying notes

Bioniche Life Sciences Inc.

CONSOLIDATED STATEMENTS OF CASH FLOWS

Year ended June 30	2003 \$	2002 \$
		<i>[restated]</i>
OPERATING ACTIVITIES		
Net loss for the year	(6,449,463)	(4,817,662)
Add (deduct) non cash items:		
Amortization	2,489,902	1,733,892
Non-cash interest expense	2,208,687	1,684,642
Foreign exchange	(1,054,615)	(34,834)
Deferred settlement payment <i>[note 15]</i>	712,749	—
Executive and directors remuneration	84,000	68,000
Non-controlling interest	111,756	—
Non-cash bonus	724,619	821,670
Employee share ownership plan	439,222	—
Gain on disposal of capital assets	(42,718)	—
Future tax (recovery) expense	399,000	(1,174,000)
Cash flow used in operations	(376,861)	(1,718,292)
Net changes in non-cash working capital balances related to operations <i>[note 16]</i>	(4,539,082)	(284,229)
Cash used in operating activities	(4,915,943)	(2,002,521)
INVESTMENT ACTIVITY		
Purchase of other assets	(222,000)	(204,225)
Government incentives received on account of capital	68,150	355,343
Disposal of capital assets	598,658	—
Purchase of capital assets	(2,508,106)	(6,187,430)
Cash used in investing activities	(2,063,298)	(6,036,312)
FINANCING ACTIVITIES		
Proceeds of bank financing	1,936,218	2,655,234
Minority interest investment	31,896	—
Common shares and special warrants issued, net	2,171,014	4,122,553
Financing fees — debt	(977,558)	(533,080)
Proceeds on debenture loans	4,050,000	1,765,391
Increase in deferred government incentives	967,429	755,564
Repayment of long-term debt	(2,686,849)	(491,173)
Cash provided by financing activities	5,492,150	8,274,489
Effect of foreign currency translation	189,653	730,526
Net increase (decrease) in cash and cash equivalents during the year	(1,297,438)	966,182
Cash and cash equivalents, beginning of year	11,145,848	10,179,666
Cash and cash equivalents, end of year	9,848,410	11,145,848

Supplementary cash flow information *[note 16]*

See accompanying notes

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2003

1. BASIS OF PRESENTATION AND DESCRIPTION OF BUSINESS

[a] Basis of presentation

The Company's consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles. The Company's common stock is traded on the Toronto Stock Exchange. The Company is engaged in research and development and the manufacturing, commercialization and sale of pharmaceutical products.

The Company has financed its cash requirements primarily from share issuances, payments from collaborators, license arrangements and government grants. The Company's ability to realize the carrying value of its assets is dependent on successfully bringing its technologies to the market and achieving future profitable operations, the outcome of which cannot be predicted at this time. It may be necessary for the Company to raise additional funds for the continuing development of its technologies.

[b] Basis of consolidation

The consolidated financial statements reflect the consolidated financial position and results of operations of Bioniche Life Sciences Inc. ["BLSI"] and its subsidiaries, Bioniche Animal Health Canada Inc., Bioniche Animal Health USA, Inc., Bioniche Animal Health (Europe) Ltd., Bioniche Animal Health (A/Asia) Pty. Ltd., Bioniche Therapeutics Ltd., Bioniche (A/Asia) Pty. Ltd. and Bioniche Pharma Group [95% owned].

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

[a] Use of estimates

The preparation of the consolidated financial statements requires management to make estimates and assumptions that affect the reported amount of assets and liabilities, the 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. The reported amounts and note disclosures are determined using management's best estimates based on assumptions that

reflect the most probable set of economic conditions and planned courses of action. Actual results, however, may differ from the estimates used in these financial statements and such differences may be material.

[b] Inventories

Inventories are valued at the lower of cost and net realizable value, with cost being determined on a weighted average basis. Cost is comprised of direct materials, direct labour and overhead allocation.

[c] Capital assets

Capital assets are recorded at cost to the Company. Rates and basis of amortization applied by the Company to charge the costs of capital assets over their estimated useful lives are as follows:

Buildings	– 5% declining balance
Equipment	– 20% declining balance
Automobiles	– 30% declining balance
Leasehold improvements	– straight-line basis over the lease term

[d] License agreements

The costs to enter into various licence agreements are amortized on a straight-line basis over a period of not more than five years. If a licence agreement is terminated or impaired, the unamortized costs relating to the agreement are immediately charged to earnings.

[e] Patents and trademarks

All costs related to the development of patents and trademarks are expensed as incurred.

[f] Government incentives

Government incentives with respect to capital assets are netted against the related asset when granted. Incentives related to research and development are deferred until the respective costs are incurred and all conditions have been met.

[g] Revenue recognition

Revenue from the sale of products is recorded at the time the products are shipped.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Licensing revenue is recognized at the date the license is granted unless there are specific events that must be completed under the terms of the licensing agreement in which case a portion of the revenue is recognized upon the completion of the specific event.

Royalty revenue is recognized on an accrual basis in accordance with the contractual agreements with third parties.

[h] Research and development costs

Research costs, which include a share of administrative expenses, are charged to earnings as incurred net of grants or related tax credits received. Development costs are charged against income in the period of the expenditure unless a development project meets the criteria under Canadian generally accepted accounting principles for deferral and amortization. At June 30, 2003 and 2002, no development costs have been deferred.

[i] Foreign exchange

Foreign currency assets and liabilities of Bioniche Animal Health USA, Inc., Bioniche Animal Health (A/Asia) Pty. Ltd., Bioniche Animal Health (Europe) Limited and Bioniche (A/Asia) Pty. Ltd. and long-term debt of Bioniche Life Sciences Inc. are translated into Canadian dollars using the temporal method. Under this method, earnings of foreign operations are translated into Canadian dollars at average rates of exchange prevailing during the year. Monetary assets and liabilities are translated at the exchange rate in effect at the balance sheet date. Non-monetary assets and liabilities are translated at their historical rate. Foreign exchange gains or losses arising from the translation of foreign currency long-term monetary items are included in income in the current period.

Foreign currency assets and liabilities of Bioniche Pharma Group are translated into Canadian dollars using the current rate method. Generally under this method, all balance sheet items are translated at current rates except the equity section which is translated at historical rates. Exchange differences are included in the equity section of the balance sheet.

[j] Income taxes and investment tax credits

Future tax benefits and obligations are determined based on differences between the financial reporting and tax basis

of assets and liabilities, and measured using the substantively enacted tax rates and laws that will be in effect when differences are expected to reverse. Future tax assets, if any, are recognized only to the extent that, in the opinion of management, it is more likely than not that future tax assets will be realized.

Investment tax credits arise as a result of incurring qualified scientific research and development expenditures and are recorded in that year as a deduction from the related expenditures when there is reasonable assurance of collection. Investment tax credits arising from capital expenditures are recorded as a reduction of the carrying value of the capital asset when there is reasonable assurance of collection.

[k] Goodwill and intangible assets

Goodwill and intangible assets with indefinite lives are no longer subject to amortization, but are subject to at least an annual assessment for impairment by applying a fair value test. The Company considers its intangible assets to have a finite life and as such are continuing to amortize on a straight-line basis over twenty years. The Company's goodwill has been tested and no impairment exists as at June 30, 2003. On an on-going basis, the Company reviews whether there has been an impairment in the carrying value of its intangible assets based on an estimation of the undiscounted cash flows from the underlying assets. Any such impairment is charged to income at that time.

[l] Deferred financing fees

Deferred financing fees are recorded at cost and are amortized over the term to maturity of the related long-term debt.

[m] Cash and cash equivalents

The Company considers cash and cash equivalents to include highly liquid investments with original maturities of three months or less at the time of purchase.

[n] Earnings (loss) per share

Earnings (loss) per share are calculated based on net income (loss) attributable to common shareholders. Basic earnings (loss) per share are calculated using the weighted average number of common shares outstanding during the year. The computation of diluted earnings (loss) per share assumes the basic weighted average number of common

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

shares outstanding during the year is increased to include the number of additional common shares that would have been outstanding if the potential dilutive common shares had been issued. The dilutive effect of warrants and stock options is determined using the treasury stock method.

[o] Stock-Based Compensation and other Stock Based Payments

Effective on July 1, 2002, the Company adopted the recommendations of the new CICA Handbook section 3870, "Stock-Based Compensation and Other Stock-Based Payments". This section establishes standards for recognition, measurement and disclosure of stock based compensation and other stock based payments, and applies to awards granted by the Company on or after the date of adoption.

Under these provisions, the Company can either measure the compensation cost of equity instruments issued under employee compensation plans using a fair value-based method or can recognize compensation cost using another method, such as the intrinsic value-based method. However, if another method is applied, pro-forma disclosure of net income (loss) and earnings (loss) per share must be presented in the financial statements as if the fair value-based method had been applied. The Company has elected not to recognize compensation costs under the fair value method, however, 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. Consideration paid on the exercise of stock options and warrants is credited to share capital.

Direct awards of stock are recorded at fair value.

[p] Derivative financial instruments

The Company has only limited involvement with derivative instruments that are used to manage well-defined foreign exchange risk out of the normal course of business. The Company's policy is not to utilize derivative financial instruments for trading or speculative purposes.

The Company applies hedge accounting to forward foreign currency exchange contracts designated as a hedge. Foreign exchange gains and losses on foreign currency

denominated derivative financial instruments used to hedge foreign currency exposure are recognized in the same period as the hedged transaction is recognized. The unrealized gains and losses on hedged items are recorded on the balance sheet under Accrued Liabilities or Other Assets, respectively.

The Company assesses all relationships between hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking various hedge transactions. This process includes linking all derivatives to specific assets and liabilities on the balance sheet or to specific firm commitments or forecasted transactions. The Company also formally assesses, on an ongoing basis, whether the derivatives that are used in hedging transactions are effective in offsetting changes in fair values or cash flows of hedged items.

The Company applies the fair value method to forward foreign currency exchange contracts not designated as a hedge. Gains and losses associated with derivative financial instruments not designated as hedges are reported in income in the current period and the unrealized gains or losses are recorded on the balances sheet under Accrued Liabilities or Other Assets, respectively.

3. CHANGE IN ACCOUNTING POLICY

Effective July 1, 2002 the Company applied the provisions of the new Canadian accounting standard for foreign currency translation retroactively and restated its 2002 financial statements.

Under the new provisions, foreign exchange gains and losses of the Company that arise on translation or settlement of a foreign currency denominated monetary item or a non-monetary item carried at market are included in the determination of net income (loss) for the current period. As a result of this retroactive restatement, foreign exchange loss and the net loss have decreased by \$137,558 and basic and fully diluted loss per share has decreased by \$0.01 for the year ended June 30, 2002 and retained earnings as at July 1, 2001 has decreased by \$136,454.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

4. ACCOUNTS RECEIVABLE

	2003 \$	2002 \$
Trade, net	10,410,504	6,568,532
Other	2,578,425	1,886,370
	12,988,929	8,454,902

Included in other accounts receivable are amounts outstanding from directors of a subsidiary company for \$238,745 (2002 – \$238,745). The amounts receivable are due December 23, 2005 and are interest bearing at the bank's prime rate + 1%. The prime rate at June 30, 2003 was 5.00% [2002 – 4.25%].

5. INVENTORIES

	2003 \$	2002 \$
Raw materials	2,755,999	2,714,550
Work in process	2,742,012	1,714,255
Finished goods	3,185,719	2,618,487
	8,683,730	7,047,292

6. CAPITAL ASSETS

	2003		
	Cost \$	Accumulated amortization \$	Net book value \$
Land	1,065,631	—	1,065,631
Buildings	6,033,235	1,296,866	4,736,369
Building under capital lease	4,179,780	911,030	3,268,750
Equipment	10,172,122	5,106,940	5,065,182
Equipment under capital lease	1,626,980	315,987	1,310,993
Automobiles	214,390	169,763	44,627
Leasehold improvements	108,168	65,391	42,777
	23,400,306	7,865,977	15,534,329

	2002		
	Cost \$	Accumulated amortization \$	Net book value \$
Land	1,288,463	—	1,288,463
Buildings	5,596,169	1,131,509	4,464,660
Building under capital lease	4,179,780	702,041	3,477,739
Equipment	8,412,857	3,781,198	4,631,659
Equipment under capital lease	1,103,705	212,086	891,619
Automobiles	225,662	170,068	55,594
Leasehold improvements	570,131	501,938	68,193
	21,376,767	6,498,840	14,877,927

Included in equipment is \$884,294 [2002 – \$783,737] of costs associated with the purchase and development of a new software system. This system has not been fully implemented and no amortization has been recognized on these costs to date. Amortization will begin when the system is implemented and being used by the Company.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

7. OTHER ASSETS

	2003 \$	2002 \$
Intangible assets	10,768,457	11,465,625
License agreements, net [note 2[d]]	447,000	225,000
Unrealized foreign exchange loss [note 12[a][i]]	141,500	—
Deferred financing fees, net [note 2[l]]	1,630,299	826,765
	12,987,256	12,517,390

As at June 30, 2003, accumulated amortization for intangible assets was \$2,577,381 [2002 – \$1,880,213] and accumulated amortization for deferred financing fees was \$724,626 [2002 – \$463,111].

8. LONG-TERM DEBT AND OPERATING FACILITIES

	2003 \$	2002 \$
		<i>[restated]</i>
Convertible debentures payable bearing interest at 7.5% payable quarterly, due five years and one month from the date of each advance [a]	8,134,589	9,178,275
ICC Equity Partners Limited [b]	5,276,584	4,482,585
Royal Bank of Canada [RBC], bearing interest at the bank's prime rate plus a range of 1% – 1.5% repayable in monthly principal payments of \$36,980 plus interest [c]	1,928,445	1,166,664
Business Development Bank of Canada [BDC] bearing interest at the bank's base fluctuating rate plus 1% - 1.5% repayable in monthly principal payments of \$21,852 plus interest [d]	1,769,468	854,204
ANZ Bank, interest bearing at the bank's fluctuating rate plus 1.03%, payable in Australian dollars [\$547,185 Australian] [e]	498,212	467,734
Debenture bearing interest at 9.5% with interest payable monthly plus bonus interest payable on quarterly sales dollars over \$8.75 million. 20% of principal payable per year starting in 2006 with balance due June 30, 2009. [f]	4,050,000	—
Obligation under capital leases for equipment, bearing interest at a range of 8% - 12% with varying repayment terms	1,061,304	924,399
	22,718,602	17,073,861
Less current portion	(1,073,704)	(568,763)
	21,644,898	16,505,098

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

[a] Bioniche Life Sciences Inc. borrowed \$9 million USD (\$13.66 million CDN) in a series of installments from a private investor group repayable five years and one month from the date of each advance commencing in 2005. The fair value of the holder's conversion option, assuming an imputed interest rate of 26.7% at that point in time, was reported as paid-in capital, net of costs. As at June 30, 2003, the fair value of the Company's obligation to make principal and interest payments is approximately \$7.34 million using an imputed interest rate of 18% on the liability component of the debt. As collateral for the debenture, the Company provided a first charge over certain real estate and other assets owned by the Company.

The principal amount of the loan is eligible for conversion, at the option of the lender, during the fifth year of the term of the loan, into common shares of Bioniche Life Sciences Inc. at a discount rate of 15% from the prevailing market prices of the shares on the Toronto Stock Exchange provided the share price shall not be less than \$2.80. The principal amount of the loan is to be converted into CDN dollars at the prevailing exchange rate on the day of conversion. The aggregate number of shares issued, for this conversion option and the hereinafter mentioned warrants, shall not exceed 5,074,257.

As part of the terms of the loan, investors were granted warrants to acquire 300,000 common shares at \$3.50 and 200,000 common shares at \$4.25, exercisable at any time during the term of the loan. In addition, warrants to acquire 130,000 common shares at \$3.50 and 70,000 common shares at \$4.25 were issued in connection with this debt. On November 1, 2002 the 700,000 options were modified to extend their term to August 31, 2008.

During the year, the Company repaid \$1.3 million USD (\$2.0 million CDN) of the installments. In addition, the private investors agreed to postpone their first charge on the real estate behind RBC and BDC and took a subse-

quent charge on other real estate owned by the Company. On the date of repayment, \$918,350 USD (\$1.4 million CDN) was applied to the outstanding debt and other paid-in capital was reduced by \$381,650 USD (\$595,488 CDN).

[b] Effective January 1, 2000, ICC Equity Partners Limited invested £2.5 million (\$4.6 million CDN) in 6% redeemable convertible loan stock of Bioniche Pharma Group. Interest is accrued and payable semi-annually. The loan stock is due in 2005 and may be converted by the lender at any time. The fair value of the holder's conversion option, assuming an imputed interest rate of 26.7% at that point in time, was reported as non-controlling interest, net of costs. As at June 30, 2003, the fair value of the Company's obligation to make principal and interest payments is approximately \$3.37 million using an imputed interest rate of 18%, as the liability component of the debt.

On March 8, 2002, the ICC Equity Partners Limited invested an additional £1.0 million (\$1.8 million CDN) in 6% redeemable convertible loan stock of Bioniche Pharma Group. Interest is accrued and payable semi-annually. The loan stock is due in 2005 and may be converted by the lender at any time. The fair value of the holder's conversion option, assuming an imputed interest rate of 18% at that point in time, was reported as non-controlling interest, net of costs. As at June 30, 2003, the fair value of the Company's obligation approximates carrying value.

[c] The Company has arranged two credit facilities with the Royal Bank of Canada for \$1.05 million and \$1.22 million respectively. Both facilities are guaranteed 70% by Investissement Quebec. The credit facility for \$1.05 million has monthly repayments of \$10,417 plus interest and is repayable in full on November 7, 2006.

The credit facility for \$1.22 million has monthly payments of \$26,563 plus interest based on a one year term. The balance of the facility is repayable in full on July 21, 2004.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

[d] The Company has been provided with a \$1.25 million building loan by the BDC, maturing on October 1, 2011. Principal repayments of \$10,417 plus interest is due monthly.

An additional \$686,000 loan has been advanced for the acquisition of equipment. Principal repayments of \$11,435 plus interest are paid monthly and the loan is due on December 1, 2006.

The following has been provided as collateral for the loans described above in [c] and [d]:

- RBC and BDC rank pari passu on real estate and certain properties owned in Canada

[e] The Company has a \$ 547,185 AUS loan facility with ANZ Bank maturing August 2004. The loan only requires interest repayments until maturity. The Company has provided a first charge over real estate and certain property in Australia as collateral for this facility.

[f] The Company borrowed \$13.5 million from a syndicate of Canadian institutions, with funds advanced in two tranches. The first tranche of \$4.05 million was received on May 30, 2003 with the second tranche to be advanced upon the Company reaching agreement regarding the repayment of certain obligations to the private investor group described in note [a] above and the granting of certain additional security to the lenders. Collateral provided is the real property owned in Canada and certain other assets excluding intellectual property on the core technology platform. Principal payments of 20% of aggregate principal are due on June 30th in each of 2006, 2007 and 2008. The balance

of loan is due on June 30, 2009. Each lender may convert any or all principal amounts outstanding on repayment date to common shares at a 20 day weighted average less 15% providing price is greater than the minimum market price of \$8.00 per share. Interest is payable monthly in arrears at 9.5% on principal outstanding. Bonus interest of 0.0025% on quarterly sales between \$8.75 and \$15.0 million and 0.00192% on sales over \$15.0 million for each \$1.0 million (or portion) of principal outstanding to be paid to lenders to a maximum pretax IRR of 25% on the loans.

[g] Royal Bank Credit Facility with Bioniche Animal Health Canada Inc. of \$1.5 million by way of RBP based loans. The aggregate borrowings must not exceed 75% of eligible Accounts Receivable (Canadian and U.S.) less potential prior-ranking claims. Interest is payable at Royal Bank Prime plus 1.5%. A first charge over the Inventory and Accounts Receivable of Bioniche Animal Health Canada Inc. as been provided as collateral.

[h] The Company has arranged a \$500,000 USD operating line of credit with Athens First National Bank & Trust Company at an interest rate of prime + 1%, maturing December 5, 2003. As at June 30, 2003, \$75,000 U.S. dollars have been drawn against this facility. As collateral for this line of credit, the Company has provided a first charge over certain U.S. owned properties, Under the terms of certain of the agreements described above, the Company is required to meet covenants. These covenants have all been satisfied at year end. Principal repayments estimated to be required after the 2003 fiscal year are as follows:

	\$
2004	1,073,704
2005	13,215,131
2006	3,370,335
2007	1,870,312
2008	1,110,772
2009 and thereafter	2,078,348
	22,718,602

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

9. GOVERNMENT INCENTIVES

Under the federal contribution program called Technology Partnerships Canada, the Company is entitled to a reimbursement of 18.3% and 21.6% of the eligible operating and capital expenses incurred by the Company in the development and commercialization of MCC and E.Coli 0157:H7 to a maximum of \$9,600,000 and \$7,600,000 respectively. At the Company's discretion, it can claim reimbursements at accelerated rates of 35% and 28% for MCC and E.Coli 0157:H7 respectively to the same maximum as noted above. If the Company does not reach certain expenditure levels for MCC and E.Coli 0157:H7 respectively by June 30, 2006, all reimbursements received in excess of 18.3% and 21.6% of said expenditures become repayable to Technology Partnerships Canada. In the event that either MCC or E.Coli 0157:H7 become commercially available prior to the required expenditure levels being reached, any excess amounts received under the accelerated method are not repayable. At June 30, 2003, deferred government incentives received under the Technology Partnerships Canada program are \$2,292,835 [2002 - \$1,325,406] and cumulative amounts received on account of capital of \$423,493 [2002 - \$355,343] have been netted against the related cost of the assets.

In fiscal 1995, Bioniche Teoranta received a capital grant from Udaras na Gaeltachta, an agency of the Government of Ireland, in conjunction with the upgrade and expansion of the Irish facilities. Udaras na Gaeltachta will require partial repayment if certain requirements relating to corporate ownership, distribution of profits and levels of employment are not met. The Company is required to comply with these conditions until June, 2004. If the conditions are not met, the Company is required to repay the unamortized portion of the grant. Based upon the agreement, the grant is amortized at an annual rate of 5% for grants related to buildings and 10% for grants related to equipment. As at June 30, 2003 and June 30, 2002 the unamortized balances were \$255,288 and \$311,572 respectively. As at June 30, 2003, the Company is in compliance with these requirements.

In addition, the Company has approximately \$3,300,000 [2002 - \$3,000,000] of unused SRED investment tax credits available to reduce future federal taxes payable which have not been recorded in the financial statements.

10. NON-CONTROLLING INTEREST IN SUBSIDIARIES

The balance in the non-controlling interest account represents the investment held by various outside parties in Bioniche Pharma Group Inc. and its subsidiary, Bioniche Teoranta. As described in *note 8[b]*, effective January 1, 2000 and amended March 8, 2002, the Company's investment in Bioniche Pharma Group Inc. was reorganized and ICC Equity Partners Limited invested by way of 6% redeemable convertible loan stock. A portion of this investment, in the amount of \$2.9 million [2002 - \$2.9 million], is included in this balance.

In addition, the Government of Ireland, an investor in Bioniche Teoranta, waived their outstanding management fees and cumulative dividends as well as reduced their future dividend rates to 6% on all preferred shares and were diluted to 2.5% from 7% of the common shares of Bioniche Teoranta, effective January 1, 2000. Therefore, the Government of Ireland's interest in Bioniche Teoranta is represented by 150,264 6% cumulative redeemable preference shares in the amount of \$742,468 CDN [€414,000], and 2.5% of the common share equity. The 6% cumulative redeemable preferences shares have fixed mandatory redemption dates. However, under Irish corporate law, the subsidiary may not redeem the shares until it is in a positive equity position.

Because of the inability to predict when Bioniche Teoranta will be in a position to redeem the preference shares, it is impractical to determine their fair value.

During the year, 3,449 shares were issued to a director of Bioniche Pharma Group Inc. for proceeds of \$31,896 CDN (\$20,419 Euro).

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

11. SHARE CAPITAL

Authorized and issued

The authorized capital of the Company is as follows:

- unlimited number of common shares; and
- unlimited non-cumulative, non-voting, redeemable preferred shares with no par value

Share capital at June 30 consisted of:

	2003 \$	2002 \$
Preferred shares - Series I [a]	161,000	161,000
Common shares [b]	47,739,701	44,561,137
Warrants [e]	232,750	—
Share bonus [c]	878,280	821,670
Employee share ownership plan [d]	38,420	—
	49,050,151	45,543,807

[a] Preferred shares

The Series I shares are redeemable by the Company at \$1,000.00 for each such share together with dividends, if any, which have been declared but not paid. The Series I shares are non-voting and are entitled to a fixed non-cumulative preferential dividend at the rate of 12% per annum.

The outstanding Series I preferred shares as at June 30, were as follows:

	2003		2002	
	Shares	Amount \$	Shares	Amount \$
Series I	167	161,000	167	161,000

[b] Common shares

The change in issued and fully paid common shares of the Company are as follows:

	2003		2002	
	Shares	Amount \$	Shares	Amount \$
Opening balance	27,896,484	44,801,137	24,423,759	35,267,374
Issued as a result of				
Executives and directors remuneration	50,911	84,000	26,152	68,000
Share offerings	1,226,051	1,938,262	3,254,869	8,937,339
Warrants exercised	—	—	141,704	354,273
In lieu of fees	44,867	87,491	—	—
Issued shares on purchase	—	—	50,000	174,151
Share bonus	421,192	668,009	—	—
Employee share ownership plan	218,676	400,802	—	—
Ending balance	29,858,181	47,979,701	27,896,484	44,801,137
Less share purchase loan	—	(240,000)	—	(240,000)
	29,858,181	47,739,701	27,896,484	44,561,137

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The weighted average number of common shares outstanding in calculating the earnings (loss) per share is 28,317,549 [2002 – 27,876,974]. A reconciliation of the number of outstanding common shares has not been included because the Company incurred a loss in the year and the effect would have an anti-dilutive impact on loss per share.

[c] Bonus

The Company has accrued a bonus for all its employees which is expected to be settled by issuing the Company's stock. As at June 30, 2003 management has estimated that 370,000 shares will be issued with respect to the Company's bonus plan.

[d] Employee Share Ownership Plan

The Company has an Employee Share Ownership Plan whereby the Company matches contributions made by employees for the purpose of purchasing the Company's stock. The Company's portion of this plan is expensed in the year incurred and totaled \$439,222 in 2003.

[e] Warrants

At June 30, 2003, the Company had 1,228,375 [2002 – 772,125] warrants outstanding to purchase 1,228,375 [2002 – 772,125] common shares as follows:

Warrants outstanding and exercisable			
	Number outstanding at June 30, 2003	Weighted- average remaining contractual life (years)	Weighted- average exercise price
Range of exercise prices			
\$2.00 to \$2.49	306,250	2.9	\$2.11
\$2.50 to \$3.50	632,925	3.6	\$3.50
\$4.25 to \$5.00	289,200	4.7	\$4.30

The following table summarizes information about warrants outstanding at June 30:

	2003		2002	
	Warrants	Weighted- average exercise price	Warrants	Weighted- average exercise price
Outstanding, beginning of year	772,125	\$3.70	1,465,228	\$3.66
Granted	506,250	\$2.76	—	—
Exercised	—	—	(141,704)	2.50
Expired	(50,000)	\$3.00	(551,399)	3.14
Outstanding, end of year	1,228,375	\$3.34	772,125	3.70

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

[f] Shares available for stock option plans

The Company has adopted a stock option plan such that the maximum number of shares subject to option shall not exceed 3,300,000. The Company has made available 2,633,001 [2002 – 2,823,001] common shares for the exercise of stock options.

The exercise price of each option equals the market rate at the date immediately preceding the date of the grant. In gen-

eral, options issued under the plan begin to vest after one year from the date of the grant and are exercisable in equal amounts over four years at the anniversary date of the grant.

No compensation expense is recognized for this plan when options are issued.

A summary of the status of the Company's stock option plan as of June 30, 2003 is presented below:

Range of exercise prices	Options outstanding			Options exercisable	
	Number outstanding at June 30, 2003	Weighted-average remaining contractual life (years)	Weighted-average exercise price	Number exercisable at June 30, 2003	Weighted-average exercise price
\$2.05 to \$3.24	389,001	4.7	\$3.08	—	—
\$3.25 to \$4.75	2,274,000	1.7	\$3.92	2,152,651	\$3.82
\$5.00 to \$7.50	20,000	2.1	\$6.75	—	—

The following table summarizes information about stock options outstanding at June 30:

	2003		2002	
	Options	Weighted-average exercise price	Options	Weighted-average exercise price
Outstanding, beginning of year	2,823,001	\$3.91	2,711,901	\$4.58
Granted	50,000	2.95	314,001	3.15
Exercised	—	—	—	—
Expired	(190,000)	\$4.91	(202,901)	5.52
Outstanding, end of year	2,683,001	\$3.82	2,823,001	3.91

During fiscal 1995, 200,000 shares were purchased under the plan for \$1.20 per share. The Company loaned \$240,000 to an employee, on a non-interest bearing basis, to purchase the shares under the employee stock option plan. There are no set terms of repayment. The shareholder has pledged the shares as collateral for the indebtedness. The fair market value of the common shares at June 30, 2003 was \$96,000 [2002 – \$127,200].

[g] Compensation expense

The Company does not recognize compensation expense for stock options granted to employees and directors. The pro forma impact on net income (loss) as if compensation

expense for stock options granted to employees and directors had been determined based on the fair value method, is a \$71,000 reduction of net income in the form of compensation expense. There is no impact on earnings (loss) per share due to the pro forma fair value expensing of the stock options granted during the year.

For the year ended June 30, 2003, the following weighted average assumptions were used: risk free interest rate of 4.25%, expected dividend yield of 0%, expected volatility of 0.698 and expected option life of three years. The weighted-average fair value of the options granted during the year was \$1.42.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The Black-Scholes model, used by the Company to calculate option values, as well as other accepted option valuation models, were developed to estimate fair value of freely tradable, fully transferable options without vesting restrictions, which significantly differ from the Company's stock option awards. These models also require four highly subjective assumptions, including future stock price volatility and expected time until exercise, which greatly affect the calculated values. Accordingly, management believes that these models do not necessarily provide a reliable single measure of the fair value of the Company's stock option awards.

12. FAIR VALUE OF FINANCIAL INSTRUMENTS

[a] Foreign exchange risk

[i] Derivative financial instruments designated as hedges

The Company enters into forward exchange contracts to hedge accounts receivable and future revenues denominated in U.S. dollars. At June 30, 2003, the Company had forward foreign exchange contracts to sell U.S. dollars for Euro in the amount of \$1,538,456 U.S. dollars outstanding at an average exchange rate of 1.1054 over the next 8 months. The market value of the forward foreign exchange contracts outstanding at June 30, 2003 was such that if these contracts had been closed out at June 30, 2003, the Company would have recorded a gain of \$566,165.

[ii] Derivative financial instruments not designated as hedges

At June 30, 2003, the Company had forward foreign exchange contracts to buy U.S. dollars for Canadian dollars in the amount of \$7,662,232 U.S. dollars at an average exchange rate of 1.3680 due to mature on August 29, 2003. The forward foreign exchange contracts were purchased with the intent of retiring U.S. dollar denominated debt. The Company has not elected to apply hedge accounting to these derivative instruments.

The Company does not anticipate any material adverse effect on its financial position resulting from its involvement in these types of contracts, nor does it anticipate non-performance by counter parties. The Company only deals with highly rated counter parties, normally major financial institutions.

[b] Credit risk

The Company is exposed to credit risk in the event of non-performance by counterparties, but does not anticipate such non-performance. The Company monitors the credit risk and credit standing of counterparties on a regular basis. The maximum credit risk is the fair value of the financial assets. The Company manages its exposure so that there is no substantial concentration of credit risk.

[c] Fair value

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates are subjective in nature and involve uncertainties and matters of significant judgement and therefore, cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

The carrying amounts in the consolidated balance sheets approximate fair value because of the limited term of these instruments.

13. SEGMENTED FINANCIAL INFORMATION

Bioniche Life Sciences Inc. has four reportable segments, Pharma, Animal Health, Therapeutics and Food Safety. The Pharma segment is involved in the development, manufacture, marketing and sale of generic pharmaceutical products directly to hospitals, through pharmaceutical distributors and as a contract manufacturer for pharmaceutical companies. The Therapeutics segment involves the research, development and commercialization of proprietary immunostimulant technology and hyaluronic acid-based products. The Animal Health segment is involved in the research, development, manufacture, marketing, sale and resale of proprietary and generic pharmaceutical and complimentary products that support the bovine, equine and porcine markets. The Food Safety segment is involved in the research, development and commercialization of the E.Coli 0157:H7.

The reportable segments are strategic business units that offer different products and services and require different

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

technology and marketing strategies. The manufacturing operations for both the Pharma and Therapeutics segments are carried out at the plant in Galway, Ireland.

The accounting policies of the segments are the same as those described in the summary of significant accounting

policies in note 2. The Company accounts for inter-segment sales on a cost plus basis. Bioniche Life Sciences Inc. evaluates performance and allocates resources based on profit or loss from operations before foreign exchange gains or losses and income taxes.

	2003				
	Human		Animal Health	Food Safety	Total
	Pharma	Therapeutics			
	\$	\$	\$	\$	\$
Sales from external customers	23,366,360	2,874,510	25,318,398	—	51,559,268
Inter-segment sales	3,528,615	—	29,732	—	3,558,347
Total sales	26,894,975	2,874,510	25,348,130	—	55,117,615
Interest expense, net	960,958	2,192,348	745,087	—	3,898,393
Amortization of capital assets and licenses	1,059,222	1,074,383	405,711	20,999	2,560,315
Amortization of deferred government incentives	(70,413)	—	—	—	(70,413)
Segment income (loss) before research and development	3,439,808	584,512	3,190,925	—	7,215,245
Segment income (loss)	1,467,184	(8,854,797)	1,250,977	(750,855)	(6,887,491)
Segment assets	25,073,280	22,838,679	18,317,050	579,716	66,808,725
Goodwill	3,504,007	1,347,695	702,096	—	5,553,798
Expenditures for segment capital assets	1,264,094	527,474	718,162	(1,624)	2,508,106

	2002				
	Human		Animal Health	Food Safety	Total
	Pharma	Therapeutics			
	\$	\$	\$	\$	\$
Sales from external customers	9,703,538	6,151,725	24,683,074	—	40,538,337
Inter-segment sales	7,742,669	13,500	21,005	—	7,777,174
Total sales	17,446,207	6,165,225	24,704,079	—	48,315,511
Interest expense, net	588,973	1,791,317	663,810	—	3,044,100
Amortization of capital assets and licenses	803,143	559,532	431,898	—	1,794,573
Amortization of deferred government incentives	(60,681)	—	—	—	(60,681)
Segment income (loss) before research and development	2,995,306	(296,466)	2,350,867	—	5,049,707
Segment income (loss)	2,001,511	(7,154,297)	792,682	(1,088,552)	(5,448,656)
Segment assets	22,363,702	18,480,934	19,428,408	591,018	60,864,062
Goodwill	3,504,007	1,347,695	702,096	—	5,553,798
Expenditures for segment capital assets	884,024	3,237,583	1,683,827	381,996	6,187,430

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

	2003 \$	2002 \$
Total loss for reportable segments	(6,887,491)	(5,448,656)
Change in inter-segment profits in inventory	131,669	(141,315)
Foreign exchange (loss) gain	1,107,462	(105,291)
Loss before income taxes	(5,648,360)	(5,695,262)

	2003 \$	2002 \$
Total assets for reportable segments	66,808,725	60,864,062
Elimination of inter-segment profits in inventory	(598,193)	(729,862)
Total assets	66,210,532	60,134,200

Revenue from two customers in the Pharma segment represents \$13.9 million of the Company's total revenues. In fiscal 2002, revenue from one customer for each of the Pharma and Therapeutics' segment represented \$2.1 million and \$3.1 million of the Company's total revenues respectively.

Segmented financial information analyzes the operations of the Company by the following geographic locations. Sales are attributed to location based on where the sale originates:

	2003 \$	2002 \$
Revenues		
Canada	10,403,080	12,163,474
Europe	14,592,689	8,678,128
United States	21,664,399	15,536,180
Australia	2,957,950	2,261,230
Other	1,941,150	1,899,325
	51,559,268	40,538,337
Total assets		
Canada	38,589,062	38,754,128
Ireland	22,311,895	16,087,694
United States	2,660,088	3,211,919
Australia	2,649,487	2,080,459
	66,210,532	60,134,200

Substantially all of the capital assets and goodwill are located in Canada.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

14. INCOME TAXES

The reconciliation of income tax computed at the statutory tax rates to the provision for income taxes is as follows:

	2003 \$	2002 \$
Loss before recovery of income taxes	5,648,360	5,695,262
Basic income tax rate	34.53%	40.37%
Computed income tax recovery	1,950,379	2,299,177
Effect on income tax rate resulting from:		
Foreign jurisdictions rate differential	(555,000)	(396,000)
Unrecorded potential tax benefits of current period losses	(1,650,000)	(1,428,077)
Benefit of losses not previously recognized	591,000	776,000
Accounting charges not deductible for tax purposes	(985,000)	(373,500)
Other	(40,726)	-
	689,347	877,600

As at June 30, 2003, the Company has approximately \$13,000,000 of Federal and \$14,256,000 of Ontario and Quebec unused non-capital tax loss carryforwards which expire as follows:

	Federal \$	Provincial \$
2004	1,520,000	1,950,000
2005	5,000	5,000
2006	3,000	34,000
2007	3,075,000	3,650,000
2008	2,725,000	2,870,000
2009	1,680,000	1,755,000
2010	3,992,000	3,992,000
	13,000,000	14,256,000

Unused Scientific Research and Experimental Development [SRED] deductions of approximately \$13,500,000 for federal purposes and \$11,500,000 for Ontario purposes are available for carryforward indefinitely for tax purposes.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Future income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's future tax assets and liabilities are as follows:

	2003 \$	2002 \$
Future tax assets		
Net operating loss carryforwards	4,200,000	3,700,000
Tax basis of capital assets and intangibles in excess of carrying values	1,600,000	1,050,000
Current and capital scientific expenditures available to reduce future years' taxable income	3,900,000	3,500,000
Investment tax credits	3,300,000	3,000,000
Total gross future tax assets	13,000,000	11,250,000
Less: valuation allowance	(9,400,000)	(6,960,000)
Net future tax asset	3,600,000	4,290,000
Future tax liabilities		
Difference between book and tax basis for intangible assets	3,999,000	4,290,000
Total future tax liabilities	3,999,000	4,290,000
Net future tax liability	399,000	—

The potential income tax benefits relating to the future tax assets have been recognized in the accounts to the extent their realization meets the requirements of "more likely than not" under the liability method of tax allocation.

Significant components of the provision for income taxes attributable to continuing operations are as follows:

	2003 \$	2002 \$
Current tax expense	290,347	296,400
Future tax recovery relating to origination and reversal of temporary differences	990,000	(398,000)
Future income tax benefit resulting from recognition of loss carryforwards	(591,000)	(776,000)
	689,347	(877,600)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

15. CONTINGENCIES AND COMMITMENTS

The Company is committed under various operating leases for building and equipment to total future minimum lease payments as follows:

	\$
2004	895,381
2005	753,361
2006	629,394
2007	387,826
2008	124,281
	2,790,243

The Company is involved from time to time in litigation, which arises in the normal course of business. In respect of these claims the Company believes it has valid defenses and/or appropriate insurance coverage in place. In management's judgment, no material exposure exists on the eventual settlement of such litigation, and accordingly, no provision has been made in the accompanying financial statements.

The Company is committed to paying royalties of 1% – 5% as a result of certain license agreements on the sales of certain products on the commercialization of specific technologies or products.

During the year, an agreement was reached with Fidia Farmaceutici S.p.A. in Germany in settlement of the patent infringement actions concerning Suplasyn. The agreement

calls for royalty payments of 486,428 Euro in 8 equal quarterly payments, the first of which is due July 16, 2003. The net present value of this payment has been charged to income in the amount of \$712,749 CDN, together with related costs to reach the settlement, with \$379,585 included in accounts payable and \$333,164 reflected as other long-term debt on the balance sheets.

The royalty payment attributable to prior fiscal years and the cost to defend the litigation have been disclosed separately as settlement of litigation on the consolidated statements of loss. In addition, there is an ongoing 5% royalty payment pursuant to a supplier agreement on all defined sales after March 31, 2003 and all future defined sales until 2005.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

16. STATEMENTS OF CASH FLOWS

	2003 \$	2002 \$
Accounts receivable	(4,534,027)	(668,266)
Inventories	(1,636,438)	(1,279,799)
Prepays and deposits	(77,037)	(69,486)
Deferred revenue	(374,300)	374,300
Accounts payable and accrued liabilities	1,965,962	1,139,641
Income taxes payable	116,758	219,381
	(4,539,082)	(284,229)
Supplementary Cash Flow Information:		
	2003 \$	2002 \$
Cash paid for		
Income taxes	159,146	39,995
Interest	1,650,757	1,308,301
	1,809,903	1,348,296
Common shares issued		
Executives and directors remuneration	84,000	68,000
In lieu of fees	87,491	—
Australian purchase	—	174,151
	171,491	242,151
Capital leases		
Assets acquired by means of a capital lease	490,777	566,469

17. SUBSEQUENT EVENT

On September 9, 2004 the Company closed the second tranche of the \$13.5 million CDN loan referred to in Note 8(f), and received the balance of the loan, equal to \$9.45 million CDN. As part of the transaction, the Company granted a pledge of its shares in Pharma in favour of the lenders. The Company has repaid the balance of the \$9 million USD loan referred to in Note 8(a) and modified the exercise price of existing warrants that were issued in connection with the private investor group convertible debenture.

This transaction will result in a gain or loss on extinguishment of debt which will be recorded in fiscal 2004.

18. COMPARATIVE AMOUNTS

Certain comparative figures have been reclassified to conform with the financial statement presentation adopted in the current year.