Second Quarter Results 2005

TRANSITION THERAPEUTICS INC.

IN BUSINESS TO MAKE A DIFFERENCE

Transition therapeutics inc.

TO OUR SHAREHOLDERS

In the second quarter of fiscal 2005 we built on the momentum generated in the previous quarter, making further clinical progress with our core technologies and completing two transactions to enhance the long-term value in our product pipeline. Halfway through the year, we have already passed a variety of important milestones, demonstrating our ability to leverage our proprietary model and rapidly grow our business.

During the second quarter, Transition:

- Received clearance to initiate an exploratory Phase IIa clinical trial to evaluate efficacy, safety and tolerability for E1-I.N.T.™ in patients with type I diabetes;
- Acquired a 17% stake in Ellipsis Neurotherapeutics Inc. ("ENI"), a company developing therapeutics for Alzheimer's disease; and
- Sold our subsidiary, Stem Cell Therapeutics Inc. ("SCT"), for upfront and anniversary payments totaling $3.5 million, plus royalties on sales and other income.

Subsequent to the quarter-end, we:

- Received clearance from the FDA to expand our clinical program for E1-I.N.T.™ into patients with type II diabetes; and
- Commenced enrolment for our Phase II clinical trial for MS-I.E.T. in patients with multiple sclerosis ("MS").

Financial Strength

At December 31, 2004, our cash and cash equivalents were $21,959,317. In addition, at December 31, 2004, we also had $3,137,039 receivable from our transfer agent for warrants that were exercised in December 2004 but for which the transfer agent had not transferred the funds received from investors to Transition until early January 2005. Transition is now well positioned financially and we intend to leverage this financial strength to advance our products through the clinic as well as seek partnerships and new value creating acquisitions.

Continued Clinical Progress

Our clinical activity continues to ramp up across our portfolio as we move a greater number of products into the clinic. Under the terms of our previously disclosed definitive licensing agreement with Novo Nordisk A/S ("Novo Nordisk"), we retained the right to advance the E1-I.N.T.™ program into Phase II. During the second quarter, we received FDA approval to move E1-I.N.T.™, a short course combination therapy aimed at stimulating the regeneration of the body's insulin-producing cells, into an exploratory Phase IIa clinical trial in patients with type I diabetes. Subsequent to the quarter end, we received approval to expand this clinical program to include type II diabetics. These clinical trials will evaluate the efficacy, safety, and tolerability of a 28-day course of daily E1-I.N.T.™ treatments with a six-month follow-up.

We continue to work closely with our partner, Novo Nordisk, to complete the pre-clinical development of our second I.N.T.™ product, GLP1-I.N.T.™, in order to advance this product into clinical trials in the future. During the quarter, our research collaborators from the University of Alberta presented data at the Canadian Diabetes Association & Canadian Society of Endocrinology and Metabolism annual conference in Quebec City, contributing to the growing library of data confirming the potential of GLP1-I.N.T.™ to treat insulin-dependent diabetics.

Our progress was not limited to our I.N.T.™ programs as we began enrolling patients, in January 2005, for a Phase II clinical trial using our MS-I.E.T. product to treat individuals with

Continued Clinical Progress (continued)

MS. We anticipate that our second I.E.T. product, HCV-I.E.T., which is currently in pre-clinical development, will enter a Phase I/II clinical trial in hepatitis C patients during the third quarter of fiscal 2005.

Strategic Transactions to Support Growth

During the quarter we announced the sale of SCT for upfront and anniversary payments totaling $3.5 million, plus royalties on sales and other income. The sale allowed us to free up resources to advance other clinical initiatives that are better aligned with our overall strategy.

Following the partnering of our I.N.T.™ program in August 2004, we committed to seeking out additional opportunities to expand our pipeline. In November 2004, we acquired a 17% interest in ENI, a developer of a series of compounds that have been shown, in animal models, to prevent, reduce and reverse the symptoms and underlying disease pathology associated with Alzheimer's disease. We have the opportunity to increase our interest in ENI to 52%, allowing us greater participation in any future success, through stock conversion at the option of certain ENI shareholders and in consideration for Transition's provision of management services. This acquisition complements Transition's focus on diseases with large potential markets as Alzheimer's disease is the 4th leading cause of death among U.S. adults, affecting 4 million Americans and 15 million individuals worldwide. The ENI acquisition also met our development criteria, with the lead compound, AZD-103, being in later stage pre-clinical development.

Outlook

Although very pleased with the progress we have made to date, we are very focused on maintaining our high level of achievement. In the second half of the year we intend to continue advancing clinical development for each of our key programs, which will ultimately support our ability to conclude additional partnerships. Partnering our I.E.T. program remains a priority as we anticipate moving a second indication into the clinic. Finally, as clinical development of each program advances, we will continue to seek out opportunities to expand our pipeline with new and innovative technologies.

I would like to thank all our stakeholders for their continued support and I look forward to sharing our progress with you next quarter.

Dr. Tony Cruz
Chairman and CEO
Transition Therapeutics Inc.

MANAGEMENT'S DISCUSSION AND ANALYSIS

The following information should be read in conjunction with the Company's unaudited interim financial statements included herein as well as the audited consolidated financial statements for the year ended June 30, 2004 and the related notes, which are prepared in accordance with Canadian generally accepted accounting principles. This Management's Discussion and Analysis ("**MD&A**") provides a review of the performance of the Company for the three-month and six-month periods ended December 31, 2004 as compared to the three-month and six-month periods ended December 31, 2003. This review was performed by management with information available as of February 4, 2005.

Where "we", "us", "our", "Transition" or the "Company" is used, it is referring to Transition Therapeutics Inc. and its wholly-owned subsidiaries, unless otherwise indicated. All amounts are in Canadian dollars, unless otherwise indicated.

Additional information relating to the Company, including the Company's most recently filed Annual Information Form, can be found on SEDAR at www.sedar.com.

FORWARD-LOOKING STATEMENTS

To the extent any statements made in this MD&A contain information that is not historical, these statements are forward-looking statements. Forward-looking statements are identified by words such as "expect", "believe", "intend", "anticipate", "will", "may", or other similar expressions. These forward-looking statements by their nature are not guarantees of the Company's future performance and involve risks and uncertainties that could cause the actual results to differ materially from those discussed in, or implied by, these forward-looking statements. The Company considers the assumptions on which these forward-looking statements are based to be reasonable at the time this MD&A was prepared, but cautions the reader that these assumptions may ultimately prove to be incorrect due to certain risks and uncertainties including, but not limited to, the difficulty of predicting regulatory approvals, acceptance and demand for new pharmaceutical products, the impact of competitive products and pricing, the Company's ability to finance, manufacture and commercialize its products, the protection of intellectual property and any other similar or related risks and uncertainties. The Company disclaims any intention or obligation to update or revise any forward-looking statement, whether as a result of new information, future events or otherwise. Given these uncertainties, the reader should not place undue reliance on these forward-looking statements.

OVERVIEW

Transition is a product-focused biopharmaceutical company, developing novel therapeutics for disease indications with large markets. The Company has two lead technologies, Islet Neogenesis Therapy ("**I.N.T.™**") for the treatment of diabetes and Interferon Enhancing Therapy ("**I.E.T.**") for the treatment of multiple sclerosis ("**MS**") and hepatitis C. These technologies have resulted in four lead products: E1-I.N.T.™ and GLP1-I.N.T.™ for the treatment of diabetes, MS-I.E.T. for the treatment of MS and HCV-I.E.T. for the treatment of hepatitis C. In addition to these lead products, Transition also has an interest in Ellipsis Neurotherapeutics Inc. ("**ENI**"), a company that is developing a series of compounds that have been shown, in animal models, to prevent, reduce and reverse the symptoms and underlying disease pathology associated with Alzheimer's disease.

General Risk Factors for the Biotechnology Industry

Prospects for companies in the biopharmaceutical industry generally may be regarded as uncertain given the nature of the industry and, accordingly, investments in such companies should be regarded as highly speculative. It is not possible to predict, based upon studies in animals and early clinical data, whether a new therapeutic or device will prove to be safe and effective in humans or whether it will ultimately receive regulatory approval. In addition, there is also no assurance that adequate funds or relationships required to continue product development, such as those with employees, collaborators, or other third parties, will be available and sustained.

General Risk Factors for the Biotechnology Industry (continued)

If a product is ultimately approved for sale, there is also no assurance that it will ever result in significant revenues or profitable operations. There are many factors such as competition, patent protection and the regulatory environment that can influence a product's profitability potential.

In addition, due to the speculative nature of this industry, market prices for securities of biotechnology companies may be highly volatile and subject to significant fluctuation and may not necessarily be related to the operating or other performances of such companies.

Recent Achievements

During the six-month period ended December 31, 2004 and up-to the date of this MD&A, the Company achieved the following significant milestones:

- Signed a definitive licensing agreement with Novo Nordisk A/S ("**Novo Nordisk**") for the I.N.T.™ technology including an equity investment of CDN $6 million, upfront and development milestones potentially totaling up to U.S. $48 million as well as commercial milestones and royalty payments;
- Received clearance to initiate exploratory Phase IIa clinical trials to evaluate efficacy, safety and tolerability for E1-I.N.T.™ in patients with both type I and type II diabetes;
- Commenced enrolment for a Phase II clinical trial for MS-I.E.T. in patients with MS;
- Initiated clinical development of HCV-I.E.T., indicated for the treatment of hepatitis C;
- Acquired a 17% interest in ENI, a company developing therapeutics for Alzheimer's disease; and
- Sold its wholly-owned subsidiary, Stem Cell Therapeutics Inc. ("**SCT**"), for upfront and anniversary payments totaling $3.5 million, plus royalties on sales and other income.

The Company's cash and cash equivalents were $21,959,317 at December 31, 2004, and the net working capital position was $24,760,004. In addition to the cash on hand, at December 31, 2004, the Company also had $3,137,039 receivable from its transfer agent for warrants that were exercised in December 2004 but for which the transfer agent had not transferred the funds received from investors to the Company until early January 2005. The Company currently believes that it has adequate financial resources for anticipated expenditures for the next three years.

PROGRAMS

Transition is focused on developing innovative therapies in several distinct areas of opportunity. Transition's vision is to build a company that has a strong foundation for growth based on multiple technologies and product opportunities, which reduces risk and enhances return. The Company's two lead technologies are described below.

I.N.T.™ for Diabetes

General

Transition has developed a patented diabetes therapy, which offers a new paradigm in the treatment of insulin-dependent diabetes through the regeneration of insulin producing cells in the body. It is estimated that there are currently more than 4 million people in the U.S. alone that suffer from insulin-dependent diabetes. Transition is currently actively developing two I.N.T.™ products in partnership with Novo Nordisk, E1-I.N.T.™ and GLP1-I.N.T.™.

Licensing Agreement

In August 2004, the Company signed a licensing agreement (the "**Licensing Agreement**") with Novo Nordisk for the I.N.T.™ technology. Under the terms of the Licensing Agreement, Novo Nordisk received exclusive worldwide rights to the Company's I.N.T.™ technology, except for I.N.T.™ for transplantation. In exchange for this license, Novo Nordisk agreed to make upfront and milestone payments which, assuming all development milestones are achieved, will total U.S. $48 million, an equity investment in the Company of $6 million, commercial milestone payments and royalty payments on future net sales and to also assume all future costs for the development of the licensed I.N.T.™ technology.

To date, under the Licensing Agreement, in addition to a $6 million equity investment, the Company has received a total of $1,968,580 (U.S. $1,500,000) which has been recorded as deferred revenue and will be recorded as licensing fee revenue over the term of the Licensing Agreement, which has been estimated as 15 years.

In addition, under the terms of an agreement between the Company and the General Hospital Corporation ("**GHC**"), the Company paid to GHC sub-licensing fees of $132,400 (U.S. $100,000), in respect of certain payments received under the Licensing Agreement. These sub-licensing fees have been recorded as deferred charges and will be recorded as research and development expense over the term of the Licensing Agreement.

E1-I.N.T.™

E1-I.N.T.™, a combination of Transition's epidermal growth factor analogue ("**E1**") and gastrin analogue ("**G1**"), has completed two Phase I clinical trials, in which it was shown that E1-I.N.T.™ is safe to administer. Transition has received clearance from the United States Food and Drug Administration ("**FDA**") to initiate exploratory Phase IIa clinical trials for E1-I.N.T.™ in both type I and type II diabetics. These two clinical trials will be evaluating efficacy, safety, and tolerability of a 28-day course of daily E1-I.N.T.™ treatments with a six-month follow-up.

GLP1-I.N.T.™

GLP1-I.N.T.™, a combination of one of the leading diabetes drug candidates, Glucagon-Like-Peptide-1 ("**GLP-1**"), with G1, is currently in pre-clinical development in partnership with Novo Nordisk.

Expenditures for the I.N.T.™ Program

During the three-month and six-month periods ended December 31, 2004, the Company incurred direct research and development costs for this program as follows:

	Three-month period ended December 31, 2004[1]	Six-month period ended December 31, 2004[1]
Clinical studies	$114,171	$166,387
Manufacturing	$250,507	$362,803
Pre-clinical toxicity studies	$0	$124,221
Other direct research	$86,621	$110,188
TOTAL	**$451,299**	**$763,599**

Note:
[1] These costs are direct research costs only and do not include patent costs, investment tax credits, salaries and benefits or an allocation of Company overhead.

I.E.T. for MS and Hepatitis C

MS

MS is a complex and unpredictable progressive disease of the central nervous system that can severely debilitate sufferers by attacking the myelin sheath that surrounds nerve fibres, disrupting the flow of messages from the brain and affecting motor function. MS typically afflicts people aged 20 to 40 and more often women than men. It is estimated that 2.5 million people worldwide suffer from MS.

Interferon-ß products are one of the primary therapeutic options for the treatment of MS and are used to slow disease progression and palliate symptoms. However, these treatments are not effective in all patients, may have limited duration of benefit and possess a side effect profile that reduces utility. To enhance the efficacy of interferon-ß alone, the Company has developed MS-I.E.T., a combination of the Company's EMZ701 and interferon-ß. The Company has completed a Phase I clinical trial for EMZ701 and has commenced enrolment in a Phase II clinical trial for MS-I.E.T. in patients with MS.

Hepatitis C

Transition has expanded its I.E.T. technology to include a second product, HCV-I.E.T, which is the combination of interferon- , ribavirin and Transition's EMZ702. Transition is currently preparing to commence a Phase I/II clinical trial for HCV-I.E.T. in patients with hepatitis C.

Expenditures for the I.E.T. Program

During the three-month and six-month periods ended December 31, 2004, the Company incurred direct research and development costs for this program as follows:

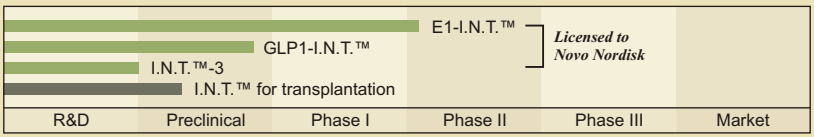
	Three-month period ended December 31, 2004[1]	Six-month period ended December 31, 2004[1]
Clinical studies	$89,144	$125,004
Manufacturing	$39,694	$106,399
Pre-clinical toxicity studies	$0	$0
Other direct research	$0	$28,696
TOTAL	**$128,838**	**$260,099**

Note:
[1] These costs are direct research costs only and do not include patent costs, investment tax credits, salaries and benefits or an allocation of Company overhead.

The Next Steps

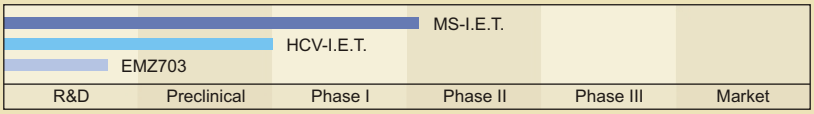
Transition's goal for each of the above programs is to achieve product approval and ultimately significant revenues or royalties. To achieve product approval, the Company must successfully complete clinical trials and achieve regulatory approval. The stage of development of the Company's two lead programs, is as illustrated below:

Islet Neogenesis Therapy (I.N.T.™) for Diabetes



The Next Steps (continued)

Interferon Enhancing Therapy (I.E.T.)



Transition has received clearance from the FDA to initiate clinical trials for E1-I.N.T.™ in patients with both type I and type II diabetes to evaluate efficacy, safety, and tolerability.

Transition will fund development of these trials until Novo Nordisk takes over the program, at its option, at which point Novo Nordisk has agreed to retroactively reimburse the Company for costs incurred. The Company is currently completing pre-clinical efficacy and toxicity studies for GLP1-I.N.T.™, in partnership with Novo Nordisk.

In terms of I.E.T., the Company has commenced enrolling MS patients in a Phase II clinical trial for MS-I.E.T. The Company is expecting to initiate a Phase I/II clinical trial for HCV-I.E.T. in hepatitis C patients in the third quarter of fiscal 2005. The I.E.T. products are now well positioned for partnering and the Company is currently pursuing partnership discussions.

OVERALL PERFORMANCE

During the first and second quarters of fiscal 2005, the Company continued to advance its lead products through the clinic. The sale of SCT, which occurred in the second quarter, has allowed Transition to free up resources to advance other clinical initiatives that are more in line with the Company's overall strategy. The acquisition of an interest in ENI, which also occurred during the second quarter, has given Transition an interest in a strong technology and will also allow Transition to capitalize on its strong management team by earning ENI common shares through the achievement of milestones.

Transition also strengthened its cash position through the completion of a $6 million private placement and the exercise of warrants. The Company's cash and cash equivalents were $21,959,317 at December 31, 2004 and the Company also had $3,137,039 receivable from its transfer agent for warrants that were exercised in December 2004 but for which the transfer agent had not transferred the funds received from investors to the Company until early January 2005. The Company currently believes that it has adequate financial resources for anticipated expenditures for the next three years.

The Company's loss for the three-month period ended December 31, 2004 increased by $1,085,915 or 42% over the same period in fiscal 2004 and the Company's loss for the six-month period ended December 31, 2004 increased by $1,336,430 or 27% over the same period in fiscal 2004. These increases primarily resulted from an increase in research and development expenses due to expenditures to support the clinical development of the Company's I.E.T. and I.N.T.™ technologies; an increase in general and administrative expenses surrounding accounting, legal and regulatory costs; and a decrease in recovery of future income taxes, partially offset by an increase in interest income. In upcoming periods, the Company's losses are expected to increase primarily as a result of clinical expenditures as the Company continues clinical development of its products; and the depletion of the Company's future tax liability.

FOR THE THREE-MONTH AND SIX-MONTH PERIODS ENDED DECEMBER 31, 2004

Results of Operations

For the three-month period ended December 31, 2004, the Company recorded a net loss of $3,660,041 ($0.03 per common and Class B share) compared to a net loss of $2,574,126 ($0.03 per common and Class B share) for the three-month period ended December 31, 2003. For the six-month period ended December 31, 2004, the Company recorded a net loss of $6,203,482 ($0.06 per common and Class B share) compared to a net loss of $4,867,052 ($0.06 per common and Class B share) for the six-month period ended December 31, 2003. These increases were primarily due to an increase in research and development and general and administrative expenses and a decrease in recovery of future income taxes, partially offset by an increase in interest income.

Licensing Fees

Licensing fees increased to $32,811 for the three-month period ended December 31, 2004 from $nil for the three-month period ended December 31, 2003. For the six-month period ended December 31, 2004, licensing fees increased to $43,748 from $nil for the same period in fiscal 2004. Licensing fees represent the recognition of revenue from the Licensing Agreement with Novo Nordisk, as described under the above heading, “Licensing Agreement”. Based on the current recognition term of 15 years, licensing fees are expected to be approximately $33,000 per quarter.

Research and Development

Research and development expenses increased to $1,155,817 for the three-month period ended December 31, 2004 from $676,944 for the three-month period ended December 31, 2003. For the six-month period ended December 31, 2004, research and development expenses increased to $1,914,669 from $1,100,377 for the same period in fiscal 2004. These increases were primarily the result of the following: an increase in clinical trial consulting, manufacturing and formulation expenses relating to the Company's I.E.T. and I.N.T.™ technologies; changes in the Company's product development team; expenses relating to the development of the Company's HCV-I.E.T. product; and the expensing of options. The Company anticipates that research and development expenses will increase during the third quarter of fiscal 2005, as it enrolls patients in the MS-I.E.T. Phase II clinical trial, prepares to initiate enrolment in clinical trials for E1-I.N.T.™ in patients with both type I and type II diabetes, initiates a clinical trial for HCV-I.E.T. and continues to strengthen its product development team.

General and Administrative

General and administrative expenses increased to $788,863 for the three-month period ended December 31, 2004 from $575,982 for the three-month period ended December 31, 2003. For the six-month period ended December 31, 2004, general and administrative expenses increased to $1,389,807 from $939,925 for the same period in fiscal 2004. These increases primarily resulted from an increase in accounting and legal fees, insurance costs and regulatory fees as well as the expensing of options. The Company anticipates that general and administrative expenses will remain consistent for the third quarter of fiscal 2005.

Amortization

Amortization for the three-month period ended December 31, 2004, was $2,016,722 as compared to $2,156,927 for the three-month period ended December 31, 2003. For the six-month period ended December 31, 2004, amortization was $4,174,301 as compared to $4,319,716 for the same period in fiscal 2004. The decreases in amortization primarily

Amortization (continued)

resulted from the cessation of amortization on the SCT technology as a result of the contractual transfer of SCT.

Recovery of Income Taxes - Future

Recovery of income taxes - future for the three-month period ended December 31, 2004, was $232,776 as compared to $702,139 for the three-month period ended December 31, 2003. For the six-month period ended December 31, 2004, recovery of income taxes - future was $1,094,335 as compared to $1,311,724 for the same period in fiscal 2004. The decreases in recovery of income taxes - future primarily resulted from the fact that the Company's future tax liability derived from the acquisition of Waratah Pharmaceuticals Inc. ("**Waratah**"), in January 2002, has been reduced to zero as Waratah now has sufficient future tax assets to offset the liability.

Interest Income

Interest income for the three-month period ended December 31, 2004, was $138,925 as compared to $52,296 for the three-month period ended December 31, 2003. For the six-month period ended December 31, 2004, interest income was $243,430 as compared to $96,752 for the same period in fiscal 2004. This increase in interest income primarily resulted from higher cash balances. Due to the exercise of share purchase warrants and Agents' Warrant (as well as the underlying share purchase warrants), which have resulted in gross proceeds during the six-month period ended December 31, 2004 of $4,054,933 (of which $3,137,039 was in receivable from transfer agent at December 31, 2004), interest income is expected to increase during the third quarter of fiscal 2005.

Capital Expenditures

During the three-month period ended December 31, 2004, the Company's capital expenditures were $101,247, as compared to $2,106 for the three-month period ended December 31, 2003. During the six-month period ended December 31, 2004, the Company's capital expenditures were $103,666, as compared to $6,241 for the six-month period ended December 31, 2003. The expenditures during the first half of fiscal 2005 were primarily for lab equipment and computer equipment. The Company does not presently anticipate any material increase in capital expenditures during the third quarter of fiscal 2005.

Transfer of SCT

On October 4, 2004, the Company signed an agreement to sell one of its wholly-owned subsidiaries, SCT, whose only significant asset is technology. SCT is developing a series of regenerative therapies for the treatment of neurological diseases including stroke and Parkinson's disease. The agreement includes an upfront cash payment of $325,000, anniversary payments totaling $3.175 million, that may be settled in either cash or shares at the option of the purchaser, and royalties on sales and other income.

This transaction has not been recorded as a sale for accounting purposes as the risks and rewards of the ownership of SCT have not been transferred to the purchaser under the terms of the share purchase agreement. In addition, the Company does not anticipate that the transaction will qualify for sale accounting within the next twelve months. Therefore, the Company has not reclassified the assets and liabilities of SCT as held for sale as at December 31, 2004, but has reclassified the assets and liabilities as transferred under a contractual arrangement. The upfront payment received of $325,000, net of disposition costs, has been recorded against the assets transferred. In the future, if circumstances change such that a transfer of the risks and rewards to the purchaser is expected within the next twelve months, the Company will reclassify SCT's assets and liabilities as held for sale at that time.

Transfer of SCT (continued)

The financial results of SCT were consolidated with the financial results of the Company until SCT was transferred on October 4, 2004. For the period of October 4, 2004 to December 31, 2004, the losses incurred by SCT of $57,849 were recorded as losses of company transferred under contractual arrangement with the corresponding amount reducing assets transferred under contractual arrangement.

Acquisition of Interest in ENI

Effective November 4, 2004, the Company acquired a 17% interest in ENI with the potential to increase this interest to approximately 52% through stock conversion, at the option of certain ENI shareholders, and consideration for the Company's management services. ENI is developing a series of compounds for the treatment of Alzheimer's disease.

Under the terms of the agreement, the Company received 2,400,000 ENI common shares, in exchange for i) 884,956 common shares of the Company (the "**Acquired Shares**"), ii) $1,000,000 in cash, and iii) 4,000,000 exchange rights (the "**Exchange Rights**"). Each Exchange Right allows the holder to convert one ENI common share into 0.8264 common shares of the Company, until they expire on February 4, 2006.

With respect to the Acquired Shares, if at the second anniversary of the agreement, the aggregate of the total proceeds from any sale of the Acquired Shares and the fair market value of the Acquired Shares retained (at this time) by ENI is less than $1,000,000, then the Company will compensate ENI for any deficiency. As a result of this obligation, the Company has not assigned any value to the shares issued and has recorded an obligation, net of the Company's interest.

In addition, through leading the development of the ENI products, the Company will also have the potential to earn up to 1,600,000 ENI common shares, over the next 24 months, through the achievement of milestones. The fair value of any ENI common shares earned will be recorded as revenue at the time the milestone is achieved.

SUMMARY OF QUARTERLY RESULTS

The following table is a summary of selected quarterly consolidated financial information of the Company for each of the eight most recently completed quarters ending at December 31, 2004.

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
2005				
Revenue	$10,937	$32,811		
Net loss [1]	$2,543,441	$3,660,041		
Basic and fully diluted net loss per Common Share and Class B Share	$0.02	$0.03		
2004				
Revenue	$-	$-	$-	$-
Net loss [1]	$2,292,926	$2,574,126	$2,985,493	$2,706,956
Basic and fully diluted net loss per Common Share and Class B Share	$0.03	$0.03	$0.03	$0.03
2003				
Revenue			$-	$-
Net loss [1]			$3,020,981	$2,735,980
Basic and fully diluted net loss per Common Share and Class B Share			$0.05	$0.04

Note:
[1] Net loss before discontinued operations and extraordinary items was equivalent to the net loss for such periods.

SUMMARY OF QUARTERLY RESULTS (continued)

The quarterly results of Transition have remained fairly stable with fluctuation primarily the result of the clinical trials being performed by the Company, the Company's closure of the Waratah facility in Woburn, MA, amortization of the technology acquired through the acquisition of SCT, and changes in the recovery of future income taxes and the structure of the Company's management team.

CRITICAL ACCOUNTING ESTIMATES

The Company's critical accounting estimates are as described in the Company's annual MD&A, which can be found on SEDAR at www.sedar.com.

CHANGES AND ADOPTIONS OF ACCOUNTING POLICIES

Other than the following, the Company has not adopted any new accounting policies during the six-month period ended December 31, 2004.

Stock-Based Compensation

In November 2003, the Canadian Institute of Chartered Accountants ("**CICA**") amended CICA Handbook Section 3870, "Stock-Based Compensation and Other Stock-Based Payments", to require the expensing of all stock-based compensation awards for fiscal years beginning on or after January 1, 2004. Effective July 1, 2004, the Company adopted the recommendations of the amended CICA Handbook Section 3870, which will result in the fair value method of accounting being used for all stock-based compensation. The standard has been applied on a retroactive basis. The consolidated statements of loss and deficit for the three-month and six-month periods ended December 31, 2003 have not been restated. During the six-month period ended December 31, 2004, the cumulative impact of stock-based compensation for the fiscal years ended June 30, 2004 and 2003 was recognized in the consolidated financial statements as an adjustment to opening deficit. The impact of the adoption was a one-time increase to deficit of $45,180, to stock options of $39,755 and to common shares of $5,425.

In the six-month period ended December 31, 2004, the effect of the adoption of the fair value method of stock-based compensation expense was an increase to general and administrative expenses of $150,978 and an increase to research and development expense of $88,766, with the corresponding total included as an increase to stock options. In the three-month period ended December 31, 2004, the effect of the adoption of the fair value method of stock-based compensation expense was an increase to general and administrative expense of $123,682 and an increase to research and development expense of $75,118 with the corresponding total included as an increase to stock options.

Compensation expense is recognized for stock options based on the fair value of the options at the grant date. The fair value of the options is recognized over the vesting period of the options as general and administrative expense or research and development expense, with the corresponding amount included in equity as stock options.

The fair value of stock options is estimated at the grant date using the Black-Scholes option pricing model. This model requires the input of a number of assumptions, including expected dividend yields, expected stock price volatility, expected time until exercise and risk-free interest rates. Although the assumptions used reflect management's best estimates, they involve inherent uncertainties based on conditions outside of the Company's control. If other assumptions are used, stock-based compensation could be significantly impacted.

The stock option balance is reduced as the options are exercised or when the stock options expire unexercised. If the stock options are exercised, the amount initially recorded for the

Stock-Based Compensation (continued)

options in stock options is credited to common shares, along with the proceeds received on the exercise. If the stock options expire unexercised, the amount initially recorded for the options in stock options is credited to contributed surplus.

Variable Interest Entities

Accounting Guideline 15 - Consolidation of variable interest entities ("**VIEs**") is to be applied to annual and interim periods beginning on or after November 1, 2004. The Company is currently analyzing the SCT and ENI transactions to determine whether or not these entities are VIEs.

LIQUIDITY AND CAPITAL RESOURCES

Overview

The Company commenced operations in July 1998, and has devoted its resources primarily to fund its research and development programs. All revenue to date has been generated from interest income on surplus funds, the sale of reagents and licensing fees. The Company has incurred a cumulative deficit to December 31, 2004 of $38,466,464. Losses are expected to continue for the next several years as the Company invests in research and development, pre-clinical studies, clinical trials, manufacturing and regulatory compliance.

Since inception, the Company has been financed primarily from public and private sales of equity, the exercise of warrants and stock options and interest earned on cash deposits and short-term investments.

The Company's cash and cash equivalents and the Company's working capital position were $21,959,317 and $24,760,004, respectively, at December 31, 2004, up significantly from June 30, 2004 balances of $17,641,155 and $17,818,393, respectively. The increase is primarily the net result of the Novo Nordisk equity investment completed in August 2004 and the proceeds received from warrant and option exercises, partially offset by expenditures incurred during the six-month period ended December 31, 2004 and the cash investment made in ENI. In addition to the cash on hand, at December 31, 2004, the Company also had $3,137,039 receivable from its transfer agent for warrants that were exercised in December 2004 but for which the transfer agent had not transferred the funds received from investors to the Company until early January 2005. The Company currently believes that it has adequate financial resources for anticipated expenditures for the next three years.

The success of the Company is dependent on its ability to bring its products to market, obtain the necessary regulatory approvals and achieve future profitable operations. The continuation of the research and development activities and the commercialization of its products are dependent on the Company's ability to successfully complete these activities and to obtain adequate financing through a combination of financing activities and operations. It is not possible to predict either the outcome of future research and development programs or the Company's ability to fund these programs going forward.

Financing Activities

During the six-month period ended December 31, 2004, the Company sold 5,000,000 common shares, through a private placement to Novo Nordisk to raise gross proceeds of $6 million. It also issued 7,628,288 common shares for total cash proceeds of $4,194,776 (of which $3,137,039 was in receivable from transfer agent at December 31, 2004) through the exercise of 5,337,289 share purchase warrants, 1,431,800 Agents' Warrants (including the exercise of the underlying share purchase warrants) and 143,300 stock options.

OUTSTANDING SHARE DATA

Authorized

The authorized share capital of the Company consists of an unlimited number of common shares.

Issued and Outstanding

The following details the issued and outstanding equity securities of the Company:

Common Shares

As at February 4, 2005, the Company has 120,035,979 common shares outstanding.

Share Purchase Warrants

The following is a summary of the share purchase warrants outstanding as at February 4, 2005:

Issue Date	Expiry Date	Number Outstanding (#)	Exercise Price ($)
May 23, 2003	May 23, 2005	25,000	0.32
June 4, 2003	June 4, 2005	35,098	0.32
February 24, 2004	February 24, 2006	1,384,615	1.00
TOTAL		**1,444,713**	

Each share purchase warrant entitles the holder, upon exercise and full payment of the exercise price, to acquire one common share of the Company until they expire at the dates indicated above. At February 4, 2005, on an if-converted basis, these share purchase warrants would result in the issuance of 1,444,713 common shares for aggregate proceeds of $1,403,846.

Stock Options

As at February 4, 2005, the Company has 4,025,662 stock options outstanding (on an after exchanged basis for Waratah options) with exercise prices ranging from $0.28 to $3.30 and expiry dates ranging from September 19, 2005 to January 7, 2010. At February 4, 2005, on an if-converted basis, these stock options would result in the issuance of 4,025,662 common shares at an aggregate exercise price of $4,828,900.

Exchange Rights

As at February 4, 2005, the Company has 4,000,000 Exchange Rights outstanding. Each Exchange Right entitles the holder, upon exercise, to exchange one common share of ENI for 0.8264 of a common share of the Company. These Exchange Rights expire on February 4, 2006.

RISKS AND UNCERTAINTIES

The Company's risks and uncertainties are as described in the Company's annual MD&A, which can be found on SEDAR at www.sedar.com.

TO THE SHAREHOLDERS OF TRANSITION THERAPEUTICS INC.

The consolidated balance sheet of Transition Therapeutics Inc. as at December 31, 2004 and the consolidated statements of loss and deficit and cash flows for the period then ended have not been reviewed by the Company's auditors, Ernst & Young LLP. These financial statements are the responsibility of management and have been reviewed and approved by the Company's Audit Committee.

CONSOLIDATED BALANCE SHEETS
(Unaudited)

	December 31, 2004 $	June 30, 2004 $
ASSETS		
Current		
Cash and cash equivalents [*note 5*]	**21,959,317**	17,641,155
Receivable from transfer agent	**3,137,039**	116,000
Investment tax credits receivable	**453,289**	511,821
Other receivables	**254,211**	154,126
Research inventory	**1,310,921**	559,378
Prepaid expenses and other assets	**202,301**	119,325
Future tax asset	**46,011**	106,277
Total current assets	**27,363,089**	19,208,082
Long-term deposits	**129,636**	143,850
Long-term research inventory	**214,078**	-
Deferred charges [*note 4*]	**129,456**	-
Capital assets, net	**485,141**	440,783
Technology [*note 3*]	**16,304,156**	22,436,674
Investment [*note 8*]	**2,267,039**	-
Assets transferred under contractual arrangement [*note 7*]	**1,676,855**	-
	48,569,450	42,229,389
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Accounts payable and accrued liabilities	**2,569,694**	1,366,983
Current portion of leasehold inducement	**13,768**	3,698
Current portion of obligation under capital leases	**19,623**	19,008
Total current liabilities	**2,603,085**	1,389,689
Leasehold inducement	**-**	17,880
Obligation under capital leases	**57,465**	67,356
Provision for facility closure	**69,394**	225,982
Deferred revenue [*note 4*]	**1,924,832**	920,580
Future tax liability	**-**	1,154,601
Liability to ENI subject to guaranteed share value obligation [*note 8*]	**820,900**	-
Liabilities transferred under contractual arrangement [*note 7*]	**34,539**	-
Total liabilities	**5,510,215**	3,776,088
Commitments [*note 12*]		
Guarantees [*note 14*]		
Shareholders' equity		
Share capital		
Common shares [*note 9[b]*]	**77,223,701**	66,001,437
Contributed surplus	**2,768,967**	2,646,643
Stock options [*note 9[d]*]	**646,997**	566,997
Warrants [*note 9[c]*]	**498,034**	1,456,026
Exchange Rights [*note 9[e]*]	**388,000**	-
Deficit	**(38,466,464)**	(32,217,802)
Total shareholders' equity	**43,059,235**	38,453,301
	48,569,450	42,229,389

See accompanying notes

CONSOLIDATED STATEMENTS OF LOSS AND DEFICIT
(Unaudited)

	Six-month period ended December 31, 2004 $	Six-month period ended December 31, 2003 $	Three-month period ended December 31, 2004 $	Three-month period ended December 31, 2003 $
REVENUES				
Licensing fees	**43,748**	-	**32,811**	-
EXPENSES				
Research and development, net of investment tax credits [*note 6*]	**1,914,669**	1,100,377	**1,155,817**	676,944
General and administrative	**1,389,807**	939,925	**788,863**	575,982
Amortization	**4,174,301**	4,319,716	**2,016,722**	2,156,927
Foreign exchange loss (gain)	**10,216**	(30,572)	**7,149**	(27,374)
	7,488,993	6,329,446	**3,968,551**	3,382,479
Loss before the following	**(7,445,245)**	(6,329,446)	**(3,935,740)**	(3,382,479)
Interest income, net	**243,430**	96,752	**138,925**	52,296
Equity loss in affiliate [*note 8*]	**(38,153)**	-	**(38,153)**	-
Losses of company transferred under contractual arrangement [*note 7*]	**(57,849)**	-	**(57,849)**	-
Loss before income taxes	**(7,297,817)**	(6,232,694)	**(3,892,817)**	(3,330,183)
Recovery of (provision for) income taxes				
Current	**-**	53,918	**-**	53,918
Future	**1,094,335**	1,311,724	**232,776**	702,139
Net loss for the period	**(6,203,482)**	(4,867,052)	**(3,660,041)**	(2,574,126)
Deficit, beginning of period, as originally stated	**(32,217,802)**	(21,658,301)	**(34,806,423)**	(23,951,227)
Adjustment for change in accounting policy related to stock-based compensation [*note 2*]	**(45,180)**	-	**-**	-
Deficit, beginning of period, as restated	**(32,262,982)**	(21,658,301)	**(34,806,423)**	(23,951,227)
Deficit, end of period	**(38,466,464)**	(26,525,353)	**(38,466,464)**	(26,525,353)
Basic and fully diluted net loss per common and Class B share [*note 9[b][ii]*]	**$(0.06)**	$(0.06)	**$(0.03)**	$(0.03)

See accompanying notes

CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Six-month period ended December 31, 2004 $	Six-month period ended December 31, 2003 $	Three-month period ended December 31, 2004 $	Three-month period ended December 31, 2003 $
OPERATING ACTIVITIES				
Net loss for the period	**(6,203,482)**	(4,867,052)	**(3,660,041)**	(2,574,126)
Add (deduct) items not involving cash				
Amortization	**4,202,219**	4,348,453	**2,032,962**	2,182,385
Amortization of leasehold inducement	**(7,810)**	(1,848)	**(6,885)**	(924)
Write-off of research inventory	**46,626**	-	**46,626**	-
Recovery of income taxes - future	**(1,094,335)**	(1,311,724)	**(232,776)**	(702,139)
Stock-based compensation expense [*note 2*]	**239,744**	-	**198,800**	-
Equity loss in affiliate [*note 8*]	**38,153**	-	**38,153**	-
Losses of company transferred under contractual arrangement [*note 7*]	**57,849**	-	**57,849**	-
	(2,721,036)	(1,832,171)	**(1,525,312)**	(1,094,804)
Net change in non-cash working capital balances related to operations [*note 10*]	**(2,188,236)**	236,446	**(2,700,868)**	424,619
Cash used in operating activities	**(4,909,272)**	(1,595,725)	**(4,226,180)**	(670,185)
INVESTING ACTIVITIES				
Investment in ENI [*note 8*]	**(1,096,292)**	-	**(1,096,292)**	-
Purchase of capital assets	**(103,666)**	(6,241)	**(101,247)**	(2,106)
Net cash received from contractual arrangement [*note 7*]	**254,996**	-	**254,996**	-
Cash used in investing activities	**(944,962)**	(6,241)	**(942,543)**	(2,106)
FINANCING ACTIVITIES				
Repayment of obligation under capital leases	**(9,276)**	(15,869)	**(8,517)**	(8,771)
Proceeds from issuance of common shares, net [*note 9[b]*]	**10,181,672**	474,325	**3,769,646**	-
Cash provided by (used in) financing activities	**10,172,396**	458,456	**3,761,129**	(8,771)
Net increase (decrease) in cash and cash equivalents during the period [*note 11*]	**4,318,162**	(1,143,510)	**(1,407,594)**	(681,062)
Cash and cash equivalents, beginning of period	**17,641,155**	6,857,576	**23,366,911**	6,395,128
Cash and cash equivalents, end of period	**21,959,317**	5,714,066	**21,959,317**	5,714,066

See accompanying notes

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. NATURE OF OPERATIONS AND BASIS OF PRESENTATION

Transition Therapeutics Inc. [the "Company"] is a biopharmaceutical company, incorporated on July 6, 1998 under the Business Corporations Act (Ontario). The Company is a product-focused biopharmaceutical company developing therapeutics for disease indications with large markets. The Company's lead technologies are focused on the treatment of diabetes, multiple sclerosis and hepatitis C.

The success of the Company is dependent on bringing its products to market, obtaining the necessary regulatory approvals and achieving future profitable operations. The continuation of the research and development activities and the commercialization of its products are dependent on the Company's ability to successfully complete these activities and to obtain adequate financing through a combination of financing activities and operations. It is not possible to predict either the outcome of future research and development programs or the Company's ability to fund these programs going forward.

These consolidated financial statements include the accounts of the Company's wholly-owned subsidiaries, Transition Therapeutics Leaseholds Inc., and Waratah Pharmaceuticals Inc. [“Waratah”], and Waratah’s wholly-owned subsidiary, Waratah Pharmaceuticals Corporation. In addition, as further described in note 8, these consolidated financial statements also include the accounts of Stem Cell Therapeutics Inc. [“SCT”] until it was transferred under a contractual arrangement on October 4, 2004.

The unaudited interim consolidated financial statements do not conform in all respects to the requirements of Canadian generally accepted accounting principles for annual financial statements. Accordingly, these unaudited interim consolidated financial statements should be read in conjunction with the June 30, 2004 annual audited consolidated financial statements.

These interim consolidated financial statements have been prepared using the same accounting policies used in the annual audited consolidated financial statements for the year ended June 30, 2004, except for the accounting policy discussed in note 2.

2. CHANGE IN ACCOUNTING POLICY

Stock-based compensation plans

In November 2003, the Canadian Institute of Chartered Accountants [“CICA”] amended CICA Handbook Section 3870, “Stock-Based Compensation and Other Stock-Based Payments”, to require the expensing of all stock-based compensation awards for fiscal years beginning on or after January 1, 2004. Effective July 1, 2004, the Company adopted the recommendations of the amended CICA Handbook Section 3870, which will result in the fair value method of accounting being used for all stock-based compensation. The standard has been applied on a retroactive basis. The consolidated statements of loss and deficit for the six-month and three-month periods ended December 31, 2003 have not been restated. During the six-month period ended December 31, 2004, the cumulative impact of stock-based compensation for the fiscal years ended June 30, 2004 and 2003 was recognized in the consolidated financial statements as an adjustment to opening deficit. The impact of the adoption was a one-time increase to deficit of $45,180, to stock options of $39,755 and to common shares of $5,425.

In the six-month period ended December 31, 2004, the effect of the adoption of the fair value method of stock-based compensation expense was an increase to general and administrative expense of $150,978 and an increase to research and development, net, of $88,766 with the

Stock-based compensation plans (continued)

corresponding total included as an increase to stock options. In the three-month period ended December 31, 2004, the effect of the adoption of the fair value method of stock-based compensation expense was an increase to general and administrative expense of $123,682 and an increase to research and development, net, of $75,118 with the corresponding total included as an increase to stock options.

Compensation expense is recognized for stock options based on the fair value of the options at the grant date. The fair value of the options is recognized over the vesting period of the options as general and administrative expense or research and development, net, with the corresponding amount included in equity as stock options.

The fair value of stock options is estimated at the grant date using the Black-Scholes option pricing model. This model requires the input of a number of assumptions, including expected dividend yields, expected stock price volatility, expected time until exercise and risk-free interest rates. Although the assumptions used reflect management's best estimates, they involve inherent uncertainties based on conditions outside of the Company's control. If other assumptions are used, stock-based compensation could be significantly impacted.

The stock option balance is reduced as the options are exercised or when the options expire unexercised. If the stock options are exercised, the amount initially recorded for the options in stock options is credited to common shares, along with the proceeds received on the exercise. If the options expire unexercised, the amount initially recorded for the options in stock options is credited to contributed surplus.

The fair value of the options at the date of grant, for options granted during the six-month period ended December 31, 2004, was estimated using the Black-Scholes option pricing model based on the following assumptions: expected option life between 2 to 4 years [six-month period ended December 31, 2003 - 2 to 4 years], volatility of between 0.918 and 1.217 [six-month period ended December 31, 2003 - 1.152 to 1.157], a risk-free interest rate of between 1.9% and 2.85% [six-month period ended December 31, 2003 - 1.75% to 2.75%] and a dividend yield of 0% [six-month period ended December 31, 2003 - 0%]. The weighted average grant date fair value of options granted during the six-month period ended December 31, 2004 was $0.89 [six-month period ended December 31, 2003 - $0.20].

If the fair value method of accounting for stock-based compensation had been applied to the Company's results prior to the adoption of the fair value method effective July 1, 2004, the Company's pro-forma net loss and basic and fully diluted net loss per common and Class B share would have been as follows:

	Six-month period ended December 31, 2003 $	Three-month period ended December 31, 2003 $
Net loss		
As reported	4,867,052	2,574,126
Pro-forma	4,887,235	2,593,559
Basic and fully diluted net loss per common and Class B share		
As reported	$0.06	$0.03
Pro-forma	$0.06	$0.03

3. TECHNOLOGY

Technology consists of the following:

	December 31, 2004		
	Cost $	Accumulated amortization $	Net book value $
Acquired on acquisition of Waratah	**39,799,917**	**23,548,282**	**16,251,635**
Acquired from Biogenesys, Inc.	**137,000**	**84,479**	**52,521**
	39,936,917	**23,632,761**	**16,304,156**

	June 30, 2004		
	Cost $	Accumulated amortization $	Net book value $
Acquired on acquisition of Waratah	39,799,917	19,568,292	20,231,625
Acquired from Biogenesys, Inc.	137,000	70,779	66,221
Acquired on acquisition of SCT	3,055,560	916,732	2,138,828
	42,992,477	20,555,803	22,436,674

The amortization to be taken on the technology by fiscal year is as follows:

	$
2005	8,136,604
2006	7,987,383
2007	4,323,080
	20,447,067

4. DEFERRED REVENUE AND CHARGES

In August 2004, the Company signed a licensing agreement with Novo Nordisk [the "Licensing Agreement"]. Under the terms of the Licensing Agreement, Novo Nordisk received exclusive worldwide rights to the I.N.T.™ technology, except for I.N.T.™ for transplantation. In exchange for this license, Novo Nordisk will pay to the Company upfront and milestone payments which, assuming all development milestones are achieved, will total U.S. $48 million, an equity investment in the Company of $6 million [*note 9[b][i]*] and commercial milestone payments and royalty payments on net sales. In addition, Novo Nordisk will assume all future costs for the development of the licensed I.N.T.™ technology.

The Licensing Agreement also provides for the Company to continue advancing programs that are already in clinical development, specifically E1-I.N.T.™. The Company has received clearance from the FDA to initiate clinical trials for E1-I.N.T.™, in patients with both type I and type II diabetes, to evaluate efficacy, safety and tolerability. The Company, will fund development of these trials until Novo Nordisk takes over the program, at its option, at which point Novo Nordisk will retroactively reimburse the Company for costs incurred.

To date, under the Licensing Agreement, the Company has received a total of $1,968,580 [U.S. $1,500,000] which has been recorded as deferred revenue and will be recorded as licensing fee revenue over the term of the Licensing Agreement, which has been estimated as 15 years.

In addition, under the terms of an agreement between the Company and the General Hospital

4. DEFERRED REVENUE AND CHARGES (continued)

Corporation ["GHC"], the Company paid to GHC sub-licensing fees of $132,400 [U.S. $100,000], in respect of certain payments received under the Licensing Agreement. These sub-licensing fees have been recorded as deferred charges and will be recorded as research and development, net over the term of the Licensing Agreement.

5. CASH AND CASH EQUIVALENTS

Included in cash and cash equivalents at December 31, 2004 is cash denominated in U.S. dollars of U.S. $355,918 [June 30, 2004 - U.S. $26,078].

6. INVESTMENT TAX CREDITS

For the six-month period ended December 31, 2004, $90,000 [six-month period ended December 31, 2003 - $40,000] and for the three-month period ended December 31, 2004, $20,000 [three-month period ended December 31, 2003 - $10,000] was recorded in research and development, net of investment tax credits for investment tax credits.

7. TRANSFER OF SCT

On October 4, 2004, the Company signed an agreement to sell one of its wholly-owned subsidiaries, SCT, whose only significant asset is technology. SCT is developing a series of regenerative therapies for the treatment of neurological diseases including stroke and Parkinson's disease. The agreement includes an upfront cash payment of $325,000, anniversary payments totaling $3.175 million, that may be settled in either cash or shares at the option of the purchaser, and royalties on sales and other income.

This transaction has not been recorded as a sale for accounting purposes as the risks and rewards of the ownership of SCT have not been transferred to the purchaser under the terms of the share purchase agreement. In addition, the Company does not anticipate that the transaction will qualify for sale accounting within the next twelve months. Therefore, the Company has not reclassified the assets and liabilities of SCT as held for sale as at December 31, 2004, but has reclassified the assets and liabilities as transferred under a contractual arrangement. The upfront payment received of $325,000, net of disposition costs, has been recorded against the assets transferred. In the future, if circumstances change such that a transfer of the risks and rewards to the purchaser is expected within the next twelve months, the Company will reclassify SCT's assets and liabilities as held for sale at that time.

The financial results of SCT were consolidated with the financial results of the Company until SCT was transferred on October 4, 2004. For the period of October 4, 2004 to December 31, 2004, the losses incurred by SCT of $57,849 were recorded as losses of company transferred under contractual arrangement with the corresponding amount reducing assets transferred under contractual arrangement.

8. INVESTMENT

The investment consists of the following:

	December 31, 2004 $	June 30, 2004 $
Investment in Ellipsis Neurotherapeutics Inc., on equity basis	**2,267,039**	-

8. INVESTMENT (continued)

Effective November 4, 2004, the Company acquired a 17% interest in Ellipsis Neurotherapeutics Inc. ["ENI"] with the potential to increase this interest to approximately 52% through stock conversion at the option of certain ENI shareholders and consideration for the Company's management services. ENI is developing a series of compounds for the treatment of Alzheimer's disease.

Under the terms of the agreement, the Company received 2,400,000 ENI common shares, in exchange for i] 884,956 common shares of the Company [the "Acquired Shares"], ii] $1,000,000 in cash, and iii] 4,000,000 exchange rights [the "Exchange Rights"]. Each Exchange Right allows the holder to convert one ENI common share into 0.8264 common shares of the Company, until they expire on February 4, 2006.

With respect to the Acquired Shares, if at the second anniversary of the agreement, the aggregate of the total proceeds from any sale of the Acquired Shares and the fair market value of the Acquired Shares retained (at this time) by ENI is less than $1,000,000, then the Company will compensate ENI for any deficiency. As a result of this obligation the Company has not assigned any value to the shares issued and has recorded an obligation, net of the Company's interest.

In addition, through leading the development of the ENI products, the Company will also have the potential to earn up to 1,600,000 ENI common shares, over the next 24 months, through the achievement of milestones. The fair value of any ENI common shares earned will be recorded as revenue at the time the milestone is achieved.

The investment in ENI is accounted for using the equity method. Total consideration paid for the investment in ENI is as follows:

	$
Cash	**1,000,000**
Liability to ENI subject to guaranteed share value obligation	**820,900**
Exchange Rights [*i*]	**388,000**
Acquisition costs	**96,292**
	2,305,192

[i] The fair value of the Exchange Rights was estimated based on the fair value of the ENI common shares received.

9. SHARE CAPITAL

[a] Authorized

As at December 31, 2004, the authorized share capital of the Company consists of unlimited common shares. The common shares are voting and are entitled to dividends if, as and when declared by the Board of Directors.

Until they were removed in December 2004, the Company's authorized share capital also consisted of unlimited Class B shares which were non-voting, and convertible by the holder on a one for one basis into common shares without additional consideration. Holders of the Class B shares also did not have any right to receive dividends, but had equal priority with the holders of the common shares with respect to return of capital on liquidation, dissolution or wind-up.

[b] Issued and outstanding and changes during the period

Common shares	#	$
Balance, June 30, 2004	**106,522,735**	**66,001,437**
Retroactive adjustment for stock-based compensation [*note 2*]	**-**	**5,425**
Issued pursuant to private placement, net [*i*]	**5,000,000**	**5,986,896**
Exercise of share purchase warrants [*note 9[c][i]*]	**5,337,289**	**3,724,306**
Exercise of Agents' Warrants [*note 9[c][ii]*]	**2,147,699**	**1,288,619**
Exercise of stock options [*note 9[d][i]*]	**143,300**	**217,018**
Shares issued to ENI [*note 8*]	**884,956**	**-**
Balance, December 31, 2004	**120,035,979**	**77,223,701**

[i] On August 27, 2004, under the terms of the Licensing Agreement, the Company sold 5,000,000 common shares to Novo Nordisk at a purchase price of $1.20 per common share, through a private placement, for a total amount of $6,000,000. The cash proceeds from the private placement, net of expenses, were $5,986,896.

[ii] The weighted average number of common and Class B shares used in the computation of basic and fully diluted net loss per common and Class B share for the six-month period ended December 31, 2004 is 110,454,127 [six-month period ended December 31, 2003 - 80,918,298] and for the three-month period ended December 31, 2004 is 112,829,347 [three-month period ended December 31, 2003 - 81,098,070].

For the six-month period ended December 31, 2004, 749,969 [six-month period ended December 31, 2003 - 642,980] and for the three-month period ended December 31, 2004, 719,174 [three-month period ended December 31, 2003 - 602,097] contingently returnable common shares were excluded from the basic and fully diluted net loss per common and Class B share calculation. The contingently returnable common shares relate to employment contracts and will be released from escrow based on the achievement of certain corporate milestones.

[c] Share purchase warrants and Agents' Warrants

Share purchase warrants	#	$
Share purchase warrants outstanding, June 30, 2004	**6,782,002**	**1,126,712**
Exercise of share purchase warrants [*i*]	**(5,337,289)**	**(628,678)**
Share purchase warrants outstanding, December 31, 2004	**1,444,713**	**498,034**

Agents' Warrants	#	$
Agents' Warrants outstanding, June 30, 2004	**1,431,800**	**329,314**
Exercise of Agents' Warrants [*ii*]	**(1,431,800)**	**(329,314)**
Agents' Warrants outstanding, December 31, 2004	**-**	**-**
Total warrants	**1,444,713**	**498,034**

[i] Share purchase warrants totaling 5,337,289 were exercised during the six-month period ended December 31, 2004. These warrants had a recorded value of $628,678 and resulted in cash proceeds to the Company of $3,095,628.

[ii] Agents' Warrants totaling 1,431,800, as well as the underlying share purchase warrants, were exercised during the six-month period ended December 31, 2004. These warrants had a recorded value of $329,314 and resulted in cash proceeds to the Company of $959,305.

[c] Share purchase warrants and Agents' Warrants (continued)

[iii] The maximum possible cash proceeds to the Company from the exercise of the warrants outstanding as at December 31, 2004 is $1,403,846 [June 30, 2004 - $5,458,780].

[d] Stock options

Stock options	#	$
Stock options outstanding, June 30, 2004	**3,585,031**	**566,997**
Retroactive adjustment for stock-based compensation [*note 2*]	**-**	**39,755**
Stock options expired	**(246,069)**	**(122,324)**
Exercise of stock options [*i*]	**(143,300)**	**(77,175)**
Stock options issued [*note 2*]	**710,000**	**200,163**
Compensation expense for options issued in prior periods [*note 2*]	**-**	**39,581**
Stock options outstanding, December 31, 2004	**3,905,662**	**646,997**

[i] Stock options totaling 143,300 were exercised during the six-month period ended December 31, 2004. These stock options had a recorded value of $77,175 and resulted in cash proceeds to the Company of $139,843.

[ii] Of the stock options that expired during the six-month period ended December 31, 2004, 194,165 [year ended June 30, 2004 - 295,832] were included as part of the consideration for the acquisition of Waratah. Therefore, the consideration associated with these options which was $122,324 [June 30, 2004 - $184,874] was reclassified to contributed surplus.

[iii] The maximum possible cash proceeds to the Company from the exercise of the stock options outstanding as at December 31, 2004 is $4,696,900 [June 30, 2004 - $4,147,063].

[e] Exchange Rights

Exchange Rights	#	$
Exchange Rights outstanding, June 30, 2004	**-**	**-**
Exchange Rights issued [*note 8*]	**4,000,000**	**388,000**
Exchange Rights outstanding, December 31, 2004	**4,000,000**	**388,000**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

10. CONSOLIDATED STATEMENTS OF CASH FLOWS

The net change in non-cash working capital balances related to operations consists of the following:

	Six-month period ended December 31, 2004 $	Six-month period ended December 31, 2003 $	Three-month period ended December 31, 2004 $	Three-month period ended December 31, 2003 $
Receivable from transfer agent	**(3,021,039)**	-	**(3,137,039)**	-
Investment tax credit receivable	**58,532**	182,464	**98,532**	192,464
Other receivables	**(100,178)**	54,523	**(87,219)**	7,905
Research inventory	**(1,012,247)**	20,093	**(1,046,989)**	9,845
Prepaid expenses and other assets	**(82,976)**	(4,189)	**315,127**	42,609
Long-term deposits	**14,214**	8,374	**6,428**	5,759
Deferred charges	**(129,456)**	-	**2,208**	-
Accounts payable and accrued liabilities	**1,237,250**	(555,554)	**1,264,137**	(436,591)
Deferred revenue	**1,004,252**	652,400	**(32,811)**	652,400
Provision for facility closure	**(156,588)**	(121,665)	**(83,242)**	(49,772)
	(2,188,236)	236,446	**(2,700,868)**	424,619
Supplemental cash flow information				
Interest paid	**4,018**	3,288	**3,428**	329
Income tax paid	**-**	26,642	**-**	-

11. NON-CASH TRANSACTIONS

During the six-month period ended December 31, 2004, the Company entered into the following non-cash activity:

On November 4, 2004, the Company issued 884,956 common shares and 4,000,000 Exchange Rights to acquire an interest in ENI [*note 8*].

12. COMMITMENTS

As at December 31, 2004, the Company is committed to aggregate expenditures of $161,250 [June 30, 2004 - $173,252] under its collaboration agreements. In addition, at December 31, 2004, the Company is committed to aggregate expenditures of approximately $673,854 [June 30, 2004 - $151,763] for clinical and toxicity studies and approximately $661,276 [June 30, 2004 - $78,215] for manufacturing agreements.

13. SEGMENTED INFORMATION

The Company considers itself to be in one business segment, that is the research and development of therapeutic agents. Following the acquisition of Waratah, the Company's operations are conducted in Canada and the United States. Geographic segment information is as follows:

15. SEGMENTED INFORMATION (continued)

	Canada $	United States $
Net loss (income):		
Six-month period ended December 31, 2004	**6,210,530**	**(7,048)**
Six-month period ended December 31, 2003	4,880,701	(13,649)
Three-month period ended December 31, 2004	**3,635,451**	**24,590**
Three-month period ended December 31, 2003	2,609,928	(35,802)
Amortization of capital assets:		
Six-month period ended December 31, 2004	**59,308**	**-**
Six-month period ended December 31, 2003	50,845	5,475
Three-month period ended December 31, 2004	**36,117**	**-**
Three-month period ended December 31, 2003	29,628	2,190
Interest income (expense), net:		
Six-month period ended December 31, 2004	**243,430**	**-**
Six-month period ended December 31, 2003	97,096	(344)
Three-month period ended December 31, 2004	**138,925**	**-**
Three-month period ended December 31, 2003	52,296	-
Recovery of (provision for) income taxes - current:		
Six-month period ended December 31, 2004	**-**	**-**
Six-month period ended December 31, 2003	-	53,918
Three-month period ended December 31, 2004	**-**	**-**
Three-month period ended December 31, 2003	-	53,918
Recovery of (provision for) income taxes - future:		
Six-month period ended December 31, 2004	**1,154,601**	**(60,266)**
Six-month period ended December 31, 2003	1,377,974	(66,250)
Three-month period ended December 31, 2004	**260,289**	**(27,513)**
Three-month period ended December 31, 2003	732,454	(30,315)
Technology:		
December 31, 2004	**16,304,156**	**-**
June 30, 2004	22,436,674	-
Capital assets:		
December 31, 2004	**485,141**	**-**
June 30, 2004	440,783	-

14. GUARANTEES

The Company indemnifies its directors and officers against any and all claims or losses reasonably incurred in the performance of their service to the Company to the extent permitted by law. The Company has acquired and maintains liability insurance for its directors and officers.

15. COMPARATIVE CONSOLIDATED FINANCIAL STATEMENTS

The comparative consolidated financial statements have been reclassified from statements previously presented to conform to the presentation of the 2005 consolidated financial statements.

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