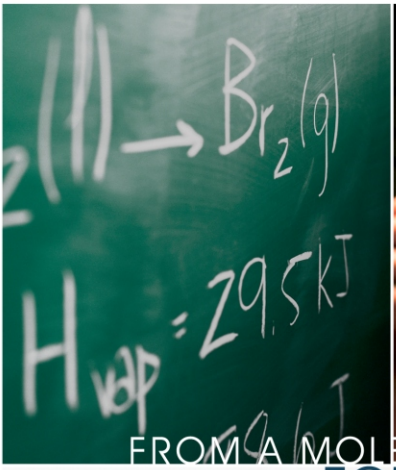
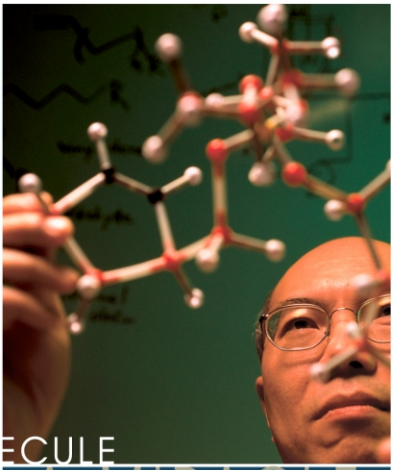
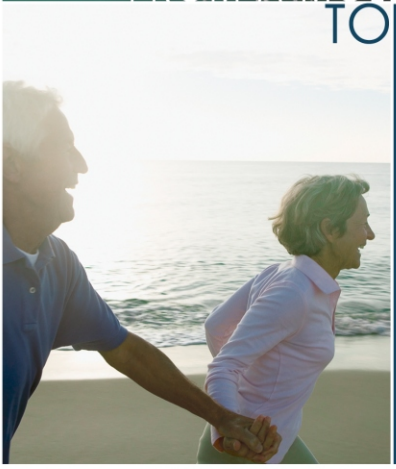




FROM A MOLECULE TO A MIRACLE

2007 Second Quarter Results



Transition therapeutics inc.

To Our Shareholders

The second quarter of fiscal 2007 is highlighted by the strengthening of our financial position through a $25 million private placement and the continued advancement of our lead clinical development programs.

In November, we announced the completion of a private placement financing raising gross proceeds of $25 million from two funds managed by Great Point Partners, LLC. These proceeds will provide Transition a solid financial foundation for the development of its lead products for the treatment of Alzheimer's disease and diabetes.

Pipeline Review

Alzheimer's Disease

Our global collaboration with Elan Pharma International Limited ("Elan") for the development and commercialization of AZD-103 for Alzheimer's disease commenced during the second quarter of fiscal 2007. Under the terms of the collaboration agreement, Transition is eligible to receive up to US$200 million in upfront and milestone payments dependant upon the successful development, regulatory approval and commercialization of AZD-103. Transition will share the costs and operating profits of AZD-103 if successfully developed and commercialized. Each party's cost share and ownership interest may vary throughout the term of the Agreement dependant on certain elections that may be made during the development of AZD-103.

We are working closely with Elan to complete a series of Phase I clinical trials in order to file for clinical regulatory clearance to commence a Phase II clinical trial in Alzheimer patients in the second half of calendar 2007.

Diabetes

The data from Transition's two exploratory Phase IIa clinical studies of its diabetes regenerative therapy, E1-I.N.T.™ for type I and type II diabetes patients are being compiled and analysed. We expect to report data from these trials in the third quarter of fiscal 2007.

The E1-I.N.T.™ program is partnered with Novo Nordisk, a world leader in diabetes care. Upon the delivery of final data from the ongoing clinical trials, Novo Nordisk shall decide whether to finalize development and commercialization of E1-I.N.T.™. Following such a decision Transition will be entitled to certain payments and reimbursement of all E1-I.N.T.™ clinical development costs since August 2004. In addition, Transition will be eligible to receive future E1-I.N.T.™ developmental milestone payments potentially totalling US$46 million plus commercial milestones and royalties on sales of E1-I.N.T.™ products.

Transition is working with the Juvenile Diabetes Research Foundation ("JDRF") in the development of the GLP1-I.N.T.™ program. Currently a series of preclinical studies are being performed to support the commencement of clinical development of the GLP1-I.N.T.™ product.

To Our Shareholders

Outlook

Looking ahead, there are many important near term milestones for these products; as we are preparing for Phase II clinical development of AZD-103, expect to report data from our exploratory Phase IIa clinical trials of diabetes product E1-I.N.T.™, and work to advance GLP1- I.N.T.™ into clinical development.

We look forward to updating the shareholders on the advancement of these important initiatives.

Dr. Tony Cruz
Chairman and CEO
Transition Therapeutics Inc.

Management's Discussion & Analysis

The following information should be read in conjunction with the Company's unaudited interim financial statements included herein as well as the revised audited consolidated financial statements for the year ended June 30, 2006 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, 2006 as compared to the three-month and six-month periods ended December 31, 2005. This review was performed by management with information available as of February 13, 2007.

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 three lead products: AZD-103 for the treatment of Alzheimer's disease, E1-I.N.T.™, and GLP1-I.N.T.™ For the treatment of diabetes. Transition also has an emerging pipeline of preclinical drug candidates developed using its proprietary drug discovery engine.

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.

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, 2006, the Company achieved the following significant milestones:

Sustaining Financial Strength:

- Completed a private placement financing issuing 26,881,720 common shares at a price of $0.93 per common share, raising gross proceeds of $25,000,000 from two funds managed by Great Point Partners, LLC. These proceeds will provide Transition a solid financial foundation for the development of its lead products for the treatment of Alzheimer's disease and diabetes.

AZD-103 Alzheimer's Disease:

- Transition and Elan Pharma International Limited ("Elan") signed a US$200 million global collaboration agreement to develop and commercialize the Alzheimer's disease product, AZD-103. Under the terms of the agreement, Transition has received an upfront payment of US$7.5 million and will receive an additional upfront payment of US$7.5 million in calendar 2007. Dependent upon the successful development, regulatory and commercial launch of AZD-103, Transition will be eligible to receive milestone payments of up to US$185 million and will share the costs of development and profits from commercialization;
- Received clearance from the United States Food and Drug Administration ("FDA") to commence Phase I clinical trials to evaluate the pharmacokinetics and safety of escalating doses of AZD-103 in healthy volunteers;
- Positive Results Released from Canadian Phase I Clinical Trial of AZD-103 showed that AZD-103 has a favourable pharmacokinetic profile and preliminary safety data indicated that AZD-103 was well tolerated and no safety concerns or significant adverse events were observed in the study.

I.N.T.™ - Diabetes:

- Transition received the remaining US$750,000 of the US$1 million relating to the amended I.N.T.™ license agreement between the Company and Novo Nordisk A/S ("Novo Nordisk") which restated the rights and responsibilities of the parties. Novo Nordisk retains exclusive, worldwide rights to the E1-I.N.T.™ program and the Company regains exclusive ownership and rights to all other I.N.T.™ programs, including GLP1-I.N.T.™;
- The Company and the Juvenile Diabetes Research Foundation International ("JDRF"), located in the United States, entered into an agreement in which the JDRF will provide milestone driven funding of up to US$4 million to assist in the expedited development of GLP1-I.N.T.™ over a two year period.

Recent Achievements (continued)

Other Financing Activities:

- Received the second anniversary payment of $400,000 from the sale of its subsidiary, Stem Cell Therapeutics Inc ("SCT").
- Extinguished the indebtedness assumed related to the November 2005 Protana asset purchase.

The Company's cash and cash equivalents and short term investments were $42,561,004 at December 31, 2006, and the net working capital position was $43,566,674. The Company now believes that it has adequate financial resources for anticipated expenditures until early fiscal 2010.

STRATEGIC COLLABORATION

In March 2006, Transition completed the acquisition of Ellipsis Neurotherapeutics Inc. ("ENI"). The key asset in the acquisition was the Alzheimer's disease compound AZD-103, a disease modifying agent with the potential to both reduce disease progression and improve symptoms including cognitive function.

In September 2006, Transition announced a global collaboration with Elan to develop and commercialize AZD-103. Under the terms of the agreement, Transition has received an upfront payment of US$7.5 million and will receive an additional upfront payment of US$7.5 million in calendar 2007. Dependent upon the successful development, regulatory and commercial launch of AZD-103, Transition will be eligible to receive milestone payments of up to US$185 million. Transition and Elan will share the costs of development and profits from commercialization. Each party's cost share and ownership interest may vary throughout the term of the Agreement dependant on certain elections that may be made during the development of AZD-103.

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 lead technologies are as follows:

AZD-103 for Alzheimer's Disease

Alzheimer's disease is a progressive brain disorder that gradually destroys a person's memory and ability to learn, reason, make judgments, communicate and carry out daily activities. As Alzheimer's disease progresses, individuals may also experience changes in personality and behavior, such as anxiety, suspiciousness or agitation, as well as delusions or hallucinations. In late stages of the disease, individuals need help with dressing, personal hygiene, eating and other basic functions. People with Alzheimer's disease die an average of eight years after first experiencing symptoms, but the duration of the disease can vary from three to 20 years.

The disease mainly affects individuals over the age 65 and it is estimated over 18 million people are suffering from Alzheimer's disease worldwide. The likelihood of developing late-onset Alzheimer's

approximately doubles every five years after age 65. By age 85, the risk reaches nearly 50 percent. In the U.S., Alzheimer's disease is the fourth leading cause of death and current direct/indirect costs of caring for an estimated 4.5 million Alzheimer's disease patients are at least US$100 billion annually.

Current FDA approved Alzheimer's disease medications may temporarily delay memory decline for some individuals, but none of the currently approved drugs is known to stop the underlying degeneration of brain cells. Certain drugs approved to treat other illnesses may sometimes help with the emotional and behavioral symptoms of Alzheimer's disease. With an aging population, there is a great need for disease-modifying compounds that can slow or reverse disease progression.

In March 2006, the Company announced the acquisition of all the remaining outstanding shares of Alzheimer's focused ENI that the Company did not already own. The key asset in the acquisition is the Alzheimer's disease compound AZD-103, a disease modifying agent with the potential to both prevent and reduce disease progression, and improve symptoms such as cognitive function.

In April 2006, the Company received clearance from the Therapeutic Products Directorate of Health Canada to commence a Phase I clinical trial to evaluate the pharmacokinetics, safety and efficacy of escalating doses of AZD-103 in healthy volunteers. The study demonstrated that AZD-103 was well tolerated and no safety concerns or significant adverse events were observed in the study. In August 2006, the Company also received clearance from the FDA to commence a subsequent Phase I clinical trial evaluating higher doses of AZD-103.

In September 2006, Transition announced a global collaboration with Elan to develop and commercialize AZD-103.

Expenditures for the AZD-103 Program

During the three-month and six-month periods ended December 31, 2006, the Company incurred direct research and development costs for this program as follows:

	Three-month period ended December 31, 2006[(1)] $	**Six-month period ended December 31, 2006[(1)] $**
Pre-clinical studies	238,867	447,159
Clinical studies	800,307	991,725
Manufacturing	464,050	904,519
Other direct research	110,402	123,865
TOTAL	**1,609,626**	**2,467,268**

[(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 costs are presented as gross amounts, prior to the reimbursement of development costs from Elan which have been netted against R&D expense ($977,275 for the three-month period ended December 31, 2006 and $1,346,932 for the six-month period ended December 31, 2006).

I.N.T.™ for Diabetes

General

Insulin-dependent diabetes is a chronic, life-long disease that results when the pancreas produces no or too little insulin to properly regulate blood sugar levels. Insulin-dependent diabetics become dependent on administered insulin for survival. It has been estimated by the American Diabetes Association that there are approximately 4 to 5 million Americans suffering from this disease.

Transition has developed a patented diabetes therapy, which offers a new paradigm in the treatment of insulin-dependent diabetes. Transition's Islet Neogenesis Therapy is based on the discovery that a short course of naturally occurring peptides can regenerate insulin-producing cells in the body. Transition is currently actively developing two I.N.T.™ products, E1-I.N.T.™ and GLP1-I.N.T.™. Transition is compiling and analyzing the data from its Phase IIa clinical trials for E1-I.N.T.™ in both type I and type II diabetics.

Licensing Agreement

In August 2004, the Company signed a licensing agreement (the "**Licensing Agreement**") with Novo Nordisk to develop I.N.T.™ for the treatment of diabetes. 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 up-front and milestone payments which, assuming all development milestones are achieved, will total US$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 costs for the development of the licensed GLP1-I.N.T.™ technology.

On July 17, 2006, the Company and Novo Nordisk amended the Licensing Agreement to restate the rights and responsibilities of the parties. Novo Nordisk retains exclusive, worldwide rights to the E1-I.N.T.™ program and the Company regains exclusive ownership and rights to all other I.N.T.™ programs, including GLP1-I.N.T.™. Novo Nordisk has in association with the execution of the amendment, paid the Company $552,650 [US$500,000] for the achievement of the first developmental milestone, which has been recognized as milestone revenue in the three-month period ended September 30, 2006. Additionally, the Company has received from Novo Nordisk $570,300 [US$500,000] in research and development funding in calendar 2006, of which the final payment of $279,050 [US$250,000] was received during the three-month period ended September 30, 2006.

The other financial terms of the amended agreement remain the same, where the Company will receive future E1-I.N.T.™ developmental milestone payments potentially totaling US$46 million plus commercial milestones and royalties on sales of E1-I.N.T.™ products.

The Company is currently advancing the clinical development of E1-I.N.T.™ for type I and type II diabetes. Upon the delivery of final data from the ongoing clinical trials, Novo Nordisk shall decide whether to finalize development and commercialization of E1-I.N.T.™. Following such an affirmative decision, the Company will be entitled to additional milestone payments and reimbursement of all E1-I.N.T.™ clinical development costs since August 2004.

To date, under the Licensing Agreement, the Company received $1,968,580 [US$1,500,000] in up-front payments that have been recorded as deferred revenue and are being recorded as licensing fee revenue over the term of the Licensing Agreement, which has been estimated as 15 years. Licensing fee revenue of $32,811 was recognized during the three-month period ended December 31, 2006 [three-month period ended December 31, 2005 - $32,811] and $65,622 for the six-month period ended December 31, 2006 [six-month period ended December 31, 2005 - $65,622]

In addition, the Company has received $1,191,025 [US$1,000,000] from Novo Nordisk in research and development funding as of December 31, 2006. Under the terms of the initial agreement, $385,671 [US$317,130] was spent on a joint research project in fiscals 2005 and 2006. As a result of the July 17, 2006 amendment to the Agreement, the Company has applied $703,300 [US$595,300] against patent costs incurred prior to the date of amendment as well as research and development costs incurred to date. The remaining $102,054 [US$87,570] will be applied against research and development costs incurred in the third quarter of fiscal 2007 and accordingly, have been classified as current deferred revenue at December 31, 2006.

E1-I.N.T.™

Transition's first Islet Neogenesis Therapy product, 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 FDA clearance to initiate exploratory Phase IIa clinical trials for E1-I.N.T.™ in both type I and type II diabetics.

Transition is compiling and analyzing the data from these two clinical trials which are evaluating efficacy, safety and tolerability of a 28-day course of daily E1-I.N.T.™ treatments with a six-month follow-up. During fiscal 2006 the Company announced blinded safety and efficacy data from the ongoing exploratory Phase IIa clinical study of E1-I.N.T.™ for type I diabetes patients. Preliminary data from three of the first four type I diabetes patients completing the 4 week treatment period showed a reduction in daytime insulin usage by 35-75% and a favorable safety profile when the therapy was titrated to maximal doses.

The data from Transition's two exploratory Phase IIa clinical studies of its diabetes regenerative therapy, E1-I.N.T.™ for type I and type II diabetes patients are being compiled and analysed. We expect to report data from these trials in the third quarter of fiscal 2007.

GLP1-I.N.T.™

Transition's second Islet Neogenesis Therapy product, 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. The Company has entered into an agreement with the JDRF to support the clinical development of GLP1-I.N.T.™ over the next two years.

Expenditures for the I.N.T.™ Program

During the three-month and six-month periods ended December 31, 2006, the Company incurred direct research and development costs for this program as follows:

Expenditures for the I.N.T.™ Program (continued)

	Three-month period ended December 31, 2006[1] $	Six-month period ended December 31, 2006[1] $
Pre-clinical studies	123,061	297,061
Clinical studies	180,953	431,900
Manufacturing	140,290	190,855
Other direct research	57,440	86,784
TOTAL	**501,744**	**1,006,600**

[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 costs are presented as gross amounts, prior to the reimbursement of development costs from Novo Nordisk and the JDRF which have been netted against R&D expense ($467,669 for the three-month period ended December 31, 2006 and $734,915 for the six-month period ended December 31, 2006).

HCV-I.E.T. for Hepatitis C

Hepatitis C is a progressive disease of the liver caused by the hepatitis C virus. Currently, it is estimated there are about 170 million people worldwide who are infected with the hepatitis C virus, and 4 million of those are in the United States. Up to 80% of individuals infected with the virus are symptom-free initially, as the infection is typically mild in its early stages. As a result, diagnosis does not usually take place until liver damage has already occurred. Long-term effects of chronic hepatitis C infection include cirrhosis, liver failure and liver cancer. Current treatments for hepatitis C, including combination therapies, can eliminate the virus in approximately 55% of cases.

HCV-I.E.T. combines Transition's interferon enhancer, EMZ702, with the current standard of care for hepatitis C, a combination therapy of interferon-α and ribavirin. The combination of EMZ702 with interferon-α and ribavirin in surrogate models for hepatitis C has demonstrated a two to three fold increase in anti-viral potency compared to interferon-α and ribavirin alone.

In July 2005, Transition commenced enrolment for a Phase I/II clinical trial for HCV-I.E.T. in hepatitis C patients. The clinical trial was designed to evaluate HCV-I.E.T.'s ability to produce a positive therapeutic response in patients who have failed to respond to previous treatment with interferon-α and ribavirin. This population of hepatitis C patients currently has no treatment alternatives and is estimated to represent nearly 45% of all hepatitis C patients. In the trial, hepatitis C patients who have not responded to a pegylated interferon and ribavirin product, receive twice-weekly treatments of EMZ702 administered along with the same pegylated interferon and ribavirin product for 12 weeks.

In August 2006, the Company announced data from a Phase I/II clinical trial of HCV-IET in hepatitis C non responders. In the study, 6 of 21 (28%) of the hepatitis C non-responder patients that completed 12 weeks of treatment had a greater than 99% reduction of virus levels. Our next steps in the development of the product will be to seek a partner to perform a larger study to identify the optimal dosing regimen for this therapy.

Expenditures for the I.E.T. Program

During the three-month and six-month periods ended December 31, 2006, the Company incurred direct research and development costs for this program as follows:

	Three-month period ended December 31, 2006[1] $	Six-month period ended December 31, 2006[1] $
Clinical studies	163,931	190,115
Manufacturing	15,608	64,041
Other direct research	7,297	14,134
TOTAL	**186,836**	**268,290**

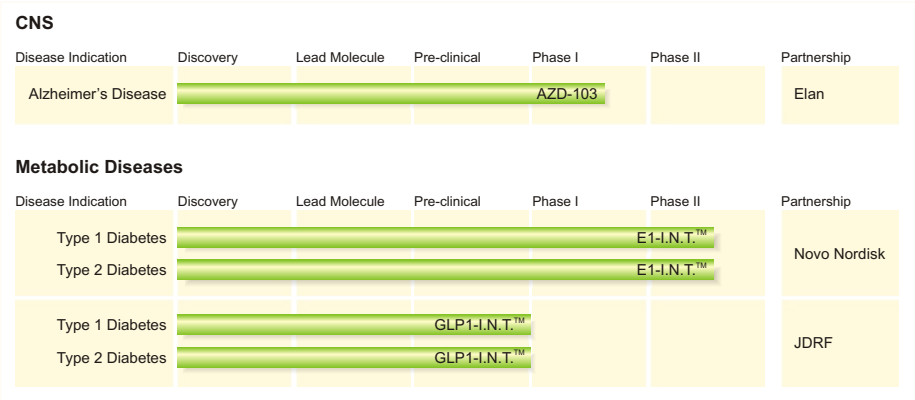
[1] These costs are direct research costs only and do not include, patent costs, investment tax credits, salaries and benefits or an allocation of Company overhead.

Drug Discovery Initiatives

Transition has prioritized its drug discovery activities to accelerate the identification and optimization of novel lead molecules. The Company is pursuing a number of discovery programs to advance novel lead molecules into pre-clinical development.

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 stages of development of the Company's technologies are illustrated below:



FOR THE THREE-MONTH AND SIX-MONTH PERIODS ENDED DECEMBER 31, 2006

Results of Operations

For the three-month period ended December 31, 2006, the Company recorded a net loss of $4,965,881 ($0.03 per common share) compared to a net loss of $5,307,972 ($0.04 per common share) for the three-month period ended December 31, 2005. The decrease in net loss of $342,091 or 6% is due to a reduction in R&D expense resulting from research expense reimbursements from Novo Nordisk and the JDRF, and an increase in interest income due to increased cash balances. The decrease in net loss was partially offset by the full quarter amortization impact of the technology, patents, and workforce resulting from the purchase of certain assets of Protana and amortization expense relating to the technology, products, and patents acquired from ENI, and an increase in general and administrative expense.

For the six-month period ended December 31, 2006, the Company recorded a net loss of $6,832,636 ($0.04 per common share) compared to a net loss of $9,630,260 ($0.08 per common share) for the six-month period ended December 31, 2005. This decrease in net loss of $2,797,624 or 29% is due to the recognition of future income tax assets resulting from the amalgamation of Ellipsis Neurotherapeutics Inc., 1255205 Ontario Inc., 1255206 Ontario Inc. and Waratah Pharmaceuticals Inc, and changes in temporary tax differences of the Company, resulting in a future income tax recovery of $2,729,422. Additionally, the decrease in net loss can also be attributed to the milestone revenue relating to the amended Novo Nordisk agreement, the gain recognized on net assets transferred under contractual obligation, and an increase in interest income due to increased cash balances. The decrease in net loss was partially offset by an increase in general and administrative expense and amortization expense relating to the acquisitions of ENI and Protana.

Research and Development

Research and development expenses decreased to $1,788,488 for the three-month period ended December 31, 2006 from $2,337,439 for the three-month period ended December 31, 2005. For the six-month period ended December 31, 2006, research and development expenses decreased to $3,419,508 from $3,817,133 for the same period in fiscal 2005. These decreases were primarily the result of decreases in clinical program expenses relating to the Company's I.E.T. And I.N.T.™ clinical trials, the reimbursement by Elan for a portion of the AZD-103 development costs incurred, a decrease in patent expenses, as well as the reimbursement of E1-I.N.T.™ development costs resulting from the amended Novo Nordisk agreement and the reimbursement by JDRF for a portion of the GLP1-I.N.T.™ development costs incurred.

The Company anticipates that research and development expenses will increase during the third quarter of fiscal 2007 as the Company will incur net development costs relating to advancing AZD-103 through Phase I, clinical development costs associated with advancing GLP1-I.N.T.™ into Phase I trials, and costs relating to the drug discovery platform.

General and Administrative

General and administrative expenses increased to $1,051,963 for the three-month period ended December 31, 2006 from $754,431 for the three-month period ended December 31, 2005. For the six-month period ended December 31, 2006, general and administrative expenses increased to $2,081,356 from $1,446,744 for the same period in fiscal 2005. The increase is due to transaction costs associated

with the Elan co-development agreement, expenses relating to the amalgamation of various subsidiaries, increased option expenses and an increase in salaries and associated recruiting fees incurred to strengthen the finance and management teams.

The Company anticipates that general and administrative expenses will decrease in the third quarter of fiscal 2007.

Amortization

Amortization for the three-month period ended December 31, 2006, was $2,465,726 as compared to $2,189,652 for the three-month period ended December 31, 2005. For the six-month period ended December 31, 2006, amortization was $5,434,033 as compared to $4,199,983 for the same period in fiscal 2005. The increase in amortization primarily resulted from amortization expense relating to the technology, products, and patents acquired from ENI and technology, patents, and workforce resulting from the purchase of certain assets of Protana.

The Company anticipates that amortization expense will decrease significantly as the Waratah technology will be fully amortized in the third quarter of fiscal 2007 and commencing in the second quarter of fiscal 2007, the ENI technology, products and patents are being amortized over 15 years.

Recovery of Future Income taxes

Recovery of future income taxes remained unchanged from Nil for the three-month periods ended December 31, 2006 and 2005. For the six-month period ended December 31, 2006, recovery of future income taxes was $2,729,422 as compared to Nil for the same period in fiscal 2005.

The majority of the increase in recovery of future income taxes is due to the recognition of future income tax assets resulting from the amalgamation of Ellipsis Neurotherapeutics Inc., 1255205 Ontario Inc., 1255206 Ontario Inc. and Waratah Pharmaceuticals Inc. As a result of the amalgamation, the Company has adjusted the valuation allowance on future income tax assets and has recognized a future income tax asset to the extent of offsetting future income tax liabilities of the amalgamated entity. Additional future income tax recovery also arose from changes in temporary differences.

The Company does not expect to record a future income tax recovery in the third quarter of fiscal 2007 as the future tax liability has been eliminated and the Company only recognizes future income tax assets to the extent they offset the future income tax liability or there is reasonable assurance that the future income tax assets will be realized.

Interest Income, net

Interest income for the three-month period ended December 31, 2006, was $344,423 as compared to $86,692 for the three-month period ended December 31, 2005. For the six-month period ended December 31, 2006, interest income was $455,664 as compared to $180,476 for the same period in fiscal 2005. These increases primarily resulted from increased cash balances due to the November 2006 private placement and the upfront payment received from Elan. Interest income is expected to decrease slightly in the third quarter of fiscal 2007 as cash balances are reduced for normal course operating expenditures.

Capital Expenditures

During the three-month period ended December 31, 2006, the Company's capital expenditures were $22,377 as compared to a reversal of $17,471 for the same period ended December 31, 2005 resulting from a negotiated reduction in leasehold improvement costs at the Company's new office facilities. During the six-month period ended December 31, 2006, the Company's capital expenditures were $31,541, as compared to $85,120 for the six-month period ended December 31, 2005. The expenditures during the first half of fiscal 2007 were primarily for leasehold improvements and computer equipment and software. The Company does not presently anticipate any significant increase in capital expenditures during the third quarter of fiscal 2007.

SCT ANNIVERSARY PAYMENT

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 and 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 was not recorded as a sale for accounting purposes as the risks and rewards of the ownership of SCT did not transfer to the purchaser under the terms of the share purchase agreement. Therefore, the Company classified the assets and liabilities of SCT as assets transferred under a contractual arrangement. Using the cost recovery method, the carrying value of the assets transferred under contractual arrangement have been reduced by [i] proceeds upon receipt, [ii] losses of SCT and [iii] amortization of the technology, resulting in a carrying value at June 30, 2006 of nil.

During the three month period ending September 30, 2006, the Company received the second anniversary payment of $400,000 in cash which has been recorded as a gain in the consolidated statement of loss. Total payments received to date amount to $1,200,000 with $2,300,000 in anniversary payments remaining to be paid over the next two fiscal years.

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, 2006.

	First Quarter $	Second Quarter $	Third Quarter $	Fourth Quarter $
2007				
Revenue	585,461	32,811		
Net loss	1,866,755 (Revised)	4,965,881		
Basic and diluted net loss per common share	0.01	0.03		
2006				
Revenue	114,901	190,651	32,811	32,811
Net loss [1]	4,322,288	5,307,972	6,536,992	6,850,838 (Revised)
Basic and diluted net loss per common share	0.04	0.04	0.05	0.04
2005				
Revenue			32,811	32,811
Net loss [1]			3,504,427	4,515,199
Basic and diluted net loss per common share			0.03	0.04

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

With the exception of the first quarter fiscal 2007, the quarterly results of Transition have remained fairly stable with fluctuations primarily the result of changes in activity levels of the clinical trials being performed by the Company, losses of company transferred under contractual arrangement (SCT), recognition of equity losses relating to ENI, changes in the recovery of future income taxes, expensing of stock options and the strengthening of the Company's management team. The results for the first quarter fiscal 2007 are not representative of historical or expected near term earnings as the net loss was significantly positively impacted by the recovery of future income taxes resulting from the amalgamation of several Transition subsidiary companies.

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

The Company has not adopted any new accounting policies during the six-month period ended December 31, 2006.

RECENT ACCOUNTING PRONOUNCEMENTS

The Canadian Institute of Chartered Accountants has issued a number of pronouncements that will affect the Company's financial reporting in fiscal 2007 and beyond. The Company is currently evaluating the implications of these pronouncements on its financial reporting. These pronouncements include:

Section 3855 Financial Instruments – Recognition and Measurement

This section establishes standards for recognizing and measuring financial assets, financial liabilities and non-financial derivatives based on specified criteria.

Section 3861 Financial Instruments – Disclosure and Presentation

This section establishes standards for presentation of financial instruments and non-financial derivatives, and identifies the information that should be disclosed about them. The presentation paragraphs deal with classification matters while the disclosure paragraphs deal with information about factors that affect the amount, timing and certainty of an entity's future cash flows relating to financial instruments and their business purposes and risks.

DISCLOSURE CONTROLS AND PROCEDURES AND INTERNAL CONTROLS

As at December 31, 2006, Transition's management evaluated the effectiveness of the design and operation of its disclosure controls. Based on their evaluation, the Chief Executive Officer and the Chief Financial Officer have concluded that Transition's disclosure controls and procedures are effective.

There have been no significant changes in Transition's internal control over financial reporting during the six-month period ended December 31, 2006, that have materially affected, or are reasonably likely to materially affect Transition's internal control over financial reporting.

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, milestone and licensing fees, management fees relating to ENI and a gain from the net assets of SCT transferred under contractual arrangement. The Company has incurred a cumulative deficit to December 31, 2006 of $76,336,816. 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, cash equivalents and short-term investments and the Company's working capital

position were $42,561,004 and $43,566,674 respectively, at December 31, 2006, increased significantly from June 30, 2006 balances of $15,005,437 and $14,286,044, respectively. The increase is the net result of the net proceeds from the November private placement in the amount of $23,964,751, the $8,420,250 (US$7,500,000) upfront payment received from Elan, the milestone payment received from Novo Nordisk in the amount of $552,650, as well as, the second anniversary payment from the sale of SCT of $400,000, partially offset by expenditures incurred during the six-month period ended December 31, 2006.

The Company now believes that it has adequate financial resources for anticipated expenditures until early fiscal 2010.

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

The Company extinguished the indebtedness assumed relating to the November 2005 Protana asset purchase through final payments disbursed in the three-month period ended September 30, 2006.

During the three-month period ended December 31, 2006 the Company closed on a private placement financing issuing 26,881,720 common shares at a price of $0.93 per common share, raising gross proceeds of $25,000,000 from two funds managed by Great Point Partners, LLC. The proceeds from the offering are planned to be used to fund Transition's clinical studies, research and product development, working capital and general corporate purposes.

Contractual Obligations

At December 31, 2006, the Company is committed to aggregate expenditures of $177,000 under its collaboration agreements. In addition, the Company is committed to aggregate expenditures of approximately $4,186,000 for clinical and toxicity studies to be completed during fiscal 2007, and approximately $1,020,000 for manufacturing agreements. However, approximately $450,000 of the clinical and toxicity studies obligation and $682,300 of the manufacturing obligation relate to Elan's share of the committed AZD-103 development cost.

OUTSTANDING SHARE DATA

Authorized

The authorized share capital of the Company consists of an unlimited number of common shares with no par value.

The common shares are voting and are entitled to dividends if, as and when declared by the Board of Directors.

Issued and Outstanding

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

Common Shares

As at February 13, 2007 the Company has 184,368,879 common shares outstanding.

Stock Options

As at February 13, 2007, the Company has 6,123,449 stock options outstanding with exercise prices ranging from $0.35 to $1.54 and expiry dates ranging from March 8, 2007 to December 11, 2011. At February 13, 2007, on an if-converted basis, these stock options would result in the issuance of 6,123,449 common shares at an aggregate exercise price of $4,402,329.

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.

Consolidated Balance Sheets

(Unaudited)

	December 31, 2006 $	June 30, 2006 $
ASSETS		**Revised**
Current		
Cash and cash equivalents	**22,687,396**	4,074,582
Short-term investments	**19,873,608**	10,930,855
Due from Elan Pharma International Limited [note 2]	**679,773**	-
Receivables	**306,016**	371,663
Investment tax credits receivable	**1,252,222**	1,176,066
Research inventory	**507,169**	587,501
Prepaid expenses and deposits	**355,756**	469,956
Assets held for sale	**25,000**	381,948
Total current assets	**45,686,940**	17,992,571
Long-term research inventory	**1,880,714**	2,638,098
Deferred charges	**111,792**	116,208
Capital assets, net	**1,327,514**	1,596,643
Intangible assets [note 3]	**16,490,044**	21,784,504
	65,497,004	44,128,024
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Accounts payable and accrued liabilities	**2,120,266**	3,396,013
Current portion of long-term debt [note 6]	**-**	292,124
Current portion of deferred revenue and advances [note 2 and 4]	**531,435**	657,541
Current portion of obligation under capital leases [note 10[b]]	**-**	18,390
Total current liabilities	**2,651,701**	4,364,068
Deferred revenue advances [note 2 and 4]	**9,951,350**	1,596,727
Obligation under capital leases [note 10[b]]	**-**	30,401
Leasehold inducement	**97,172**	102,888
Future tax liability [note 7]	**-**	2,729,422
Total liabilities	**12,700,223**	8,823,506
Commitments [note 11]		
Guarantees [note 12]		
Shareholders' equity		
Share capital		
Common shares	**123,556,331**	99,563,853
Contributed surplus	**4,487,752**	4,469,987
Stock options	**1,089,514**	774,858
Deficit	**(76,336,816)**	(69,504,180)
Total shareholders' equity	**52,796,781**	35,304,518
	65,497,004	44,128,024

See accompanying notes

On behalf of the Board:

Tony Cruz
Director

Christopher Henley
Director

Consolidated Statements of Loss

(Unaudited)

	Six-month period ended December 31, 2006 $	Six-month period ended December 31, 2005 $	Three-month period ended December 31, 2006 $	Three-month period ended December 31, 2005 $
REVENUES				
Milestone revenue [note 4]	**552,650**	-	**-**	-
Licensing fees [note 4]	**65,622**	65,622	**32,811**	32,811
Management fees from ENI	**-**	239,930	**-**	157,840
	618,272	305,552	**32,811**	190,651
EXPENSES				
Research and development [note 2 and 4]	**3,419,508**	3,817,133	**1,788,488**	2,337,439
General and administrative	**2,081,356**	1,446,744	**1,051,963**	754,431
Amortization	**5,434,033**	4,199,983	**2,465,726**	2,189,652
Foreign exchange loss (gain)	**8,483**	(64,256)	**(3,577)**	(48,367)
Loss on disposal of capital assets and assets held for sale	**41,614**	6,081	**27,515**	2,112
Write-down on short-term investments	**51,000**	-	**13,000**	-
	11,035,994	9,405,685	**5,343,115**	5,235,267
Loss before the following:	**(10,417,722)**	(9,100,133)	**(5,310,304)**	(5,044,616)
Interest income, net	**455,664**	180,476	**344,423**	86,692
Equity loss in affiliate	**-**	(345,683)	**-**	(183,315)
Gain (losses) of company transferred under contractual arrangement [note 5]	**400,000**	(364,920)	**-**	(166,733)
Loss before income taxes	**(9,562,058)**	(9,630,260)	**(4,965,881)**	(5,307,972)
Recovery of future income taxes [note 7]	**2,729,422**	-	**-**	-
Net loss for the period	**(6,832,636)**	(9,630,260)	**(4,965,881)**	(5,307,972)
Basic and diluted net loss per common share [note 8[b]]	**$(0.04)**	$(0.08)	**$(0.03)**	$(0.04)

See accompanying notes

Consolidated Statement of Shareholders' Equity

For the six-month period ended December 31, 2006 and year ended June 30, 2006
(Unaudited)

	Number of Shares	Share Capital	Contributed Surplus	Stock Options	Warrants	Exchange Rights	Total Deficit	Shareholders' Equity
Balance, July 1, 2005	120,096,077	77,254,351	2,811,966	743,628	486,615	388,800	(46,486,090)	35,198,470
Share issued for purchased assets of Protana, net	2,000,000	1,184,569	-	-	-	-	-	1,184,569
Issued pursuant to bought deal financing, net	15,575,000	9,648,600	-	-	-	-	-	9,648,600
Issued on exercise of Exchange Rights	1,239,600	1,009,437	-	-	-	(145,500)	-	863,937
Exchange Rights expired unexercised	-	-	242,500	-	-	(242,500)	-	-
Expiry of share purchase warrants	-	-	486,615	-	(486,615)	-	-	-
Issued on acquisition of ENI, net	18,985,308	10,727,317	-	-	-	-	-	10,727,317
Issued to acquire patent portfolio	414,492	286,000	-	-	-	-	-	286,000
Cancellation of shares issued to ENI	(884,956)	(559,475)	559,475	-	-	-	-	-
Stock options exercised	22,902	13,054	-	(5,038)	-	-	-	8,016
Stock options expired	-	-	369,431	(369,431)	-	-	-	-
Stock-based compensation expense	-	-	-	405,699	-	-	-	405,699
Net loss for the year	-	-	-	-	-	-	(23,018,090)	(23,018,090)
Balance, June 30, 2006 Revised	**157,448,423**	**99,563,853**	**4,469,987**	**774,858**	-	-	**(69,504,180)**	**35,304,518**
Stock options exercised [note 8[c][ii]]	**29,566**	**27,727**	**-**	**(11,192)**	-	-	-	**16,535**
Stock options expired [note 8[c][iii]]	**-**	**-**	**17,765**	**(17,765)**	-	-	-	**-**
Stock-based compensation expense	**-**	**-**	**-**	**343,613**	-	-	-	**343,613**
Issued pursuant to private placement, net [note 8[b][i]]	**26,881,720**	**23,964,751**	**-**	**-**	-	-	-	**23,964,751**
Net loss for the six-month period ended December 31, 2006	**-**	**-**	**-**	**-**	-	-	**(6,832,636)**	**(6,832,636)**
Balance, December 31, 2006	**184,359,709**	**123,556,331**	**4,487,752**	**1,089,514**	-	-	**(76,336,816)**	**52,796,781**

See accompanying notes

Consolidated Statements of Cash Flows

(Unaudited)

	Six-month period ended December 31, 2006 $	Six-month period ended December 31, 2005 $	Three-month period ended December 31, 2006 $	Three-month period ended December 31, 2005 $
OPERATING ACTIVITIES				
Net loss for the period	**(6,832,636)**	(9,630,260)	**(4,965,881)**	(5,307,972)
Add (deduct) items not involving cash:				
Amortization of:				
capital assets	**156,762**	261,790	**78,855**	235,088
intangible assets	**5,394,460**	4,106,586	**2,445,464**	2,109,740
deferred charges	**4,416**	4,416	**2,208**	2,208
leasehold inducement	**(5,716)**	-	**(2,858)**	-
Leasehold inducement	**-**	51,444	**-**	25,722
Write-off of research inventory	**-**	15,422	**-**	-
Recovery of future income taxes	**(2,729,423)**	-	**-**	-
Stock-based compensation expense	**343,613**	116,523	**173,084**	73,953
Equity loss in ENI	**-**	345,683	**-**	183,315
Losses of company transferred under contractual arrangement	**-**	364,683	**-**	166,733
Loss on disposal of capital assets and assets held for sale	**59,290**	6,081	**36,514**	2,112
Write-down on short-term investments	**51,000**	-	**13,000**	-
Management fees from ENI	**-**	(239,930)	**-**	(157,840)
Foreign exchange loss (gain)	**8,583**	(37,465)	**-**	(37,465)
	(3,549,651)	(4,634,790)	**(2,219,614)**	(2,704,406)
Net change in operating assets and liabilities [note 9]	**7,289,302**	(865,362)	**7,472,072**	136,831
Cash provided by (used in) operating activities	**3,739,651**	(5,500,152)	**5,252,458**	(2,567,575)
INVESTING ACTIVITIES				
Maturity of short-term investments	**10,810,855**	14,000,748	**-**	-
Purchase of short-term investments	**(19,804,608)**	-	**(19,804,608)**	-
Acquisition of Protana assets	**-**	(3,109,756)	**-**	(3,109,756)
Proceeds of assets held for resale	**235,223**	-	**78,589**	-
Investment in ENI	**-**	(381,062)	**-**	(381,062)
Purchase of capital assets	**(31,541)**	(85,120)	**(22,377)**	17,471
Purchase of intangible assets	**(50,000)**	-	**-**	-
Proceeds on disposal of capital assets	**32,655**	3,433	**285**	421
Cash received under contractual Arrangement [note 5]	**-**	475,000	**-**	-
Cash provided by (used in) investing activities	**(8,807,416)**	10,903,243	**(19,748,111)**	(3,472,926)

Consolidated Statements of Cash Flows (continued)

(Unaudited)

	Six-month period ended December 31, 2006 $	Six-month period ended December 31, 2005 $	Three-month period ended December 31, 2006 $	Three-month period ended December 31, 2005 $
FINANCING ACTIVITIES				
Repayment of long-term debt	**(300,707)**	(242,673)	**-**	(242,673)
Repayment of obligation under capital leases	**-**	(8,344)	**-**	(8,344)
Proceeds from issuance of common shares, net	**23,981,286**	8,016	**23,977,504**	8,016
Deferred costs paid	**-**	(62,927)	**-**	(62,927)
Cash provided by (used in) financing activities	**23,680,579**	(305,928)	**23,977,504**	(305,928)
Net increase (decreases) in cash and cash equivalents during the period	**18,612,814**	5,097,163	**9,481,851**	(6,346,429)
Cash and cash equivalents, beginning of period	**4,074,582**	6,598,221	**13,205,545**	18,041,813
Cash and cash equivalents, end of period	**22,687,396**	11,695,384	**22,687,396**	11,695,384

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 Alzheimer's disease and diabetes.

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.

Effective September 22, 2006, Ellipsis Neurotherapeutics Inc., 1255205 Ontario Inc. and 1255206 Ontario Inc. amalgamated with Waratah Pharmaceuticals Inc. As a result of the amalgamation, these consolidated financial statements include the accounts of the Company's wholly-owned subsidiaries, Transition Therapeutics Leaseholds Inc., Waratah Pharmaceuticals Inc ["Waratah"] and Waratah's wholly-owned subsidiary, Waratah Pharmaceuticals Corporation.

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 revised June 30, 2006 annual consolidated financial statements. These interim consolidated financial statements have been prepared using the same accounting principles used in the annual audited consolidated financial statements for the year ended June 30, 2006.

2. GLOBAL COLLABORATION AGREEMENT WITH ELAN PHARMA INTERNATIONAL LIMITED

On September 25, 2006, Elan Pharma International Limited (Elan) and the Company entered into an exclusive, worldwide collaboration agreement for the joint development and commercialization of the Company's novel therapeutic agent, AZD-103, for the treatment of Alzheimer's disease.

Under the terms of the agreement, the Company will receive upfront payments of US$15 million: US$7.5 million in calendar 2006 and the remaining US$7.5 million in calendar 2007. In addition, dependent upon the successful development, regulatory approval and commercialization of AZD-103, the Company will be eligible to receive milestone payments of up to US$185 million. Elan and the Company will share the costs and operating profits of AZD-103 if successfully developed and commercialized. Each party's cost share and ownership interest may vary throughout the term of the agreement dependent on certain elections that may be made during the development of AZD-103. Under the terms of the agreement the Company can elect to convert the co-development collaboration to a licensing arrangement. If converted, the Company would no longer share in the development costs and operating profits but would receive reduced developmental and commercial milestones and royalties on worldwide aggregate net sales.

Under the terms of the agreement, AZD-103 inventory on hand as of August 4, 2006 and development

costs incurred by the Company subsequent to that date will be reimbursed by Elan in accordance with their cost sharing percentage, corresponding to a receivable of $679,773 as of December 31, 2006.

During the three-month period ended December 31, 2006, the Company received the first upfront payment of $8,420,250 (US$7,500,000) from Elan which has been recorded as deferred revenue.

3. INTANGIBLE ASSETS

Intangible assets consist of the following:

	December 31, 2006		
	Cost $	Accumulated amortization $	Net book value $
Technology acquired on acquisition of Waratah Pharmaceuticals Inc. ("Waratah")	**39,799,917**	**39,468,250**	**331,667**
Technology acquired from Biogenesys, Inc.	**137,000**	**137,000**	**-**
Technology acquired from Protana	**3,459,633**	**807,250**	**2,652,383**
Technology, products and patents acquired from ENI	**14,244,423**	**1,797,366**	**12,447,057**
Workforce acquired from Protana	**623,276**	**145,430**	**477,846**
Patents acquired from Protana	**329,685**	**76,927**	**252,758**
Patent portfolio [note 10[a]]	**386,000**	**57,667**	**328,333**
	58,979,934	**42,489,890**	**16,490,044**

Intangible assets are recorded at cost and are being amortized on a straight line basis over 5 to 15 years.

	Revised June 30, 2006		
	Cost $	Accumulated amortization $	Net book value $
Technology acquired on acquisition of Waratah	**39,799,917**	**35,488,259**	**4,311,658**
Technology acquired from Biogenesys, Inc.	**137,000**	**125,579**	**11,421**
Technology acquired from Protana	**3,459,633**	**461,287**	**2,998,346**
Technology, products and patents acquired from ENI	**14,244,423**	**874,179**	**13,370,244**
Workforce acquired from Protana	**623,276**	**83,103**	**540,173**
Patents acquired from Protana	**329,685**	**43,956**	**285,729**
Patent portfolio	**286,000**	**19,067**	**266,933**
	58,879,934	**39,095,430**	**21,784,504**

The amortization to be taken on intangible assets by fiscal year is as follows:

	$
2007(balance of the year)	1,226,427
2008	1,789,522
2009	1,789,522
2010	1,789,522
2011	1,182,109
Thereafter	8,712,942
	16,490,044

4. DEFERRED REVENUE AND ADVANCES

On July 17, 2006, the Company and Novo Nordisk amended the I.N.T.™ license agreement to restate the rights and responsibilities of the parties. Novo Nordisk retains exclusive, worldwide rights to the E1-I.N.T.™ program and the Company regains exclusive ownership and rights to all other I.N.T.™ programs, including GLP1-I.N.T.™. Novo Nordisk has in association with the execution of the amendment, paid the Company $552,650 [US$500,000] for the achievement of the first developmental milestone, which has been recognized as milestone revenue in the three-month period ended September 30, 2006. Additionally, the Company has received from Novo Nordisk $570,300 [US$500,000] in research and development funding in calendar 2006, of which the final payment of $279,050 [US$250,000] was received during the three-month period ended September 30, 2006.

The other financial terms of the amended agreement remain the same, where the Company will receive future E1-I.N.T.™ developmental milestone payments potentially totalling US$46 million plus commercial milestones and royalties on sales of E1-I.N.T.™ products.

The Company is currently advancing the clinical development of E1-I.N.T.™ for type I and type II diabetes. Upon the delivery of final data from the ongoing clinical trials, Novo Nordisk shall decide whether to finalize development and commercialization of E1-I.N.T.™. Following such a decision the Company will be entitled to additional milestone payments and reimbursement of all E1-I.N.T.™ clinical development costs since August 2004.

To date, under the Licensing Agreement, the Company received $1,968,580 [US$1,500,000] in up-front payments that have been recorded as deferred revenue and are being recorded as licensing fee revenue over the term of the Licensing Agreement, which has been estimated as 15 years. Licensing fee revenue of $32,811 was recognized during the three-month period ended December 31, 2006 [three-month period ended December 31, 2005 - $32,811] and $65,622 for the six-month period ended December 31, 2006 [six-month period ended December 31, 2005 - $65,622].

In addition, the Company has received $1,191,025 [US$1,000,000] from Novo Nordisk in research and development funding as of December 31, 2006. Under the terms of the initial agreement, $385,671 [US$317,130] was spent on a joint research project in fiscals 2005 and 2006. As a result of the July 17, 2006 amendment to the Agreement, the Company has applied $703,300 [US$595,300] against patent costs incurred prior to the date of amendment and research and development costs. The remaining $102,054 [US$87,570] will be applied against research and development costs incurred in fiscal 2007 and accordingly, have been classified as current deferred revenue at December 31, 2006.

Effective September 13, 2006, the Company and the Juvenile Diabetes Research Foundation International ("JDRF") entered into an agreement in which the JDRF will provide funding to assist in the development of GLP1-I.N.T.™ over a two year period. The JDRF will contribute funding payments of up to US$4 million. During the three-month period ended December 31, 2006, the Company received a funding payment of $564,800 [US$500,000] of which $266,669 was applied against GLP1-I.N.T.™ development costs. The remaining advance of $298,131 will be applied against future development costs incurred in fiscal 2007 and accordingly has been classified as current deferred revenue and advances at December 31, 2006.

5. NET ASSETS TRANSFERRED UNDER CONTRACTUAL ARRANGEMENT

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 was not recorded as a sale for accounting purposes as the risks and rewards of the ownership of SCT did not transfer to the purchaser under the terms of the share purchase agreement. Therefore, the Company classified the assets and liabilities of SCT as assets transferred under a contractual arrangement. Using the cost recovery method, the carrying value of the assets transferred under contractual arrangement have been reduced by [i] proceeds upon receipt, [ii] losses of SCT and [iii] amortization of the technology, resulting in a carrying value at June 30, 2006 of nil.

During the three month period ending September 30, 2006, the Company received the second anniversary payment of $400,000 in cash which has been recorded as a gain in the statement of loss. As of December 31, 2006, total payments received amount to $1,200,000.

6. LONG TERM DEBT

In conjunction with the Protana asset purchase, the Company entered into an Assignment and Assumption Agreement with Oxford Finance Corporation ("Oxford") and assumed the full amount of Protana's indebtedness to Oxford in the amount of US$2,543,372 as at November 1, 2005.

The full amount of the indebtedness was secured by certain assets purchased from Protana. The Company was authorized to sell these assets and the full proceeds from the sale was applied against the outstanding principal balance of the loan, in the form of a Disposition Payment. Disposition Payments are not subject to Prepayment Fees.

Changes in the loan balance from the date of acquisition are as follows:

	$
Oxford loan payable, interest at 9.41%, payable in monthly blended payments of US $121,283, secured by specified equipment, payable in full on September 1, 2007	3,001,433
Disposition Payments	(1,682,646)
Principal repayments	(990,651)
Foreign exchange gain	(36,012)
Balance as of June 30, 2006	**292,124**
Disposition Payments	**(124,101)**
Principal repayments	**(176,606)**
Foreign exchange loss	**8,583**
Balance as of December 31, 2006	**-**

7. RECOVERY OF FUTURE INCOME TAXES

On September 22, 2006, Ellipsis Neurotherapeutics Inc. ["ENI"], 1255205 Ontario Inc. and 1255206 Ontario Inc. amalgamated with Waratah Pharmaceuticals Inc. As a result of the amalgamation, the Company has adjusted the valuation allowance on future income tax assets and has recognized a future income tax asset to the extent of offsetting future income tax liabilities of the amalgamated entity, resulting in a future income tax recovery of $2,472,168. An additional future income tax recovery of $257,254 arose from changes in temporary differences during the six-month period ended December 31, 2006, for a total recovery of $2,729,422 [six-month period ended December 31, 2005 - $Nil].

8. SHARE CAPITAL

[a] Authorized

At December 31, 2006, 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.

[b] Weighted average number of common shares outstanding during the period

[i] During the three-month period ended December 31, 2006, the Company completed a private placement financing issuing 26,881,720 common shares at a price of $0.93 per common share, raising gross proceeds of $25,000,000. The Company incurred total share issuance costs of $1,035,249 resulting in net cash proceeds of $23,964,751.

[ii] The weighted average number of common shares used in the computation of basic and diluted net loss per common share for the six-month period ended December 31, 2006 is 164,482,562 [six-month period ended December 31, 2005 - 120,760,365] and for the three-month period ended December 31, 2006 is 172,230,349 [three-month period ended December 31, 2005 - 121,425,151].

For the six and three-month period ended December 31, 2006, 719,174 contingently returnable common shares were excluded from the basic and diluted net loss per common share calculation [six and three-month period ended December 31, 2005 - 719,174]. The contingently returnable common shares relate to employment contracts and will be released from escrow based on the achievement of certain corporate milestones.

[c] Stock Options

	#	$
Stock options outstanding, June 30, 2006	**4,238,035**	**774,858**
Stock options issued [i]	**2,515,000**	**-**
Stock options exercised [ii]	**(29,566)**	**(11,192)**
Stock options expired [iii]	**(565,850)**	**(17,765)**
Stock-based compensation expense	**-**	**343,613**
Stock options outstanding, December 31, 2006	**6,157,619**	**1,089,514**

[i] The fair value of stock options granted during the three-month period ended December 31, 2006 is $156,450. The fair value of stock options granted during the six-month period ended December 31, 2006 is $1,076,650.

[ii] Stock options totaling 29,566 were exercised during the six-month period ended December 31, 2006. These stock options had a recorded value of $11,192 and resulted in cash proceeds to the Company of $16,535.

[iii] The stock options that expired during the six-month period ended December 31, 2006 had a recorded value of $17,765 and this amount was reclassified to contributed surplus when they expired.

[iv] The maximum possible cash proceeds to the Company from the exercise of the stock options outstanding at December 31, 2006 are $4,436,431 [June 30, 2006 - $3,744,775].

9. CONSOLIDATED STATEMENTS OF CASH FLOWS

The net change in operating assets and liabilities consists of the following:

	Six-month period ended December 31, 2006 $	Six-month period ended December 31, 2005 $	Three-month period ended December 31, 2006 $	Three-month period ended December 31, 2005 $
Due from Elan Pharma International Limited	(679,773)	-	283,839	-
Receivables	65,647	60,457	(256,303)	(70,475)
Investment tax credits receivable	(76,156)	(175,000)	(76,065)	(125,000)
Research inventory	837,716	326,929	107,774	135,086
Prepaid expenses and other assets	114,200	(543,464)	112,956	(253,420)
Deposits	-	6,729	-	(33)
Accounts payable and accrued liabilities	(1,200,849)	(376,575)	(1,184,699)	582,300
Deferred revenue and advances	8,228,517	(164,438)	8,484,570	(131,627)
	7,289,302	(865,362)	7,472,072	136,831
Supplemental cash flow information				
Interest paid	2,312	49,346	-	49,341

10. NON-CASH TRANSACTIONS

During the six-month period ended December 31, 2006, the Company entered into the following non-cash activities:

[a] On August 1, 2006, the Company signed an Assignment Agreement ("Agreement") for the exclusive rights to intellectual property relating to apparatus, devises and methods for screening of compound libraries using the Optimol drug discovery technology acquired from Protana in fiscal 2006. Under the terms of the Agreement, the Company paid $50,000 cash and granted

10. NON-CASH TRANSACTIONS (continued)

laboratory equipment with a fair market value of $50,000 resulting in additions to the Company's patent portfolio totaling $100,000. The laboratory equipment had a net book value of $51,418 and the assignment resulted in the recognition of a loss of $1,418.

[b] The Company terminated its obligation under capital lease and returned the office equipment to the lessor. The equipment had a cost of $99,934 and accumulated amortization of $43,425 resulting in a loss of $7,718.

11. COMMITMENTS

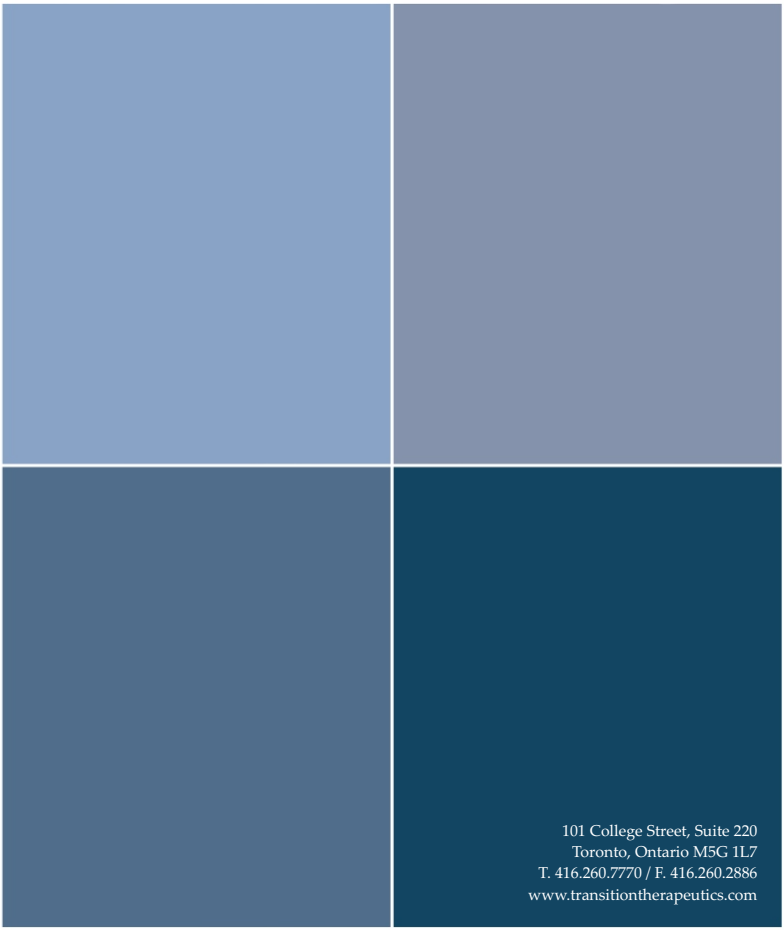
At December 31, 2006, the Company is committed to aggregate expenditures of $177,000 [June 30, 2006 - $198,000] under its collaboration agreements. In addition, at December 31, 2006, the Company is committed to aggregate expenditures of approximately $4,186,000 [June 30, 2006 - $3,440,000] for clinical and toxicity studies to be completed during fiscal 2007 and approximately $1,021,000 [June 30, 2006 – $202,000] for manufacturing agreements.

12. 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.

13. COMPARATIVE CONSOLIDATED FINANCIAL STATEMENTS

The comparative consolidated financial statements have been reclassified from financial statements previously presented to conform to the presentation of the fiscal 2007 consolidated financial statements.



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