advancing health through

life-changing therapies

2009 Second Quarter Results

Transition therapeutics inc.

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To Our Shareholders

Since our last update, we are pleased to report the completion of patient enrolment in Phase II studies of Transition's lead products for Alzheimer's disease and diabetes. The achievement of these clinical development milestones together with the Company's solid financial footing has Transition well-positioned to continue to build value through its lead products in the clinic as well as its pipeline of preclinical candidates.

PIPELINE REVIEW

ELND005 (AZD-103) – Alzheimer's Disease:

In October, we announced the achievement of the patient enrolment target for the Phase II clinical study of ELND005 (AZD-103) in patients with Alzheimer's disease. The on-going study is a randomized, double-blind, placebo-controlled, dose-ranging, safety and efficacy study in approximately 340 patients with mild to moderate Alzheimer's disease. Each patient's planned treatment period is approximately 18 months.

TT-223 – Diabetes:

Subsequent to quarter-end, we announced the completion of patient enrolment for the Phase II clinical study of gastrin analogue, TT-223, in type 2 diabetes patients. The study is a randomized, double-blind, placebo-controlled, dose-ranging study to evaluate the safety, tolerability and efficacy of daily TT-223 treatments for 12 weeks with a 6-month follow-up. Approximately 80 patients with type 2 diabetes have been enrolled in the study and will receive a daily treatment of TT-223 in addition to their current regimen of oral glucose lowering agents. Transition and its development partner Eli Lilly and Company ("Lilly") are in discussions regarding the timing and planning of another clinical study with TT-223 in combination with a GLP1 analogue in type 2 patients.

OUTLOOK

Through our collaborations, the clinical development timelines for our lead products have been met to date. Going forward, we will continue to work closely with our development partners, Lilly and Elan, toward the completion of the current clinical trials underway. In addition, we are looking to build on our current development plans and examining further studies that can broaden the potential application of these products.

We look forward to updating the shareholders on the progress of these clinical programs.

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 audited consolidated financial statements for the year ended June 30, 2008 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, 2008 as compared to the three-month and six-month periods ended December 31, 2007. This review was performed by management with information available as of February 11, 2009.

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.

CAUTION REGARDING FORWARD-LOOKING STATEMENTS

This MD&A contains certain forward looking statements relating, but not limited to operations, anticipated financial performance, business prospects and strategies. This forward looking information is subject to various risks and uncertainties, that could cause actual results and experience to differ materially from the anticipated results or other expectations expressed. Readers are cautioned not to place undue reliance on this forward looking information, which is provided as of the date of this MD&A unless otherwise stated, and the Company will not undertake any obligation to publicly update or revise any forward looking information, whether as a result of new information, future events, or otherwise, except as required by securities laws.

Forward looking information typically contains statements with words such as "anticipate", "believe", "expect", "plan", "estimate", "intend", "may" or similar words suggesting future outcomes or statements regarding an outlook on the estimated amounts and timing of capital expenditures, anticipated future debt levels and partnership revenues or other revenues or other expectations, beliefs, plans, objectives, assumptions, intentions or statements about future events or performance.

Factors which could cause future outcomes to differ materially from those set forth in the forward looking information include, but are not limited to: (i) obtaining sufficient and suitable financing to support operations, clinical trials and commercialization of products, (ii) capitalizing on partnering and acquisition opportunities; (iii) clinical trial timing and results; (iv) adequately protecting proprietary information and technology from competitors; (v) regulatory approvals; (vi) successfully competing in the targeted markets; and (vii) maintaining third party relationships, including key personnel, and key collaborators.

By its nature, forward looking information involves numerous assumptions, inherent risks and uncertainties, both general and specific, that contribute to the possibility that the predictions, forecasts, projections or other forward looking statements will not occur. Prospective investors should carefully consider the information contained under the heading "RISKS AND UNCERTAINTIES" in the Company's annual MD&A and all other information included in or incorporated by reference in this MD&A before making investment decisions with regard to the securities of the Company.

OVERVIEW

Transition is a product-focused biopharmaceutical company, developing novel therapeutics for disease indications with large markets. The Company's lead products are: ELND005 (AZD-103) for the treatment of Alzheimer's disease and TT-223 for the treatment of diabetes. Transition also has an emerging pipeline of pre-clinical drug candidates acquired externally or developed internally 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 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 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, 2008 and up to the date of this MD&A, the Company achieved the following significant milestones:

ELND005 (AZD-103) – Alzheimer's Disease:

- ***On October 20, 2008, Elan Pharma International Limited ("Elan") and Transition announced the achievement of the patient enrollment target for a Phase II clinical study of ELND005 (AZD-103) in patients with Alzheimer's disease.*** The study is a randomized, double-blind, placebo-controlled, dose-ranging, safety and efficacy study in patients with mild to moderate Alzheimer's disease. Each patient's planned treatment period is approximately 18 months;

TT-223 – Diabetes:

- ***On February 5, 2009, Transition announced the completion of patient enrolment for a Phase II clinical study of gastrin analogue, TT-223, in patients with type 2 diabetes;***

- ***On September 11, 2008, Transition dosed the first patient in a Phase II clinical study of gastrin analogue, TT-223, in patients with type 2 diabetes.*** The study is a randomized, double-blind, placebo-controlled, dose-ranging study to evaluate the safety, tolerability and efficacy of daily TT-223 treatments for 12 weeks with a 6-month follow-up. Approximately 80 patients with type 2 diabetes have been enrolled in the study and

will receive a daily treatment of TT-223 in addition to their current regimen of oral glucose lowering agents (metformin and/or thiazolidinediones);

Drug Discovery Initiatives:

- ***On August 18, 2008, the Company announced the acquisition of certain assets and the exclusive rights to selected drug discovery projects from Forbes Medi-Tech (Research) Inc., a wholly owned subsidiary of Forbes Medi-Tech Inc. ("Forbes").*** In consideration for the acquisition of these assets and intellectual property rights, Forbes has received from Transition US$1 million, and will potentially receive up to an additional US$6 million in contingent consideration dependent on the successful achievement of certain developmental and regulatory milestones. These acquired discovery projects and other internal projects will be the focus of a small group of research scientists which shall operate through a newly formed United States-based subsidiary called Transition Therapeutics (USA) Inc.;

Corporate Developments:

- ***In January 2009, the Company disposed of 23,272,633 shares of Stem Cell Therapeutics Corp. ("Stem Cell") in open market transactions over the TSX Venture Exchange which resulted in net proceeds of approximately $1.38 million;***

- ***On October 3, 2008, the Company received 23,272,633 freely tradable common shares of Stem Cell pursuant to the terms of a share purchase agreement entered into on October 4, 2004.*** Under the terms of this agreement, the final $1,650,000 milestone payment was due from Stem Cell to Transition on September 30, 2008. Stem Cell elected to make this payment in the form of Stem Cell common shares from treasury.

STRATEGIC COLLABORATIONS

Elan Pharma International Limited

In September 2006, Transition announced a global collaboration with Elan to develop and commercialize ELND005 (AZD-103). Under the terms of the agreement, Transition has received an upfront payment of US$15 million in two separate tranches. The upfront payments received from Elan have been recorded as deferred revenue. On December 21, 2007, the Company and Elan jointly announced that the first patient had been dosed in the Phase II clinical study of ELND005 (AZD-103). As a result, the Company received a US$5 million milestone payment, which was triggered by the initiation of the Phase II clinical trial. On October 20, 2008, Elan and Transition announced the achievement of the patient enrollment target for a Phase II clinical study of ELND005 (AZD-103) in patients with Alzheimer's disease.

Dependent upon the successful development, regulatory and commercial launch of ELND005 (AZD-103), Transition will be eligible to receive additional milestone payments of up to US$180 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 ELND005 (AZD-103).

Eli Lilly and Company

On March 13, 2008, Eli Lilly and Company ("Lilly") and Transition entered into a licensing and collaboration agreement granting Lilly exclusive worldwide rights to develop and commercialize Transition's gastrin-based therapies, including the lead compound TT-223, which is currently in early Phase II testing. Under the terms of the agreement, Transition has received a US$7 million upfront payment, and may also receive up to US$130 million in potential development and sales milestones, as well as royalties on sales of gastrin-based therapies if any product is successfully commercialized. Transition and Lilly are both participating in the Phase II clinical trial with lead compound TT-223 in type 2 diabetes and under the terms of the agreement, Lilly will reimburse the Company up to US$3 million for development costs associated with this trial. In addition, the parties have established a joint development committee to coordinate and oversee activities relating to the TT-223 program. Upon completion of this trial, Lilly will be responsible for further development activities and the commercialization of all gastrin-based therapeutic products worldwide.

On September 11, 2008, Transition dosed the first patient in a Phase II clinical study of gastrin analogue, TT-223, in patients with type 2 diabetes.

On February 5, 2009, Transition announced the completion of patient enrolment for a Phase II clinical study of gastrin analogue, TT-223, in patients with type 2 diabetes.

Transition and Lilly are both funding this Phase II clinical trial. Upon completion of this trial, Lilly will be responsible for further development activities and the commercialization of all gastrin-based therapeutic products worldwide.

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:

ELND005 (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 April 2007, Transition announced that the FDA granted Fast Track designation to the investigational drug candidate ELND005 (AZD-103) which is being developed in collaboration with Elan. Under the FDA Modernization Act of 1997, Fast Track designation is intended to facilitate the development and expedite the review of a drug or biologic if it is intended for the treatment of a serious or life-threatening condition, and it demonstrates the potential to address unmet medical needs for such a condition.

On August 30, 2007, the Company announced the completion of Phase I clinical studies with ELND005 (AZD-103). Transition and its development partner Elan have performed multiple Phase I studies evaluating the safety, tolerability and pharmacokinetic profile of ELND005 (AZD-103) in healthy volunteers. Approximately 110 subjects have been exposed to ELND005 (AZD-103) in multiple Phase I studies, including single and multiple ascending dosing; pharmacokinetic evaluation of levels in the brain; and CSF and plasma studies. ELND005 (AZD-103) was safe and well-tolerated at all doses and dosing regimens examined. There were no severe or serious adverse events observed. ELND005 (AZD-103) was also shown to be orally bio-available, cross the blood-brain barrier and achieve levels in the human brain and CSF that were shown to be effective in animal models for Alzheimer's disease.

On December 21, 2007, Elan and Transition announced that the first patient had been dosed in a Phase II clinical study of ELND005 (AZD-103) in patients with Alzheimer's disease. The study is a randomized, double-blind, placebo-controlled, dose-ranging, safety and efficacy study in approximately 340 patients with mild to moderate Alzheimer's disease. The study will evaluate both cognitive and functional endpoints, and each patient's participation is planned to last approximately 18 months.

On December 24, 2007, Transition announced that in connection with the initiation of the Phase II clinical study, the Company issued the former shareholders of Ellipsis Neurotherapeutics Inc. ("ENI") the first contingent consideration milestone in the form of 174,123 Transition common shares at a price of $10.86 per share. The shares issued had a fair value of $1,890,976 which represents additional consideration paid to acquire the technology, products and patents from ENI and accordingly, has been capitalized as intangible assets and will be amortized over the remaining useful life of the technology, products and patents.

On October 20, 2008, Elan and Transition announced the patient enrollment target for the Phase II clinical study of ELND005 (AZD-103) in patients with Alzheimer's disease was achieved.

Transition and its partner Elan are considering initiating clinical trials for other amyloid beta related indications including early/pre-Alzheimer's disease.

Under the terms of the agreement, the Company can elect to participate in post Phase II development. The Company has 45 days after the receipt of the proof of concept data from the on-going Phase II clinical trial to make this election. Currently, certain post Phase II development costs are being incurred by Elan and these costs are being tracked by Elan for potential reimbursement by Transition should the Company elect to participate in post Phase II development. If the Company elects to participate in the post Phase II development, based on the

Company's development percentage, the Company would owe Elan approximately US$1.5 million for post Phase II development costs incurred up to December 31, 2008. These costs have not been recorded as an expense or a liability at December 31, 2008 as the Company has not yet made a decision as to its participation.

Expenditures for the ELND005 (AZD-103) Program

During the three-month and six-month periods ended December 31, 2008 and 2007, the Company incurred direct research and development costs for this program as follows:

ELND005 (AZD-103) Program[1]	**Three-month period ended December 31, 2008**	Three-month period ended December 31, 2007	**Six-month period ended December 31, 2008**	Six-month period ended December 31, 2007
Pre-clinical studies	**$ 6,468**	$ -	**$ 62,877**	$ -
Clinical studies	**-**	100,914	**-**	225,522
Manufacturing	**10,071**	33,351	**20,184**	101,919
Other direct research	**2,883**	7,142	**3,584**	9,526
Due to (from) Elan				
Clinical studies	**1,596,322**	676,984	**3,114,455**	1,001,692
Manufacturing	**441,137**	32,338	**742,748**	435,968
Other direct research	**225,463**	(91,406)	**398,709**	(163,346)
Other	**259,388**	110,530	**326,521**	132,701
TOTAL	**$ 2,541,732**	$ 869,853	**$ 4,669,078**	$ 1,743,982

[1] These costs, except "Due to (from) Elan", are direct research and development costs only and do not include patent costs, investment tax credits, salaries and benefits or an allocation of Company overhead.

TT-223 for Diabetes

General

Diabetes is a disease in which the body does not produce or properly use insulin. Insulin is a hormone released from islet cells located in the pancreas that is needed to convert sugar, starches and other food into energy needed for daily life. There are two primary forms of diabetes; type 1 diabetes and type 2 diabetes.

Type 1 diabetes develops when the body's immune system destroys pancreatic islet beta cells, the only cells in the body that make the hormone insulin that regulates blood glucose. To survive, people with type 1 diabetes must have insulin delivered by injection or pump. Type 1 diabetes accounts for 5-10% of all diagnosed cases of diabetes.

Type 2 diabetes usually begins as insulin resistance, a disorder in which the cells do not use insulin properly. As the need for insulin increases, the pancreas gradually loses its ability to produce it. Current treatments for type 2 diabetes include lifestyle changes, oral medications, incretin therapy and insulin therapy. Type 2 diabetes accounts for about 90-95% of all diagnosed cases of diabetes.

Management's Discussion & Analysis

Transition has developed a patented diabetes therapy, which offers a new paradigm in the treatment of diabetes. Pre-clinical and clinical data suggest that gastrin plays an important role in beta cell differentiation and function; capable of providing sustained glucose control in type 2 diabetes.

TT-223 in combination with EGF

Transition's first diabetes therapy TT-223 in combination with EGF, a combination of Transition's epidermal growth factor analogue and a gastrin analogue, has completed two Phase I clinical trials, in which it was shown that it was safe to administer. Transition received FDA clearance to initiate exploratory Phase IIa clinical trials for the drug candidate in both type 1 and type 2 diabetics. These two clinical trials evaluated the efficacy, safety and tolerability of a 28-day course of daily TT-223 in combination with EGF treatment with a six month follow-up.

In March, 2007, the Company announced positive unblinded interim safety, tolerability and efficacy data from these exploratory Phase IIa trials for type 1 and type 2 diabetes patients. In the type 1 diabetes study, 6 of 11 (54%) patients responded to TT-223 in combination with EGF therapy, either by decreasing their average daily insulin usage by more than 20% or reducing their HbA1c levels by 1.2 to 2%. There were no responders among the placebo group.

On June 28, 2007, the Company announced final results from the exploratory Phase IIa clinical trial. A 4-week therapy with TT-223 in combination with EGF lead to sustained reductions in blood glucose levels for 6 months post-treatment in type 2 diabetes patients. In the treated group of patients, the mean HbA1c level was reduced by 0.94% to 1.21% vs. baseline levels in months 2 to 6 post-treatment. More specifically, the mean HbA1c level among treated patients was reduced 0.43%, 0.94% ($p<0.05$), 1.09% ($p<0.05$), 1.12% ($p<0.05$), 1.21% ($p<0.05$), and 1.14% in months 1, 2, 3, 4, 5, and 6 post-treatment, respectively. In contrast, the mean HbA1c levels of the placebo group ranged from a reduction of 0.1% to an increase of 1.0% over the same period. In addition to the HbA1c reductions, the data demonstrated decreases in fasting blood glucose levels as well as improvements in glucose tolerance over a six month period following treatment with TT-223 in combination with EGF. Trends in increased insulin levels as measured with an oral glucose tolerance test were also observed, particularly in patients where the HbA1c levels decreased over 1% with the TT-223 in combination with EGF therapy. These data are consistent with the increased glucose control observed in diabetes animal models where a short treatment with TT-223 in combination with EGF resulted in a sustained increase in beta cell mass and function. These clinical improvements, including HbA1c reductions greater than 1% in patients six month post-treatment, highlight the potential that TT-223 in combination with EGF therapy could provide patients significant clinical benefit in excess of six months.

TT-223 Clinical Development

These clinical data support the potential of the TT-223 gastrin analogue as a stand alone therapy and in combination with other diabetes therapies. On March 13, 2008, Lilly and the Company entered into a licensing and collaboration agreement granting Lilly exclusive worldwide rights to develop and commercialize Transition's gastrin-based therapies, including the lead compound TT-223, which is currently in Phase II testing.

To support the Phase II clinical development program for TT-223, Transition has performed two Phase I studies to expand the dose ranges for TT-223. The first study, a single ascending dose study of TT-223 in healthy volunteers and the second study, a multiple ascending dose study of TT-223 have both been completed.

In August 2008, Transition and its collaboration partner Lilly initiated a Phase II trial evaluating TT-223 in type 2 diabetes patients receiving metformin and/or thiazolidinediones (TZDs) which has completed enrolling patients in February 2009. Transition and its development partner Lilly are in discussions regarding the timing and planning of another clinical study with TT-223 in combination with a GLP1 analogue in type 2 patients.

The next steps in the development of TT-223 in combination with epidermal growth factor analogue, will be evaluated following the review of data from the above Phase II trials.

Juvenile Diabetes Research Foundation ("JDRF")

In September 2006, the Company entered into an agreement with the JDRF to support the clinical development of TT-223 in combination with GLP1 analogues for the treatment of type 1 diabetes over a two year period. The clinical studies in type 1 diabetes patients will be disclosed at a later date.

Under the terms of the agreement, the Company is obligated to pay the JDRF a 5% royalty on license fees and milestone payments received in connection with the Company's diabetes technology. Accordingly, the Company owes the JDRF $426,300 [US$350,000] resulting from the US$7 million up-front payment received from Lilly. The obligation to the JDRF is included in accounts payable and accrued liabilities at December 31, 2008.

Expenditures for the TT-223 Program

During the three-month and six-month periods ended December 31, 2008 and 2007, the Company incurred direct research and development costs for this program as follows:

TT-223 Program[(1)]	**Three-month period ended December 31, 2008**	Three-month period ended December 31, 2007	**Six-month period ended December 31, 2008**	Six-month period ended December 31, 2007
Pre-clinical studies	**$ 66,220**	$ 1,871	**$ 78,099**	$ 280,117
Clinical studies	**950,996**	406,700	**2,247,422**	736,952
Manufacturing	**462,086**	58,291	**661,127**	59,463
Other direct research	**138,912**	28,381	**266,818**	39,476
Reimbursement from Lilly				
Clinical studies	**(481,204)**	-	**(1,116,295)**	-
Manufacturing	**(30,089)**	-	**(123,263)**	-
Other research	**(33,434)**	-	**(536,321)**	-
Other	**(332,454)**	-	**(551,048)**	-
TOTAL	**$ 741,033**	$495,243	**$ 926,539**	$1,116,008

(1) These costs, except "Reimbursement from Lilly", are direct research and development costs only and do not include patent costs, investment tax credits, salaries and benefits or an allocation of Company overhead.

Drug Discovery Initiatives

On August 18, 2008, the Company announced the acquisition of certain assets and the exclusive rights to three drug discovery projects from Forbes Medi-Tech (Research) Inc., a wholly owned subsidiary of Forbes Medi-Tech Inc. (Forbes). These newly acquired discovery projects and other early-stage internal projects will be the focus of a group of research scientists and will operate through a newly formed United States-based subsidiary called Transition Therapeutics (USA) Inc. which was incorporated on July 14, 2008.

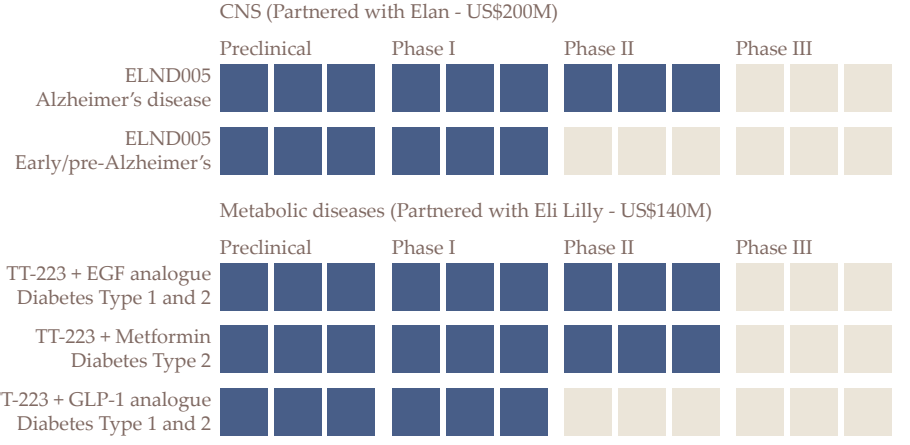
In consideration for the acquisition of these assets and intellectual property rights, Forbes has received from Transition US$1 million, and will potentially receive up to an additional US$6 million in contingent consideration dependent on all three technologies successfully achieving certain developmental and regulatory milestones.

Total consideration for the purchased assets, including acquisition costs, was $1,131,280. Based on the relative fair values of all the assets acquired, the total consideration paid has been recorded as an asset group of compounds, technology and patents acquired from Forbes.

In light of this acquisition, 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 its 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:



Results of Operations

For the three-month period ended December 31, 2008, the Company recorded a net loss of $4,873,270 ($0.21 per common share) compared to a net loss of $1,552,208 ($0.07 per common share) for the three-month period ended December 31, 2007.

For the six-month period ended December 31, 2008, the Company recorded a net loss of $9,906,066 ($0.43 per common share) compared to a net loss of $5,651,186 ($0.25 per common share) for the six-month period ended December 31, 2007.

The increase in net loss of $3,321,062 or 214% for the three-month period ended December 31, 2008 and $4,254,880 or 75% for the six-month period ended December 31, 2008 is due to an increase in research and development expenses primarily resulting from an increase in clinical development costs related to ELND005 (AZD-103). The increase in net loss for the three and six-month periods ended December 31, 2008 is also attributed to an increase in general and administrative expense and decreases in interest income, revenue, and gain on note receivable. The increase in net loss was partially offset by foreign exchange gains resulting from the Company's US dollar investments.

Research and Development

Research and development expenses increased $2,657,687 from $2,480,123 for the three-month period ended December 31, 2007 to $5,137,810 for the three-month period ended December 31, 2008. For the six-month period ended December 31, 2008, research and development expenses increased $3,673,936 to $8,919,858 from $5,245,922 for the same period in fiscal 2008. For the three and six-month periods ended December 31, 2008, these increases were primarily the result of significant increases in clinical development costs due to the ongoing Phase II ELND005 (AZD-103) trial, preclinical costs associated with advancing the family of compounds acquired in the NeuroMedix transaction, and increased drug development costs relating to the Company's newly formed subsidiary, Transition Therapeutics (USA) Inc.

During the three-month period ended December 31, 2008, there was an increase in direct clinical program expenses relating to the Company's TT-223 program. However, for the six-month period ended December 31, 2008 there was an overall decrease in the program costs resulting from the reimbursement of costs from Lilly.

The Company anticipates that research and development expenses will increase slightly in the third quarter of fiscal 2009 as the Company incurs net development costs relating to the on-going ELND005 (AZD-103) Phase II clinical trials, clinical development costs associated with the TT-223 Phase II clinical trials, the costs relating to the preclinical development of the compounds acquired in the NeuroMedix transaction, and the full quarter impact of research and development costs incurred by the newly formed subsidiary, Transition Therapeutics (USA) Inc.

General and Administrative

During the three-month period ended December 31, 2008, general and administrative expenses increased $117,525 to $1,623,724 from $1,506,199 for the same period in fiscal 2008. For the six-month period ended December 31, 2008, general and administrative expenses increased $333,442 to $3,171,822 from $2,838,380 for the same six-month period in fiscal 2008. The increases in general and administrative expenses for the three and six-month

periods ended December 31, 2008 are due to increased stock option expenses, salaries and facility expenses. These increases have been partially offset by decreases in professional and regulatory costs as the comparative periods contained increased costs associated with the NASDAQ listing of August, 2007.

The Company anticipates that general and administrative expenses will not increase significantly in the third quarter of fiscal 2009 compared to the second quarter of fiscal 2009.

Amortization

Amortization for the three-month period ended December 31, 2008, increased $27,262 to $691,168 as compared to $663,906 for the three-month period ended December 31, 2007. For the six-month period ended December 31, 2008, amortization increased $159,173 to $1,482,397 as compared to $1,323,224 for the same period in fiscal 2008.

The three-month period increase in amortization expense is primarily due to the amortization expense relating to the compounds, technology and patents acquired from Forbes during the first quarter of fiscal 2009. The six-month period increase in amortization expense is due to increased amortization expense relating to the workforce acquired from Protana due to a workforce reduction, the full-quarter impact of amortizing the additional consideration paid to acquire the ENI technology in December, 2007 and the amortization expense resulting from the assets acquired from Forbes.

The Company anticipates that amortization expense will be relatively unchanged in the third quarter of fiscal 2009.

Interest Income, net

Interest income for the three-month period ended December 31, 2008 was $346,505 as compared to $692,552 for the same period in fiscal 2008, resulting in a decrease of $346,047. For the six-month period ended December 31, 2008, interest income was $760,129 as compared to $1,289,031 for the same period in fiscal 2007, resulting in a decrease of $528,902. The decreases in interest income resulted from decreased cash balances due to cash disbursements as well as decreases in effective interest rates.

In the absence of additional financing, interest income is expected to decrease in the third quarter of fiscal 2009.

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, 2008.

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
2009				
Revenue	**$ -**	**$ -**		
Net loss[(1)]	**$ 5,032,796**	**$ 4,873,270**		
Basic and diluted net loss per Common Share	**$ 0.22**	**$ 0.21**		
2008				
Revenue	$ 32,811	$1,563,911	$ -	$ -
Net loss[(1)]	$ 4,098,978	$1,552,208	$4,977,020	$5,490,996
Basic and diluted net loss per Common Share	$ 0.18	$0.07	$0.22	$0.23
2007				
Revenue			$ 32,811	$ 32,811
Net loss[(1)]			$ 3,804,694	$ 5,974,267
Basic and diluted net loss per Common Share			$ 0.19	$ 0.30

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

The fluctuations of Transition's quarterly results are primarily due to changes in activity levels of the clinical trials being performed by the Company, amortization of the technology relating to the assets acquired from Waratah, Protana, ENI, NeuroMedix and Forbes, recognition of upfront and licensing fees relating to the Novo Nordisk agreement, interest income, corporate development costs, and the growth of the Company's management team.

CRITICAL ACCOUNTING ESTIMATES

The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results can differ from those estimates. We have identified the following areas which we believe require management's most subjective judgments, often requiring the need to make estimates about the effects of matters that are inherently uncertain and may change in subsequent periods.

Valuation and Amortization of Intangible Assets

The Company's intangible assets are comprised of purchased or licensed pharmaceutical technology, patents and workforce. The costs of the Company's intangible assets are amortized over the estimated useful life ranging from 5 to 20 years. Factors considered in estimating the useful life of the intangible asset include the expected use of the asset by the Company, legal, regulatory and contractual provisions that may limit the useful life, the effects of competition and other economic factors, and the level of expenditures required to obtain the expected future cash flows from the intangible asset. The Company assesses its intangible assets for recoverability whenever indicators of impairment exist. When the carrying value of an asset is greater than its net recoverable value as determined on an undiscounted basis, an impairment loss is recognized to the extent that its fair value is below the asset's carrying value.

Valuation Allowance for Future Tax Assets

The Company has recorded a valuation allowance on certain future tax assets primarily related to the carryforward of operating losses and qualifying research and development expenses. The Company has determined that it is more likely than not that some of these carryforward amounts will not be realized based on historical results and estimated future taxable income. The generation of future taxable income or the implementation of tax planning strategies could result in the realization of some or all of the carryforward amounts, which could result in a material change in our net income (loss) through the recovery of future income taxes. However, there is no assurance that the Company will be able to record future income tax recoveries in the future.

Equity Based Valuations

When the Company issues equity based instruments (i.e. stock options), an estimate of fair value is derived for the equity instrument using the Black-Scholes pricing model. The application of this pricing model requires management to make assumptions regarding several variables, including the period for which the instrument will be outstanding, the price volatility of the Company's stock over a relevant timeframe, the determination of a relevant risk free interest rate and an assumption regarding the Company's dividend policy in the future. If other assumptions are used, the value derived for the equity instruments could be significantly impacted.

Recognition of Deferred Revenue

As a result of the Company's collaboration agreements with Elan and Lilly, the Company has recorded deferred revenue.

The up-front and milestone payments received from Elan and the up-front payment received from Lilly have been recorded as deferred revenue and will be recognized as income on a systematic basis once the profitability of the collaboration arrangement can be reasonably estimated. Actual results could differ materially from the estimates made by management.

ADOPTION OF NEW ACCOUNTING POLICIES

Effective July 1, 2008, the Company adopted the following new accounting policies: CICA Handbook Section 1400, General Standards of Financial Statement Presentation, CICA Handbook Section 1535, Capital Disclosures; CICA Handbook Section 3862, Financial Instruments – Disclosures; and CICA Handbook Section 3863, Financial Instruments – Presentation.

CICA Handbook Section 1535, Capital Disclosures requires disclosure of the Company's objectives, policies and processes for managing capital and compliance with any capital requirements, and, in case of non-compliance, the consequences of such non-compliance. Note 14 has been added to the Company's consolidated financial statements regarding these disclosures.

CICA Handbook Section 3862, Financial Instruments – Disclosures provides standards for disclosures about financial instruments, including disclosures about fair value and the credit, liquidity and market risks associated with the financial instruments. Note 15 has been added to the Company's consolidated financial statements regarding these required disclosures.

CICA Handbook Section 3863, Financial Instruments – Presentation, provides standards for the presentation of financial instruments and non-financial derivatives. The adoption of this standard does not have an impact on the presentation of the Company's financial instrument disclosures.

RECENT CANADIAN ACCOUNTING PRONOUNCEMENTS

CICA Section 3064, Goodwill and Intangible Assets

This pronouncement replaces CICA 3062, "Goodwill and Other Intangible Assets" and CICA 3450, "Research and Development Costs". The standard establishes standards for recognition, measurement, and disclosure of goodwill and intangibles. The changes relating to the definition and initial recognition of intangible assets, including internally generated intangible assets, are equivalent to the corresponding provisions of International Financial Reporting Standards. These changes are effective for years beginning on or after October 1, 2008, with early adoption encouraged. The Company is evaluating the effects of adopting this new standard.

CICA Section 1582, Business Combinations

This pronouncement replaces CICA 1581, "Business Combinations". The standard establishes standards for the accounting for a business combination and represents the Canadian equivalent to the IFRS standard, IFRS 3 (Revised), "Business Combinations". These changes are effective for business combinations occurring on or after January 1, 2011, with early adoption permitted. The Company is currently evaluating the impact of the adoption of this new standard on the consolidated financial statements.

CICA Section 1601, Consolidated Financial Statements and CICA Section 1602, Non-Controlling Interests

These pronouncements collectively replace CICA 1600, "Consolidated Financial Statements". Section 1601 establishes standards for the preparation of consolidated financial statements. Section 1602 establishes standards for accounting for a non-controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. This standard is equivalent to the corresponding provisions of IFRS standard IAS 27 (Revised), "Consolidated and Separate Financial Statements". These new sections apply to interim and annual consolidated financial statements relating to fiscal years beginning on January 1, 2011. Early adoption is permitted as of the beginning of a fiscal year. The Company is evaluating the effects of adopting this standard as to potential impact and the date at which the Company will adopt the new standard.

INTERNAL CONTROLS OVER FINANCIAL REPORTING

There have been no changes in Transition's internal controls over financial reporting 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 payments, and licensing fees. The Company has incurred a cumulative deficit to December 31, 2008 of $114,066,837. 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, interest earned on cash deposits, held-to-maturity investments and investment tax credits, revenues and reimbursements from partners, and proceeds from the sale of assets transferred under contractual arrangement.

The Company's cash, cash equivalents and held-to-maturity investments and the Company's working capital position were $55,800,010 and $55,557,938, respectively, at December 31, 2008, a decrease from June 30, 2008 balances of $63,663,630 and $64,360,685 respectively. The decrease is primarily the result of the expenditures incurred during the six-month period ended December 31, 2008. As a result, the Company currently believes it has adequate financial resources for anticipated expenditures until the end of fiscal 2010.

Financial instruments of the Company consist mainly of cash and cash equivalents, held-to-maturity investments, available-for-sale investments, accounts payable and accrued liabilities and amounts due to/from Elan and Lilly. Management's primary investment objective is to maintain safety of principal and provide adequate liquidity to meet all current payment obligations and future planned expenditures.

The Company is exposed to market risks related to volatility in interest rates for the Company's investment portfolio and foreign currency exchange rates related to purchases of supplies and services made in US dollars.

The Company is exposed to interest rate risk to the extent that the cash equivalents and held-to-maturity investments are at a fixed rate of interest and their market value can vary with the change in market interest rates. The Company's maximum exposure to interest rate risk is based on the effective interest rate of the current carrying value of these assets. Although the Company monitors market interest rates, the Company's investment policies are designed to maintain safety of principal and provide adequate liquidity to meet all current payment obligations and future planned expenditures. The Company does not speculate on interest rates and holds all deposits until their date of maturity.

Fluctuations in the US dollar exchange rate may potentially have a significant impact on the Company's results of operations.

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, operations, and partnerships. 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

There were no significant financing activities during the six-month period ended December 31, 2008.

Contractual Obligations

Minimum payments under our contractual obligations as of December 31, 2008 are as follows:

	Less than 1 Year	1 - 3 Years	4 - 5 Years	After 5 Years	Total
Operating leases	$ 219,695	$ 1,018,395	$ -	$ -	$ 1,238,090
Collaboration agreements	$ 25,206	$ -	$ -	$ -	$ 25,206
Clinical and toxicity study agreements	$ 1,565,961	$ 1,579,799	$ -	$ -	$ 3,145,760
Manufacturing agreements	$ 118,916	$ -	$ -	$ -	$ 118,916
TOTAL	**$ 1,929,778**	**$ 2,598,194**	**$ -**	**$ -**	**$ 4,527,972**

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 11, 2009, the Company has 23,215,160 common shares outstanding.

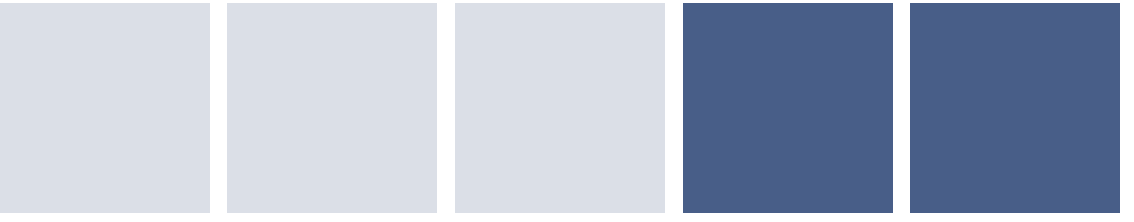
Stock Options

As at February 11, 2009, the Company has 1,876,454 stock options outstanding with exercise prices ranging from $4.68 to $18.00 and expiry dates ranging from May 10, 2009 to December 8, 2013. At February 11, 2009, on an if-converted basis, these stock options would result in the issuance of 1,876,454 common shares at an aggregate exercise price of $22,171,506.

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 Financial Statements



For the three and six-month periods ended
December 31, 2008

Consolidated Balance Sheets

(Unaudited)

	December 31, 2008 $	June 30, 2008 $
ASSETS		
Current		
Cash and cash equivalents [note 3]	**19,183,981**	22,952,865
Held-to-maturity investments [note 3]	**36,616,029**	40,710,765
Available-for-sale investments [note 8]	**930,905**	-
SCT receivable [note 8]	**-**	1,650,000
Due from Eli Lilly and Company [note 5]	**1,128,219**	472,220
GST receivable	**392,050**	278,784
Investment tax credits receivable	**889,922**	693,057
Prepaid expenses and deposits	**1,256,879**	974,426
Total current assets	**60,397,985**	67,732,117
Capital assets, net	**855,573**	958,689
Intangible assets [notes 6 and 7]	**25,847,604**	26,185,155
	87,101,162	94,875,961
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Accounts payable and accrued liabilities	**2,317,737**	1,576,190
Due to Elan Pharma International Limited [note 4]	**2,522,310**	1,795,242
Total current liabilities	**4,840,047**	3,371,432
Deferred revenue [notes 4 and 5]	**27,736,750**	27,736,750
Leasehold inducement	**74,308**	80,024
Total liabilities	**32,651,105**	31,188,206
Research and development commitments [note 11]		
Guarantees [note 12]		
Shareholders' equity		
Common shares	**160,471,098**	160,262,540
Contributed surplus	**4,501,050**	4,492,251
Stock options	**4,263,841**	3,093,735
Accumulated other comprehensive loss	**(719,095)**	-
Deficit	**(114,066,837)**	(104,160,771)
Total shareholders' equity	**54,450,057**	63,687,755
	87,101,162	94,875,961

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, 2008 $	Six-month period ended December 31, 2007 $	**Three-month period ended December 31, 2008 $**	Three-month period ended December 31, 2007 $
REVENUES				
Licensing fees	**-**	1,596,722	**-**	1,563,911
	-	1,596,722	**-**	1,563,911
EXPENSES				
Research and development	**8,919,858**	5,245,922	**5,137,810**	2,480,123
General and administrative	**3,171,822**	2,838,380	**1,623,724**	1,506,199
Amortization	**1,482,397**	1,323,224	**691,168**	663,906
Foreign exchange gain	**(2,918,176)**	(220,587)	**(2,232,927)**	(191,557)
Loss on disposal of capital assets	**10,294**	-	**-**	-
	10,666,195	9,186,939	**5,219,775**	4,458,671
Loss before the following:	**(10,666,195)**	(7,590,217)	**(5,219,775)**	(2,894,760)
Interest income from held-to-maturity investments	**760,129**	1,289,031	**346,505**	692,552
Gain on note receivable [note 8]	**-**	650,000	**-**	650,000
Net loss for the period	**(9,906,066)**	(5,651,186)	**(4,873,270)**	(1,552,208)
Basic and diluted net loss per common share [note 9[b]]	**(0.43)**	(0.25)	**(0.21)**	(0.07)

See accompanying notes

Consolidated Statement of Shareholders' Equity

For the six-month period ended December 31, 2008 and year ended June 30, 2008
(Unaudited)

	Number of Shares #	Share Capital $
Balance, July 1, 2007	21,230,741	133,988,318
Adjustment to opening deficit for change in accounting policy related to financial instruments	-	-
Issued pursuant to private placement, net	1,736,107	23,968,567
Issued as additional consideration regarding Ellipsis Neurotherapeutics Inc.	174,123	1,890,976
Stock options exercised or cancelled	45,736	414,679
Stock-based compensation expense	-	-
Net loss and comprehensive loss for the year	-	-
Balance, June 30, 2008	**23,186,707**	**160,262,540**
Net loss for the six-month period ended December 31, 2008	**-**	**-**
Unrealized loss on available-for-sale investments [note 8]	**-**	**-**
Total Other Comprehensive income (loss)	**23,186,707**	**160,262,540**
Stock options exercised, expired or cancelled [note 9[c]]	**28,453**	**208,558**
Stock-based compensation expense [note 9[c]]	**-**	**-**
Balance, September 30, 2008	**23,215,160**	**160,471,098**

See accompanying notes

Contributed Surplus $	Stock Options $	Deficit $	Accumulated Other Comprehensive Loss $	Total Deficit and Other Comprehensive Loss $	Total Shareholders' Equity $
4,487,752	1,538,396	(89,691,569)	-	(89,691,569)	50,322,897
-	-	1,650,000	-	1,650,000	1,650,000
-	-	-	-	-	23,968,567
-	-	-	-	-	1,890,976
4,499	(166,534)	-	-	-	252,644
-	1,721,873	-	-	-	1,721,873
-	-	(16,119,202)		(16,119,202)	(16,119,202)
4,492,251	**3,093,735**	**(104,160,771)**	**-**	**(104,160,771)**	**63,687,755**
-	**-**	**(9,906,066)**	**-**	**(9,906,066)**	**(9,906,066)**
-	**-**	**-**	**(719,095)**	**(719,095)**	**(719,095)**
4,492,251	**3,093,735**	**(114,066,837)**	**(719,095)**	**(114,785,932)**	**53,062,594**
8,799	**(91,806)**	**-**	**-**	**-**	**125,551**
-	**1,261,912**	**-**	**-**	**-**	**1,261,912**
4,501,050	**4,263,841**	**(114,066,837)**	**(719,095)**	**(114,785,932)**	**54,450,057**

Consolidated Statements of Cash Flows

(Unaudited)

	Six-month period ended December 31, 2008 $	Six-month period ended December 31, 2007 $	**Three-month period ended December 31, 2008 $**	Three-month period ended December 31, 2007 $
OPERATING ACTIVITIES				
Net loss for the period	**(9,906,066)**	(5,651,186)	**(4,873,270)**	(1,552,208)
Add (deduct) items not involving cash:				
Amortization of:				
capital assets	**98,623**	119,133	**49,770**	59,928
intangible assets	**1,468,831**	1,293,084	**683,937**	648,473
leasehold inducement	**(5,716)**	(5,716)	**(2,858)**	(2,858)
Stock-based compensation expense	**1,261,912**	684,170	**618,364**	359,380
Gain of company transferred under contractual arrangement	**-**	(650,000)	**-**	(650,000)
Loss on disposal of capital assets	**10,294**	-	**-**	-
Unrealized foreign exchange (gain) loss	**(1,815,088)**	26,150	**(1,714,414)**	12,968
Accrued interest on held-to-maturity investments	**(277,634)**	(664,566)	**(248,810)**	(460,232)
Net change in operating assets and liabilities [note 10]	**220,032**	4,308,794	**1,235,990**	5,882,782
Cash provided by (used in) operating activities	**(8,944,812)**	(540,137)	**(4,251,291)**	4,298,233
INVESTING ACTIVITIES				
Maturity of short-term investments	**164,334,463**	202,906,278	**46,750,925**	41,670,570
Purchase of short-term investments	**(158,990,674)**	(214,446,806)	**(50,844,858)**	(53,916,928)
Purchase of capital assets	**(53,962)**	(10,157)	**(10,645)**	(6,910)
Purchase of intangible assets [note 6]	**(1,131,280)**	-	**-**	-
Proceeds on disposal of capital assets	**48,161**	-	**-**	-
Cash received from company transferred under contractual arrangement	**-**	650,000	**-**	650,000
Cash provided by (used in) investing activities	**4,206,708**	(10,900,685)	**(4,104,578)**	(11,603,268)

	Six-month period ended December 31, 2008 $	Six-month period ended December 31, 2007 $	Three-month period ended December 31, 2008 $	Three-month period ended December 31, 2007 $
FINANCING ACTIVITIES				
Proceeds from issuance of common shares, net	**125,551**	24,046,496	**-**	8,050
Cash provided by financing activities	**125,551**	24,046,496	**-**	8,050
Impact of foreign exchange on cash and cash equivalents	**843,669**	(13,885)	**654,344**	(673)
Net increase (decrease) in cash and cash equivalents during the period	**(3,768,884)**	12,591,789	**(7,701,525)**	(7,297,658)
Cash and cash equivalents, beginning of period	**22,952,865**	1,377,387	**26,885,506**	21,266,834
Cash and cash equivalents, end of period [note 3]	**19,183,981**	13,969,176	**19,183,981**	13,969,176

See accompanying notes

Notes to Consolidated Financial Statements

(Unaudited)

1. NATURE OF OPERATIONS AND BASIS OF PRESENTATION

Transition Therapeutics Inc. ["Transition" or 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.

These consolidated financial statements include the accounts of the Company's wholly-owned subsidiaries, Transition Therapeutics Leaseholds Inc. and Waratah Pharmaceuticals Inc. ["Waratah"]. These consolidated financial statements also include the results of Transition Therapeutics (USA) Inc. a wholly-owned subsidiary which was incorporated on July 14, 2008.

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, 2008 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, 2008 except for the accounting policies discussed in note 2.

All material intercompany transactions and balances have been eliminated on consolidation.

2. CHANGES IN ACCOUNTING POLICIES

Effective July 1, 2008, the Company adopted the following new accounting policies: CICA Handbook Section 1400, General Standards of Financial Statement Presentation, CICA Handbook Section 1535, Capital Disclosures; CICA Handbook Section 3862, Financial Instruments – Disclosures; and CICA Handbook Section 3863, Financial Instruments – Presentation.

CICA Handbook Section 1535, Capital Disclosures requires disclosure of the Company's objectives, policies and processes for managing capital and compliance with any capital requirements, and, in case of non-compliance, the consequences of such non-compliance. Note 14 has been added to the Company's consolidated financial statements regarding these disclosures.

CICA Handbook Section 3862, Financial Instruments – Disclosures provides standards for disclosures about financial instruments, including disclosures about fair value and the credit, liquidity and market risks associated with the financial instruments. Note 15 has been added to the Company's consolidated financial statements regarding these required disclosures.

CICA Handbook Section 3863, Financial Instruments – Presentation, provides standards for the presentation of financial instruments and non-financial derivatives. The adoption of this standard does not have an impact on the presentation of the Company's financial instrument disclosures.

Recent Canadian accounting pronouncements:

CICA Section 3064, Goodwill and Intangible Assets

This pronouncement replaces CICA 3062, "Goodwill and Other Intangible Assets" and CICA 3450, "Research and Development Costs". The standard establishes standards for recognition, measurement, and disclosure of goodwill and intangibles. The changes relating to the definition and initial recognition of intangible assets, including internally generated intangible assets, are equivalent to the corresponding provisions of International Financial Reporting Standards ("IFRS"). These changes are effective for years beginning on or after October 1, 2008, with early adoption encouraged. The Company is evaluating the effects of adopting this new standard.

CICA Section 1582, Business Combinations

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CICA Section 1601, Consolidated Financial Statements and CICA Section 1602, Non-Controlling Interests

These pronouncements collectively replace CICA 1600, "Consolidated Financial Statements". Section 1601 establishes standards for the preparation of consolidated financial statements. Section 1602 establishes standards for accounting for a non-controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. This standard is equivalent to the corresponding provisions of IFRS standard IAS 27 (Revised), "Consolidated and Separate Financial Statements". These new sections apply to interim and annual consolidated financial statements relating to fiscal years beginning on January 1, 2011. Early adoption is permitted as of the beginning of a fiscal year. The Company is evaluating the effects of adopting this standard as to potential impact and the date at which the Company will adopt the new standard.

3. CASH AND CASH EQUIVALENTS AND HELD-TO-MATURITY INVESTMENTS

The Company's cash equivalents are invested in bankers' acceptances and other short-term instruments with a rating of R-1 or higher and maturities less than 90 days at the date of purchase. The annualized rate of return on these funds at December 31, 2008 was 2.8% [June 30, 2008 – 3.4%]. The amortized cost of the cash equivalents approximates fair value due to the short time to maturity.

Held-to-maturity investments consist of bankers' acceptances and medium term note debentures totaling $36,616,029 at December 31, 2008 with effective interest rates between 1.45% and 3.56% and maturity dates between January 5, 2009 and October 23, 2009. The fair value of the held-to-maturity investments at December 31, 2008 is $36,705,775 [June 30, 2008 – $40,710,765].

Cash and cash equivalents consist of the following:

	December 31 2008 $	June 30 2008 $
Cash	**6,187,339**	6,155,340
Cash equivalents	**12,996,642**	16,797,525
	19,183,981	22,952,865

4. 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, ELND005 (AZD-103), for the treatment of Alzheimer's disease.

Under the terms of the agreement, the Company has received 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 ELND005 (AZD-103), the Company will be eligible to receive milestone payments of up to US$185 million of which US$5 million was received during fiscal 2008. Elan and the Company will share the costs and operating profits of ELND005 (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 ELND005 (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.

During fiscal 2008, the Company received the second upfront payment of $7,284,000 (US$7,500,000) from Elan, and also received a milestone payment of $5,015,500 (US$5,000,000) for the initiation of the Phase II clinical study which was announced December 21, 2007. These payments, totaling $12,299,500 (US$12,500,000) have been recorded as deferred revenue and will be recognized as revenue on a systematic basis once the profitability of the collaboration arrangement can be reasonably estimated. At December 31, 2008, the Company has received a total of $20,719,750 (US$20,000,000) in up-front and milestone payments since the initiation of the collaboration agreement.

Under the terms of the agreement, the Company can elect to participate in post Phase II development. The Company has 45 days after the receipt of the proof of concept data from the on-going Phase II clinical trial to make this election. Currently, certain post Phase II development costs are being incurred by Elan and these costs are being tracked by Elan for potential reimbursement by Transition should the Company elect to participate in post Phase II development. If the Company elects to participate in the post Phase II development, based on the Company's development percentage, the Company would owe Elan approximately US$1.5 million for post Phase II development costs incurred up to December 31, 2008. These costs have not been recorded as an expense or a liability at December 31, 2008 as the Company has not yet made a decision as to its participation.

At December 31, 2008, under the terms of the agreement, the Company owes Elan $2,522,310 for costs incurred during the three-month period ending December 31, 2008 relating to the on-going Phase II clinical trial [June 30, 2008 – $1,795,242]. This amount has been recorded as a liability at December 31, 2008 and is expected to be paid during the three-month period ending March 31, 2009.

5. LICENSING AND COLLABORATION AGREEMENT WITH ELI LILLY AND COMPANY

On March 13, 2008, Eli Lilly and Company ("Lilly") and the Company entered into a licensing and collaboration agreement granting Lilly exclusive worldwide rights to develop and commercialize Transition's gastrin based therapies, including the lead compound TT-223, which is currently in Phase II testing. Under the terms of the agreement, Transition has received a US$7 million upfront payment, and may also receive up to US$130 million in potential development and sales milestones, as well as royalties on sales of gastrin based therapies if any product is successfully commercialized. Transition and Lilly are both participating in the Phase II clinical trial with lead compound TT-223 in type 2 diabetes and under the terms of the agreement, Lilly will reimburse the Company up to US$3 million for development costs associated with this trial. In addition, the parties have established a joint development committee to coordinate and oversee activities relating to the TT-223 program through to 1 year after commercialization. Upon completion of this trial, Lilly will be responsible for the costs of further development activities and the commercialization of all gastrin based therapeutic products worldwide. The Company's costs will be limited to the participation in the joint development committee.

During the fourth quarter of fiscal 2008, the Company received the upfront payment of $7,017,000 (US$7,000,000) from Lilly which was recorded as deferred revenue and will be recognized as revenue on a systematic basis once the profitability of the collaboration arrangement can be reasonably estimated. At December 31, 2008 the Company has a receivable from Lilly in the amount of $1,128,219 for costs incurred under the agreement in connection with the Phase II clinical trial [June 30, 2008 – $472,220].

6. ACQUISITION OF ASSETS FROM FORBES MEDI-TECH (RESEARCH) INC.

On August 18, 2008, the Company announced the acquisition of certain assets and the exclusive rights to three drug discovery projects from Forbes Medi-Tech (Research) Inc., a wholly owned subsidiary of Forbes Medi-Tech Inc. ("Forbes"). These newly acquired discovery projects and other early-stage internal projects will be the focus of a group of research scientists and will operate through a newly formed United States-based subsidiary called Transition Therapeutics (USA) Inc. which was incorporated on July 14, 2008.

In consideration for the acquisition of these assets and intellectual property rights, Transition paid Forbes US$1 million, and will potentially pay up to an additional US$6 million in contingent consideration dependent on all three technologies successfully achieving certain developmental and regulatory milestones.

Total consideration for the purchased assets, including acquisition costs, was $1,131,280. Based on the relative fair values of all the assets acquired, the total consideration paid has been recorded as one asset group of compounds, technology and patents acquired from Forbes. The compounds, technology, and patents acquired from Forbes will be amortized over 20 years which estimates the remaining useful life of the assets acquired.

7. INTANGIBLE ASSETS

Intangible assets consist of the following:

	December 31, 2008		
	Cost $	Accumulated Amortization $	Net Book value $
Technology acquired on acquisition of Waratah	39,799,917	39,799,917	-
Technology acquired from Biogenesys, Inc.	137,000	137,000	-
Sub-licensing fees and prepaid royalties paid to General Hospital Corp.("GHC")	778,691	92,840	685,851
Technology, workforce and patents acquired from Protana	4,412,594	2,909,058	1,503,536
Technology, products and patents acquired from ENI	16,135,399	3,632,572	12,502,827
Patent portfolio	386,000	212,067	173,933
Compounds acquired from NeuroMedix	11,085,259	1,213,812	9,871,447
Compounds, technology and patents acquired from Forbes [note 6]	1,131,280	21,270	1,110,010
	73,866,140	48,018,536	25,847,604

	June 30, 2008		
	Cost $	Accumulated Amortization $	Net book value $
Technology acquired on acquisition of Waratah	39,799,917	39,799,917	-
Technology acquired from Biogenesys, Inc.	137,000	137,000	-
Sub-licensing fees and prepaid royalties paid to GHC	778,691	65,214	713,477
Technology, workforce and patents acquired from Protana	4,412,594	2,390,969	2,021,625
Technology, products and patents acquired from ENI	16,135,399	3,138,837	12,996,562
Patent portfolio	386,000	173,467	212,533
Compounds acquired from NeuroMedix	11,085,259	844,301	10,240,958
	72,734,860	46,549,705	26,185,155

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

	$
2009 (balance of the fiscal year)	1,367,810
2010	2,756,097
2011	2,148,788
2012	1,838,036
2013	1,838,036
Thereafter	15,898,837
	25,847,604

The amortization of all intangible assets relates to the research and development efforts of the Company.

8. NET ASSETS TRANSFERRED UNDER CONTRACTUAL ARRANGEMENT

On October 4, 2004, the Company signed a Share Purchase Agreement (the "Agreement") to sell one of its wholly-owned subsidiaries, Stem Cell Therapeutics Inc. ("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.

During the three-month period ending December 31, 2008, Stem Cell Therapeutics Corporation ["Stem Cell"] elected to make the final payment of $1,650,000 in the form of Stem Cell common shares from treasury. Pursuant to the terms of the agreement, the shares were issued at a price of approximately $0.07 per Stem Cell share resulting in Transition receiving 23,272,633 freely tradable Stem Cell common shares, representing approximately 18.35% of the post issuance outstanding common shares of Stem Cell. The shares received are the only shares that Transition owns of Stem Cell and the Company does not intend to acquire any additional Stem Cell shares in the future. The Stem Cell shares have been classified as available-for-sale investments and at December 31, 2008, the Company recognized an unrealized loss of $719,095 through other comprehensive loss account.

Subsequent to the six-month period ending December 31, 2008, the Company disposed of all its shares of Stem Cell. The Company received net proceeds of approximately $1,381,000 and will recognize a loss on disposal of approximately $269,000 during the third quarter ending March 31, 2009.

9. SHARE CAPITAL

[a] Authorized

At December 31, 2008, the authorized share capital of the Company consists of an unlimited number of no par value common shares. The common shares are voting and are entitled to dividends if, as and when declared by the board of directors.

[b] Common shares issued and outstanding during the period

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, 2008 is 23,129,305 [six-month period ended December 31, 2007 – 22,970,679] and for the three-month period ended December 31, 2008 is 23,215,160 [three-month period ended December 31, 2007 – 23,079,242].

The outstanding options to purchase common shares of 1,880,325 [three-month period ended December 31, 2007 – 773,769] are not included in the calculation of diluted earnings per share as the effect is anti-dilutive.

[c] Stock Options

Stock options	#	$	Weighted Average Exercise Price $
Stock options outstanding, June 30, 2007	605,883	1,538,396	7.02
Stock options issued	1,345,266	-	13.59
Stock options exercised	(45,736)	(162,035)	5.52
Stock options expired	-	-	-
Stock options forfeited or cancelled	(35,150)	(4,499)	8.51
Stock based compensation expense	-	1,721,873	-
Stock options outstanding, June 30, 2008	**1,870,263**	**3,093,735**	**11.77**
Stock options issued [i]	**54,800**	**-**	**8.43**
Stock options exercised [ii]	**(28,453)**	**(83,007)**	**4.41**
Stock options expired [iii]	**(4,444)**	**(8,799)**	**3.15**
Stock options forfeited or cancelled [iv]	**(11,841)**	**-**	**12.17**
Stock based compensation expense	**-**	**1,261,912**	**-**
Stock options outstanding, December 31, 2008	**1,880,325**	**4,263,841**	**11.82**

[i] The fair value of the stock options issued during the six-month period ended December 31, 2008 is $222,008 [six-month period ended December 31, 2007 – $1,685,487].

[ii] During the six-month period ending December 31, 2008, 28,453 stock options were exercised [six-month period ended December 31, 2007 – 14,294]. These stock options had a recorded value of $83,007 [six-month period ended December 31, 2007 – $42,590] and resulted in cash proceeds to the Company of $125,551 [six-month period ended December 31, 2007 – $77,929].

[iii] During the six-month period ending December 31, 2008, 4,444 stock options expired unexercised [six-month period ended December 31, 2007 – nil]. These expired stock options had a fair value of $8,799 which has been reclassified to contributed surplus.

[iv] Turing the six-month period ending December 31, 2008, 11,841 stock options were forfeited [six-month period ended December 31, 2007 – 28,595]. These forfeited stock options had a fair value of $72,923 [six-month period ended December 31, 2007 – $152,829] and these options were not vested at the time of forfeit.

[v] The maximum possible cash proceeds to the Company from the exercise of the stock options outstanding at December 31, 2008 are $22,217,243 [June 30, 2008 – $22,005,602]

10. CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six-month period ended December 31, 2008	Six-month period ended December 31, 2007	**Three-month period ended December 31, 2008**	Three-month period ended December 31, 2007
Due from Lilly	**(655,999)**	-	**785,286**	-
GST receivable	**(113,266)**	232,848	**(66,674)**	95,640
Investment tax credits receivable	**(196,865)**	(78,964)	**(94,761)**	(83,940)
Prepaid expenses and deposits	**(282,453)**	61,281	**(618,068)**	34,473
Accounts payable and accrued liabilities	**741,547**	(1,624,352)	**768,020**	66,643
Due from Elan	**727,068**	30,703	**462,187**	49,877
Deferred revenue	**-**	5,687,278	**-**	5,720,089
	220,032	4,308,794	**1,235,990**	5,882,782
Supplemental cash flow information				
Interest paid	**-**	2,224	**-**	-
Income tax paid	**-**	-	**-**	-

11. RESEARCH AND DEVELOPMENT COMMITMENTS

At December 31, 2008, the Company is committed to aggregate expenditures of $25,000 [June 30, 2008 – $45,000] under its collaboration agreements. In addition, at December 31, 2008, the Company is committed to aggregate expenditures of approximately $3,146,000 [June 30, 2008 – $5,868,000] for clinical and toxicity studies to be completed during fiscal 2009 and approximately $119,000 [June 30, 2008 – $104,000] 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. SEGMENT DISCLOSURE

The Company operates in one operating segment, the research and development of therapeutic agents, and operates in Canada and the United States.

14. CAPITAL MANAGEMENT

The Company's primary objective when managing capital is to ensure that it has sufficient cash resources to fund its development and commercialization activities and to maintain its ongoing operations. To secure the additional capital necessary to pursue these plans, the Company may attempt to raise additional funds through the issuance of equity or through revenues derived from their existing or future strategic partnerships. Management will raise capital when market conditions are favorable to the existing shareholders or as capital is required to fund its development and commercialization activities. Management attempts to balance their need for additional capital with the goal of increasing shareholder value.

The Company considers cash, cash equivalents, held-to-maturity investments, accounts payable and accrued liabilities in the definition of capital.

The Company is not subject to externally imposed capital requirements and there has been no change with respect to the overall capital management strategy during the six-months ended December 31, 2008 from the fiscal year ended June 30, 2008.

15. FINANCIAL INSTRUMENTS

[a] Categories of financial assets and liabilities

Under CICA Section 3862, Financial Instruments – Disclosures, the Company is required to provide disclosures regarding its financial instruments. Financial instruments are either measured at amortized cost or fair value. The Company has classified its cash equivalents and short-term investments as "held-to-maturity" which are measured at amortized cost using the effective interest method. The Company has classified the Stem Cell shares as "available-for-sale investments" and they are measured at fair value with reevaluation gains and losses included in the statement of shareholders equity and other comprehensive loss. The Company has classified the amounts due from Lilly as "loans and receivables" and its accounts payable as "other financial liabilities" both of which are measured at amortized cost.

The Company has determined the estimated fair values of its financial instruments based on appropriate valuation methodologies; however, considerable judgment is required to develop these estimates. Fair value of held-to-maturity investments is determined based on information provided by the Company's investment broker who determines fair value based on a valuation model that uses daily pricing reports to determine the amount the holder would receive if the instrument were redeemed on that day. Management regularly reviews the activity and stability of their investment issuers and prevailing interest rates to ensure that the fair value information provided by their broker appears reasonable. The fair value of the Stem Cell shares, classified as available-for-sale investments, was determined using the TSX Venture Exchange's closing trading price of $0.04 per share on December 31, 2008.

[b] Financial risk management:

The Company's activities expose it to a variety of financial risks: market risk, including foreign exchange and interest rate risks, credit risk and liquidity risk. Risk management is the responsibility of the Company's finance function which identifies, evaluates and where appropriate, mitigates financial risks.

[i] Foreign exchange risk:

The Company operates in Canada and the United States and has relationships with entities in other countries. Foreign exchange risk arises from purchase transactions, as well as recognized financial assets and liabilities denominated in foreign currencies. The Company does not enter into hedging or other contracts to mitigate its exposure to foreign exchange risk.

Balances in foreign currencies at December 31, 2008 and June 30, 2008 are approximately:

	December 31, 2008 US$	June 30, 2008 US$
Cash and cash equivalents	**4,254,507**	8,480,116
Held-to-maturity investments	**9,497,213**	8,337,657
Due from Lilly	**926,288**	463,097
Accounts payable and accrued liabilities	**(573,203)**	(98,095)
Due to Elan	**(2,070,858)**	(1,760,559)
	12,033,947	15,422,216

At December 31, 2008, the Company also has exposure to foreign exchange risk relating to the Euro as it has an amount payable of €165,000.

Fluctuations in the US dollar exchange rate may potentially have a significant impact on the Company's results of operations. At December 31, 2008, if the Canadian dollar weakened 10% against the US dollar, with all other variables held constant, net loss and comprehensive loss for the six-month period ended December 31, 2008 would have decreased by approximately $1,008,000. Conversely, if the Canadian dollar strengthened 10% against the US dollar, with all other variables held constant, net loss and comprehensive loss for the period would have increased by approximately $1,008,000.

[ii] Interest rate risk:

Interest rate risk is the risk that the future cash flows of a financial instrument will fluctuate because of changes in market interest rates.

The Company is exposed to interest rate risk to the extent that the cash equivalents and held-to-maturity investments are at a fixed rate of interest and their market value can vary with the change in market interest rates. The Company's maximum exposure to interest rate risk is based on the effective interest rate of the current carrying value of these assets. Although the Company monitors market interest rates, the Company's investment policies are designed to maintain safety of principal and provide adequate liquidity to meet all current payment obligations and future planned expenditures. The Company does not speculate on interest rates and holds all deposits until their date of maturity.

Based on the Company's cash equivalents and held-to-maturity investments at December 31, 2008, a 1% change in market interest rates would have an impact of approximately $275,000 on the Company's interest income for the six-month period ended December 31, 2008.

[iii] Credit risk:

Credit risk is the risk of a financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligation.

The maximum exposure to credit risk of the Company at period end is the carrying value of its cash, cash equivalents, held-to-maturity investments, amounts receivable and due from Lilly.

The Company manages credit risk by maintaining bank accounts with Schedule 1 banks and investing in cash equivalents with maturities less than 90 days and ratings of R-1 or higher. Held-to-maturity investments consist of bankers' acceptances and other debentures maturing in less than 12 months and ratings of R-1 or higher. At December 31, 2008, cash, cash equivalents and held-to-maturity investments are spread amongst six Canadian financial institutions. The Company mitigates other credit risk by entering into long-term revenue agreements with companies that are well-funded and represent a low risk of default. The Company currently does not have an allowance against amounts receivable.

[iv] Liquidity risk:

Liquidity risk is the risk that the Company will not be able to meet its obligations as they become due.

The Company's objective in managing liquidity risk is to maintain sufficient readily available cash in order to meet its liquidity requirements. The Company manages its liquidity risk by forecasting cash flows from operations and anticipated investing and financing activities. All cash equivalents and held-to-maturity investments have maturities less than one year.

At December 31, 2008 the Companies financial liabilities which include accounts payable and accrued liabilities and amounts due to Elan are current and will be repaid within 1 to 3 months.

16. COMPARATIVE CONSOLIDATED FINANCIAL STATEMENTS

The comparative consolidated financial statements have been reclassified from statements previously presented to conform to the presentation of the 2009 consolidated financial statements.

Transition Therapeutics Inc.

101 College Street, Suite 220
Toronto, Ontario M5G 1L7, Canada
www.transitiontherapeutics.com