Third Quarter Results 2005

TRANSITION THERAPEUTICS INC.

IN BUSINESS TO MAKE A DIFFERENCE

Transition therapeutics inc.

TO OUR SHAREHOLDERS

In fiscal 2005, one of our key objectives was to have multiple clinical programs move forward. As we pass through the second half of our fiscal year, we have received approval for four trials and expect to have interim results for three of these trials during the second quarter of fiscal 2006. Rapidly advancing these clinical programs remains a core element of our strategy to realize value from our expanding pipeline.

In the third quarter, Transition:

- Received clearance from the U.S. Food and Drug Administration ("FDA") to initiate a clinical trial for our first Islet Neogenesis Therapy product, E1-I.N.T.™, in patients with type II diabetes; and
- Commenced enrolment in a Phase II clinical trial for our first Interferon Enhancing Therapy product, MS-I.E.T., in patients with multiple sclerosis ("MS").

Subsequent to quarter-end, we:

- Obtained approval from Health Canada to initiate a Phase I/II clinical trial for a second Interferon Enhancing Therapy product, HCV-I.E.T., in patients with hepatitis C.

Financial Strength

At March 31, 2005, our cash and cash equivalents and short-term investments were $23,081,951. Transition is well positioned financially and we intend to leverage this financial strength to advance our products through the clinic as well as seek partnerships and new value creating acquisitions.

Pipeline Review

In the third quarter, we received FDA approval to expand our exploratory Phase IIa clinical trial in patients with type I diabetes to include patients with type II diabetes. These clinical trials will evaluate the efficacy, safety, and tolerability of daily E1-I.N.T.™ treatments, a short course combination therapy aimed at stimulating the regeneration of the body's insulin-producing cells, over 28 days. Interim results from these trials are expected in the second quarter of fiscal 2006.

During the quarter, results from a study conducted in the laboratory of one of our scientific advisors, Dr. Alex Rabinovitch, were published in the *Journal of Clinical Endocrinology and Metabolism*. The data showed that researchers were able to stimulate human beta cell expansion by treating islets with Transition's E1-I.N.T.™. Scientific evidence that human islet beta cell regeneration is possible provides the foundation for the development of therapies to regenerate islet cells in the body for the treatment of diabetes.

Enrolment in the Phase II clinical trial for our first Interferon Enhancing Therapy product, MS-I.E.T., which is the combination of interferon-ß and Transition's EMZ701, is proceeding in patients with relapsing/remitting MS. The reporting of clinical data for this trial is expected in the first half of fiscal 2007.

Transition's second Interferon Enhancing Therapy product, HCV-I.E.T., is the combination of interferon-α, ribavirin and Transition's EMZ702 and we have received Health Canada approval to begin a Phase I/II clinical trial in patients with hepatitis C. Patients will receive twice-weekly treatments of EMZ702 administered in combination with standard interferon-α and ribavirin therapy for a period of 12 weeks. The primary efficacy endpoint is reduction of HCV RNA viral load as a measure of response to therapy. We expect to commence enrolment for this trial at several sites in Canada this summer, with interim results expected in the second quarter of fiscal 2006.

Outlook

Our goal over the next few quarters is to advance our four clinical trials as rapidly as possible. In addition, we remain focused on continuing to evaluate opportunities to partner our Interferon

Outlook (continued)

Enhancing Therapy products, especially now that a second indication is advancing into the clinic. In anticipation of our programs moving through the clinic, and ultimately reaching the partnership stage, we also continue to seek out new technologies to expand our growing pipeline.

I look forward to updating all shareholders next quarter, at the end of our fiscal year.

Dr. Tony Cruz
Chairman and CEO
Transition Therapeutics Inc.

MANAGEMENT'S DISCUSSION AND ANALYSIS

The following information should be read in conjunction with the Company's unaudited interim financial statements included herein as well as the audited consolidated financial statements for the year ended June 30, 2004 and the related notes, which are prepared in accordance with Canadian generally accepted accounting principles. This Management's Discussion and Analysis ("**MD&A**") provides a review of the performance of the Company for the three-month and nine-month periods ended March 31, 2005 as compared to the three-month and nine-month periods ended March 31, 2004. This review was performed by management with information available as of May 6, 2005.

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

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

FORWARD-LOOKING STATEMENTS

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

OVERVIEW

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

General Risk Factors for the Biotechnology Industry

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

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 nine-month period ended March 31, 2005 and up-to the date of this MD&A, the Company achieved the following significant milestones:

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

The Company's cash and cash equivalents and short-term investments were $23,081,951 at March 31, 2005, and the net working capital position was $22,551,260. The Company currently believes that it has adequate financial resources to meet anticipated expenditures until early calendar 2008.

PROGRAMS

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

I.N.T.™ Technology 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.

General (continued)

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 in partnership with Novo Nordisk, E1-I.N.T.™, which has received clearance to initiate exploratory Phase IIa clinical trials in both type I and type II diabetes patients and GLP1- I.N.T.™, which is currently in pre-clinical development.

Licensing Agreement

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

To date, under the Licensing Agreement, in addition to a $6 million equity investment, the Company has received a total of $2,282,955 (U.S. $1,750,000). Of this total, $1,968,580 (U.S. $1,500,000) has been recorded as deferred revenue and will be recorded as licensing fee revenue over the term of the Licensing Agreement, which has been estimated as 15 years and $314,375 (U.S. $250,000) has been recorded as deferred revenue until the corresponding research expenses are incurred.

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

E1-I.N.T.™

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 clearance from the United States Food and Drug Administration ("**FDA**") to initiate exploratory Phase IIa clinical trials for E1-I.N.T.™ in both type I and type II diabetics. These two clinical trials will be evaluating efficacy, safety and tolerability of a 28-day course of daily E1-I.N.T.™ treatments with a six-month follow-up. Transition expects to commence enrolment for the type I diabetes trial in June 2005 and to have interim results for this trial in the second quarter of fiscal 2006. With respect to the trial in type II diabetics, Transition expects to commence enrolment for this trial in the first quarter of fiscal 2006 and to have interim results in the second quarter of fiscal 2006. The final reports for both trials are expected in the second half of fiscal 2006.

Transition will fund development of these trials until Novo Nordisk takes over the program, at its option, at which point Novo Nordisk has agreed to retroactively reimburse the Company for costs incurred.

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 in partnership with Novo Nordisk.

Expenditures for the I.N.T.™ Program

During the three-month and nine-month periods ended March 31, 2005, 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 March 31, 2005[1]	Nine-month period ended March 31, 2005[1]
Clinical studies	$66,384	$232,771
Manufacturing	$269,987	$632,790
Pre-clinical toxicity studies	$0	$124,221
Other direct research	$19,540	$129,728
TOTAL	**$355,911**	**$1,119,510**

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

I.E.T. for MS and Hepatitis C

General

Interferon Enhancing Therapy is a key development initiative for Transition and has resulted in the discovery and development of two drug products: MS-I.E.T. for MS, which is currently in Phase II studies in patients with MS, and HCV-I.E.T. for hepatitis C, which has been approved for a Phase I/II clinical trial.

MS-I.E.T. for MS

MS is a complex and unpredictable progressive disease of the central nervous system in which the protective sheath around nerve fibres, called myelin, is destroyed and replaced by sclerotic patches or plaques. The result is a disruption of the flow of messages from the brain and a loss of motor function. According to the US National MS Society and the Multiple Sclerosis International Federation, MS affects one in 1,000 individuals in the US and Europe; and an estimated 2.5 million individuals worldwide. Patients diagnosed with MS are typically between 20 to 40 years of age with the majority being female. Due to the chronic nature of the disease, MS patients need constant medication.

Interferon-based products are one of the primary therapeutic options for the treatment of MS and are used to slow disease progression and palliate symptoms. However, these treatments are not effective in all patients, may have limited duration of benefit and possess a side effect profile that reduces utility. Interferon-based products for MS have annual sales in excess of US $2.5 billion representing approximately 70% of the MS therapeutic market.

To enhance the efficacy of interferon-ß alone, the Company has developed MS-I.E.T., its first Interferon Enhancing Therapy product, which is the combination of the Company's EMZ701 and interferon-ß. In pre-clinical studies, Transition has demonstrated that MS-I.E.T. is significantly more effective than interferon-ß alone in reducing both symptoms and pathologies associated with MS in multiple animal models. In a Phase I clinical trial, Transition's EMZ701 was well tolerated with a good safety profile.

Transition has commenced enrolment in a Phase II clinical trial for MS-I.E.T. in patients with MS. The Phase II study will enroll 40 relapsing/remitting MS patients currently on interferon-ß therapy showing renewed disease activity as evidenced by magnetic resonance imaging ("**MRI**") changes. After monitoring MRI activity for 12 weeks while on interferon-ß therapy alone, patients will receive weekly EMZ701 treatments in addition to their standard interferon-ß therapy for 24 weeks. The reporting of clinical data for this trial is expected in the first half of fiscal 2007.

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

HCV-I.E.T. for Hepatitis C (continued)

for hepatitis C, including combination therapies, can eliminate the virus in approximately 55% of cases.

Transition has expanded its Interferon Enhancing Therapy to include a second product, HCV-I.E.T, which is indicated for the treatment of hepatitis C. 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. EMZ702 has an excellent safety profile and 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.

Transition has received approval from Health Canada to initiate a Phase I/II clinical trial for HCV-I.E.T. in hepatitis C patients. The clinical trial is 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.

The Phase I/II study will be conducted in centres across Canada. Patients will receive twice-weekly treatments of EMZ702 administered in combination with standard interferon-α and ribavirin therapy for a period of 12 weeks. Among many endpoints, the primary efficacy endpoint will be the reduction of HCV RNA viral load, a clinical endpoint indicative of positive response to therapy. Transition expects to commence enrolment for this trial at several sites in Canada this summer, with interim results expected in the second quarter of fiscal 2006.

Expenditures for the I.E.T. Program

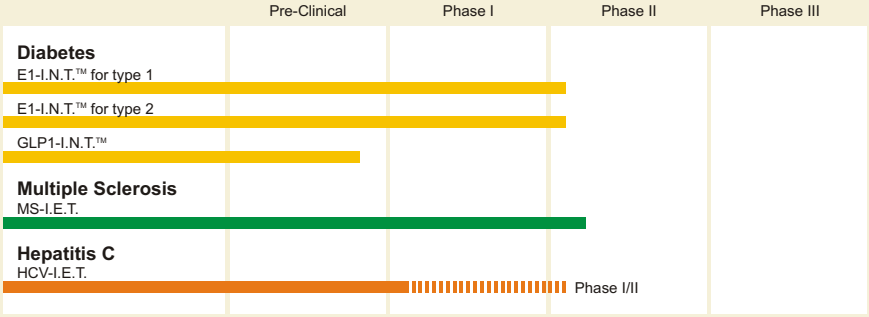
During the three-month and nine-month periods ended March 31, 2005, the Company incurred direct research and development costs for this program as follows:

	Three-month period ended March 31, 2005 [1]	Nine-month period ended March 31, 2005 [1]
Clinical studies	$79,163	$204,167
Manufacturing	$127,384	$233,783
Pre-clinical toxicity studies	$0	$0
Other direct research	$2,725	$31,421
TOTAL	**$209,272**	**$469,371**

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

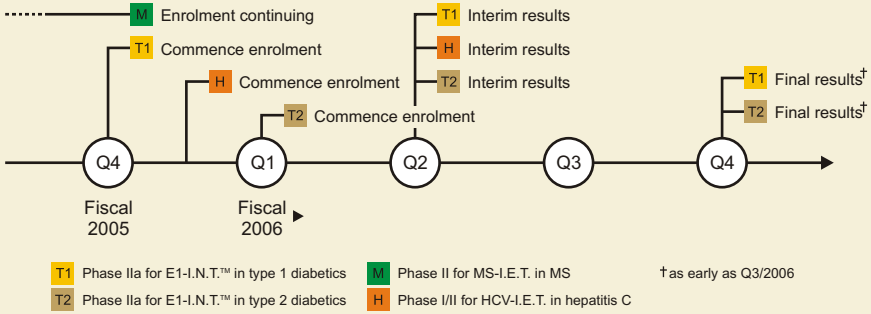
The Next Steps

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



The Next Steps (continued)

A summary of the expected timelines during the remainder of fiscal 2005 and into fiscal 2006 for the Company's current clinical trials is as follows:



In addition to rapidly advancing the clinical development of its products, Transition also remains focused on pursuing partnership discussions for its two Interferon Enhancing Therapy products and seeking out opportunities to expand its pipeline with new and innovative technologies.

OVERALL PERFORMANCE

During the first three quarters of fiscal 2005, the Company continued to advance its lead products through the clinic. Transition has now received approval for three Phase II clinical trials and one Phase I/II clinical trial and expects to have interim results for three of these trials by the end of calendar 2005. The sale of SCT has allowed Transition to free up resources to advance other clinical initiatives that are more in line with the Company's overall strategy. The acquisition of an interest in ENI has given Transition an interest in a compelling technology and will also allow the Company to earn additional ENI common shares through the achievement of certain milestones.

Transition also strengthened its cash position through the completion of a $6 million private placement and the exercise of previously issued warrants. The Company's cash and cash equivalents and short-term investments were $23,081,951 at March 31, 2005. The Company currently believes that it has adequate financial resources for anticipated expenditures until early calendar 2008.

The Company's loss for the three-month period ended March 31, 2005 increased by $518,934 or 17% over the same period in fiscal 2004 and the Company's loss for the nine-month period ended March 31, 2005 increased by $1,855,364 or 24% over the same period in fiscal 2004.

The increase in loss for the three-month period primarily resulted from an increase in general and administrative expenses and a decrease in recovery of future income taxes, partially offset by a decrease in research and development expenses and an increase in interest income, the details of which are as follows:

- The increase in general and administrative expenses was primarily the result of expensing of options and an increase in accounting and legal fees, regulatory costs and insurance premiums;
- The decrease in recovery of future income taxes was the result of the fact that the Company has depleted its future tax liability from the acquisition of Waratah Pharmaceuticals Inc. ("**Waratah**");
- The decrease in research and development expenses was primarily the net result of a decrease in I.N.T.™ technology expenses while the Company focused on completing manufacturing and contracting clinical sites and a decrease in patent costs, partially offset by an increase in I.E.T. technology expenses which resulted from the Company commencing enrolment for its Phase II clinical trial in MS patients; and
- The increase in interest income was the result of higher cash balances.

OVERALL PERFORMANCE (continued)

The increase in loss for the nine-month period primarily resulted from an increase in general and administrative expenses and research and development costs and a decrease in recovery of future income taxes, partially offset by an increase in interest income, the details of which are as follows:

- The increase in general and administrative expenses was primarily the result of expensing of options and an increase in accounting and legal fees, regulatory costs and insurance premiums;
- The decrease in recovery of future income taxes was the result of the fact that the Company has depleted its future tax liability from the acquisition of Waratah;
- The increase in research and development expenses was primarily the result of an increase in I.E.T. technology expenses as the Company prepared for and commenced enrolment for its Phase II trial in MS patients, additions to the Company's product development team and the expensing of options, partially offset by a slight decrease in I.N.T.™ technology expenses; and
- The increase in interest income was the result of higher cash balances.

In upcoming periods, the Company's losses are expected to increase primarily as a result of increased clinical expenditures as the Company continues the clinical development of multiple products and strengthens its product development team, and the depletion of the Company's future tax liability.

FOR THE THREE-MONTH AND NINE-MONTH PERIODS ENDED MARCH 31, 2005

Results of Operations

For the three-month period ended March 31, 2005, the Company's net loss increased by $518,934 or 17% to $3,504,427 ($0.03 per common and Class B share) compared to a net loss of $2,985,493 ($0.03 per common and Class B share) for the three-month period ended March 31, 2004. For the nine-month period ended March 31, 2005, the Company's net loss increased by $1,855,364 or 24% to $9,707,909 ($0.09 per common and Class B share) compared to a net loss of $7,852,545 ($0.09 per common and Class B share) for the nine-month period ended March 31, 2004.

The increase for the three-month period primarily resulted from an increase in general and administrative expenses and a decrease in recovery of future income taxes, partially offset by a decrease in research and development expenses and an increase in interest income.

The increase for the nine-month period primarily resulted from an increase in general and administrative expenses and research and development costs and a decrease in recovery of future income taxes, partially offset by an increase in interest income.

Licensing Fees

Licensing fees increased by $32,811 or 100% to $32,811 for the three-month period ended March 31, 2005 from $nil for the three-month period ended March 31, 2004. For the nine-month period ended March 31, 2005, licensing fees increased by $76,559 or 100% to $76,559 from $nil for the same period in fiscal 2004. Licensing fees represent the recognition of revenue from the Licensing Agreement with Novo Nordisk, as described above under the heading, "Licensing Agreement". Based on the current recognition term of 15 years, licensing fees are expected to be approximately $33,000 per quarter.

Research and Development

Research and development expenses decreased by $407,961 or 32% to $862,358 for the three-month period ended March 31, 2005 from $1,270,319 for the three-month period ended March 31, 2004. For the nine-month period ended March 31, 2005, research and development expenses increased by $406,331 or 17% to $2,777,027 from $2,370,696 for the same period in fiscal 2004.

Research and Development (continued)

The decrease in research and development expenses for the three-month period was primarily the net result of a decrease in I.N.T.™ technology expenses while the Company focused on completing manufacturing and contracting clinical sites and a decrease in patent costs, partially offset by an increase in costs for the I.E.T. technology resulting from the Company commencing enrolment for its Phase II clinical trial in MS.

The increase in research and development expenses for the nine-month period was primarily the result of an increase in I.E.T. technology expenses as the Company prepared for and commenced enrolment for its Phase II trial in MS patients, additions to the Company's product development team and the expensing of options, partially offset by a slight decrease in I.N.T.™ technology expenses.

It is expected that research and development expenses will increase for the fourth quarter of fiscal 2005 as the Company commences enrolment for a Phase IIa clinical trial in type I diabetics, initiates a Phase I/II clinical trial in hepatitis C patients, continues enrolment for a Phase II clinical trial in MS and continues to strengthen its product development team.

General and Administrative

General and administrative expenses increased by $173,309 or 38% to $624,986 for the three-month period ended March 31, 2005 from $451,677 for the three-month period ended March 31, 2004. For the nine-month period ended March 31, 2005, general and administrative expenses increased by $623,191 or 45% to $2,014,793 from $1,391,602 for the same period in fiscal 2004.

The increases primarily resulted from the expensing of options and an increase in accounting and legal fees, regulatory costs and insurance premiums. The Company anticipates that general and administrative expenses will remain consistent for the fourth quarter of fiscal 2005.

Amortization

Amortization for the three-month period ended March 31, 2005 decreased by $144,771 or 7% to $2,016,721 as compared to $2,161,492 for the three-month period ended March 31, 2004. For the nine-month period ended March 31, 2005, amortization decreased by $290,186 or 4% to $6,191,022 as compared to $6,481,208 for the same period in fiscal 2004.

The decreases in amortization primarily resulted from the cessation of amortization on the SCT technology as a result of the contractual transfer of SCT.

Recovery of (provision for) income taxes - future

Recovery of income taxes - future for the three-month period ended March 31, 2005 decreased by $942,788 or 103% to a provision of $27,045 as compared to a recovery of $915,743 for the three-month period ended March 31, 2004. For the nine-month period ended March 31, 2005, recovery of income taxes - future decreased by $1,160,177 or 52% to $1,067,290 as compared to $2,227,467 for the same period in fiscal 2004.

The decreases in recovery of income taxes - future primarily resulted from the fact that the Company's future tax liability derived from the acquisition of Waratah in January 2002 has been reduced to zero as Waratah now has sufficient future tax assets to offset the liability.

Interest Income

Interest income for the three-month period ended March 31, 2005 increased by $73,180 or 106% to $142,489 as compared to $69,309 for the three-month period ended March 31, 2004. For the nine-month period ended March 31, 2005, interest income increased by $219,858 or 132% to $385,919 as compared to $166,061 for the same period in fiscal 2004.

These increases in interest income primarily resulted from higher cash balances. In the absence of additional financing, interest income is expected to decrease in the fourth quarter of fiscal 2005.

Capital Expenditures

During the three-month period ended March 31, 2005, the Company's capital expenditures decreased by $10,153 or 66% to $5,319, as compared to $15,472 for the three-month period ended March 31, 2004. During the nine-month period ended March 31, 2005, the Company's capital expenditures increased by $87,272 or 402% to $108,985, as compared to $21,713 for the same period in fiscal 2004.

The expenditures during the first three quarters of fiscal 2005 were primarily for lab equipment and computer equipment. The Company anticipates an increase in capital expenditures during the fourth quarter of fiscal 2005 as a result of additions to the Company's product development team and relocation of the Company's office facilities.

Transfer of SCT

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

This transaction has not been recorded as a sale for accounting purposes as the risks and rewards of the ownership of SCT have not been transferred to the purchaser under the terms of the share purchase agreement. In addition, the Company does not anticipate that the transaction will qualify for sale accounting within the next twelve months. Therefore, the Company has not reclassified the assets and liabilities of SCT as held for sale as at March 31, 2005, but has reclassified the assets and liabilities as transferred under a contractual arrangement. The upfront payment received of $325,000, net of disposition costs, has been recorded against the assets transferred. In the future, if circumstances change such that a transfer of the risks and rewards to the purchaser is expected within the next twelve months, the Company will reclassify SCT's assets and liabilities as held for sale at that time.

The financial results of SCT were consolidated with the financial results of the Company until SCT was transferred on October 4, 2004. For the period of October 4, 2004 to March 31, 2005, the losses incurred by SCT of $98,546 were recorded as losses of company transferred under contractual arrangement with the corresponding amount reducing assets transferred under contractual arrangement.

Acquisition of Interest in ENI

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

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

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

In addition, through leading the development of the ENI products, the Company will also have the potential to earn up to 1,600,000 ENI common shares, over the 24 month period ending November 4, 2006, through the achievement of milestones. The fair value of any ENI common shares earned will be recorded as revenue at the time the milestone is achieved.

SUMMARY OF QUARTERLY RESULTS

The following table is a summary of selected quarterly consolidated financial information of the Company for each of the eight most recently completed quarters ending at March 31, 2005.

	First Quarter Ended Sept. 30	Second Quarter Ended Dec. 31	Third Quarter Ended March 31	Fourth Quarter Ended June 30
Fiscal 2005				
Revenue	$10,937	$32,811	$32,811	
Net loss[(1)]	$2,543,441	$3,660,041	$3,504,427	
Basic and fully diluted net loss per Common Share and Class B Share	$0.02	$0.03	$0.03	
Fiscal 2004				
Revenue	$-	$-	$-	$-
Net loss[(1)]	$2,292,926	$2,574,126	$2,985,493	$2,706,956
Basic and fully diluted net loss per Common Share and Class B Share	$0.03	$0.03	$0.03	$0.03
Fiscal 2003				
Revenue				$-
Net loss[(1)]				$2,735,980
Basic and fully diluted net loss per Common Share and Class B Share				$0.04

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

The quarterly results of Transition have remained fairly stable with fluctuation primarily the result of changes in activity levels of the clinical trials being performed by the Company, changes in the Company's management and product development team, amortization of the technology acquired through the acquisition of SCT, changes in the recovery of future income taxes and the expensing of options.

CRITICAL ACCOUNTING ESTIMATES

The Company's critical accounting estimates are as described under the heading "Critical Accounting Estimates" in the Company's annual MD&A which can be found on SEDAR at www.sedar.com.

CHANGES AND ADOPTIONS OF ACCOUNTING POLICIES

Other than the following, the Company has not adopted any new accounting policies during the nine-month period ended March 31, 2005.

Stock-Based Compensation

In November 2003, the Canadian Institute of Chartered Accountants ("**CICA**") amended CICA Handbook Section 3870, "Stock-Based Compensation and Other Stock-Based Payments", to require the expensing of all stock-based compensation awards for fiscal years beginning on or after January 1, 2004. Effective July 1, 2004, the Company adopted the recommendations of the amended CICA Handbook Section 3870, which will result in the fair value method of accounting being used for all stock-based compensation. The standard has been applied on a retroactive basis. The consolidated statements of loss and deficit for the three-month and nine-month periods ended March 31, 2004 have not been restated. During the nine-month period ended March 31, 2005, the cumulative impact of stock-based compensation for the fiscal years ended June 30, 2004 and 2003 was recognized in the consolidated financial statements as an adjustment to opening deficit. The impact of the adoption was a one-time increase to deficit of $45,180, to stock options of $39,755 and to common shares of $5,425.

In the nine-month period ended March 31, 2005, the effect of the adoption of the fair value method of stock-based compensation expense was an increase to general and administrative expenses of $234,435 and an increase to research and development expense of $105,477, with the

Stock-Based Compensation (continued)

corresponding total included as an increase to stock options. In the three-month period ended March 31, 2005, the effect of the adoption of the fair value method of stock-based compensation expense was an increase to general and administrative expense of $83,457 and an increase to research and development expense of $16,711, with the corresponding total included as an increase to stock options.

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

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

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

Variable Interest Entities

In September 2004, the CICA issued Accounting Guideline 15 ("**AcG-15**"), "Consolidation of Variable Interest Entities", which applies to annual and interim periods beginning on or after November 1, 2004. AcG-15 requires that the assets, liabilities, and results of a Variable Interest Entity ("**VIE**") be consolidated into the financial statements of the enterprise when that enterprise is the primary beneficiary of the VIE.

In general, an entity is classified as a VIE if: 1) total equity is not sufficient to permit the entity to finance its activities without additional subordinated financial support; 2) its equity investors lack the direct or indirect ability to make decisions about an entity's activities through voting rights; or 3) its equity investors do not absorb the expected losses of the entity if they occur or receive the expected residual returns of the entity if they occur. To determine if an investor in a VIE is the primary beneficiary, the investor must determine if it will absorb a majority of the VIE's expected losses, receive a majority of the VIE's expected returns, or both. An enterprise holding an interest in a VIE for which it is not the primary beneficiary does not consolidate the VIE, but is required to provide certain disclosures.

The Company has analyzed its interests in entities which it does not wholly-own and has determined that it has an interest in one VIE. It has determined that SCT is a VIE, for which the Company is not the primary beneficiary, and has added additional disclosure to its financial statements surrounding its involvement with SCT.

LIQUIDITY AND CAPITAL RESOURCES

Overview

The Company commenced operations in July 1998, and has devoted its resources primarily to fund its research and development programs. All revenue to date has been generated from interest income on surplus funds, the sale of reagents and licensing fees. The Company has incurred a cumulative deficit to March 31, 2005 of $41,970,891. 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.

Overview (continued)

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

The Company's cash and cash equivalents and short-term investments and the Company's working capital position were $23,081,951 and $22,551,260, respectively, at March 31, 2005, up significantly from June 30, 2004 balances of $17,641,155 and $17,767,250, respectively. The increase is primarily the net result of the Novo Nordisk equity investment completed in August 2004 and the proceeds received from warrant and option exercises, partially offset by expenditures incurred during the nine-month period ended March 31, 2005 and the cash investment made in ENI. The Company currently believes that it has adequate financial resources to meet anticipated expenditures until early calendar 2008.

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

Financing Activities

During the nine-month period ended March 31, 2005, the Company sold 5,000,000 common shares, through a private placement to Novo Nordisk to raise gross proceeds of $6 million. It also issued 7,628,288 common shares for total cash proceeds of $4,194,776 through the exercise of 5,337,289 share purchase warrants, 1,431,800 Agents' Warrants (including the exercise of the underlying share purchase warrants) and 143,300 stock options.

OUTSTANDING SHARE DATA

Authorized

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

Issued and Outstanding

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

Common Shares

As at May 6, 2005, the Company had 120,035,979 common shares outstanding.

Share Purchase Warrants

The following is a summary of the share purchase warrants outstanding as at May 6, 2005:

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

Each share purchase warrant entitles the holder, upon exercise and full payment of the exercise price, to acquire one common share of the Company until they expire at the dates indicated above. At May 6, 2005, on an if-converted basis, these share purchase warrants would result in the issuance of 1,444,713 common shares for aggregate proceeds of $1,403,846.

Stock Options

As at May 6, 2005, the Company had 4,100,662 stock options outstanding (on an after exchanged basis for Waratah options) with exercise prices ranging from $0.28 to $3.30 and expiry dates ranging from June 13, 2005 to April 25, 2010. At May 6, 2005, on an if-converted basis, these stock options would result in the issuance of 4,100,662 common shares at an aggregate exercise price of $4,881,900.

Exchange Rights

As at May 6, 2005, the Company has 4,000,000 Exchange Rights outstanding. Each Exchange Right entitles the holder, upon exercise, to exchange one common share of ENI for 0.8264 of a common share of the Company. All unexercised Exchange Rights expire on February 4, 2006.

RISKS AND UNCERTAINTIES

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

TO THE SHAREHOLDERS OF TRANSITION THERAPEUTICS INC.

The consolidated balance sheet of Transition Therapeutics Inc. as at March 31, 2005 and the consolidated statements of loss and deficit and cash flows for the period then ended have not been reviewed by the Company's auditors, Ernst & Young LLP. These financial statements are the responsibility of management and have been reviewed and approved by the Company's Audit Committee.

CONSOLIDATED BALANCE SHEETS
(Unaudited)

	March 31, 2005 $	June 30, 2004 $
ASSETS		
Current		
Cash and cash equivalents [*note 5*]	**9,083,503**	17,641,155
Short-term investments [*note 5*]	**13,998,448**	-
Receivables	**69,330**	270,126
Investment tax credits receivable	**526,854**	511,821
Research inventory	**1,093,664**	559,378
Prepaid expenses and other assets	**145,402**	119,325
Future tax asset	**18,966**	106,277
Total current assets	**24,936,167**	19,208,082
Long-term deposits	**130,455**	143,850
Long-term research inventory	**946,508**	-
Deferred charges [*note 4*]	**127,248**	-
Capital assets, net	**456,453**	440,783
Technology [*note 3*]	**14,307,309**	22,436,674
Investment [*note 8*]	**2,179,233**	-
Assets transferred under contractual arrangement [*note 7*]	**1,636,158**	-
	44,719,531	42,229,389
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Accounts payable and accrued liabilities	**1,913,620**	1,366,983
Current portion of leasehold inducement	**6,883**	3,698
Current portion of obligation under capital leases	**18,790**	19,008
Current portion of deferred revenue [*note 4*]	**445,614**	51,143
Total current liabilities	**2,384,907**	1,440,832
Leasehold inducement	**-**	17,880
Obligation under capital leases	**57,465**	67,356
Provision for facility closure	**5,962**	225,982
Deferred revenue [*note 4*]	**1,760,782**	869,437
Future tax liability	**-**	1,154,601
Liability to ENI subject to guaranteed share value obligation [*note 8*]	**820,900**	-
Liabilities transferred under contractual arrangement [*note 7*]	**34,539**	-
Total liabilities	**5,064,555**	3,776,088
Commitments [*note 12*]		
Guarantees [*note 14*]		
Shareholders' equity		
Share capital		
Common shares [*note 9[b]*]	**77,223,701**	66,001,437
Contributed surplus	**2,768,967**	2,646,643
Stock options [*note 9[d]*]	**747,165**	566,997
Warrants [*note 9[c]*]	**498,034**	1,456,026
Exchange Rights [*note 9[e]*]	**388,000**	-
Deficit	**(41,970,891)**	(32,217,802)
Total shareholders' equity	**39,654,976**	38,453,301
	44,719,531	42,229,389

See accompanying notes

CONSOLIDATED STATEMENTS OF LOSS AND DEFICIT
(Unaudited)

	Nine-month period ended March 31, 2005 $	Nine-month period ended March 31, 2004 $	Three-month period ended March 31, 2005 $	Three-month period ended March 31, 2004 $
REVENUES				
Licensing fees	**76,559**	-	**32,811**	-
EXPENSES				
Research and development, net of investment tax credits [*note 6*]	**2,777,027**	2,370,696	**862,358**	1,270,319
General and administrative	**2,014,793**	1,391,602	**624,986**	451,677
Facility closure	**-**	60,129	**-**	60,129
Amortization	**6,191,022**	6,481,208	**2,016,721**	2,161,492
Foreign exchange loss (gain)	**30,330**	(19,353)	**20,114**	11,219
	11,031,172	10,284,282	**3,524,179**	3,954,836
Loss before the following	**(10,936,613)**	(10,284,282)	**(3,491,368)**	(3,954,836)
Interest income, net	**385,919**	166,061	**142,489**	69,309
Equity loss in affiliate [*note 8*]	**(125,959)**	-	**(87,806)**	-
Losses of company transferred under contractual arrangement [*note 7*]	**(98,546)**	-	**(40,697)**	-
Loss before income taxes	**(10,775,199)**	(10,118,221)	**(3,477,382)**	(3,885,527)
Recovery of (provision for) income taxes				
Current	**-**	38,209	**-**	(15,709)
Future	**1,067,290**	2,227,467	**(27,045)**	915,743
Net loss for the period	**(9,707,909)**	(7,852,545)	**(3,504,427)**	(2,985,493)
Deficit, beginning of period, as originally stated	**(32,217,802)**	(21,658,301)	**(38,466,464)**	(26,525,353)
Adjustment for change in accounting policy related to stock-based compensation [*note 2*]	**(45,180)**	-	**-**	-
Deficit, beginning of period, as restated	**(32,262,982)**	(21,658,301)	**(38,466,464)**	(26,525,353)
Deficit, end of period	**(41,970,891)**	(29,510,846)	**(41,970,891)**	(29,510,846)
Basic and fully diluted net loss per common and Class B share [*note 9[b][ii]*]	**$(0.09)**	$(0.09)	**$(0.03)**	$(0.03)

See accompanying notes

CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Nine-month period ended March 31, 2005 $	Nine-month period ended March 31, 2004 $	Three-month period ended March 31, 2005 $	Three-month period ended March 31, 2004 $
OPERATING ACTIVITIES				
Net loss for the period	**(9,707,909)**	(7,852,545)	**(3,504,427)**	(2,985,493)
Add (deduct) items not involving cash				
Amortization	**6,233,073**	6,524,517	**2,030,854**	2,176,064
Amortization of leasehold inducement	**(14,695)**	(2,772)	**(6,885)**	(924)
Write-off of research inventory	**46,626**	24,588	**-**	24,588
Provision for (recovery of) income taxes - future	**(1,067,290)**	(2,227,467)	**27,045**	(915,743)
Stock-based compensation expense [*note 2*]	**339,912**	-	**100,168**	-
Equity loss in affiliate [*note 8*]	**125,959**	-	**87,806**	-
Losses of company transferred under contractual arrangement [*note 7*]	**98,546**	-	**40,697**	-
	(3,945,778)	(3,533,679)	**(1,224,742)**	(1,701,508)
Net change in non-cash working capital balances related to operations [*note 10*]	**165,292**	316,122	**2,353,528**	79,676
Cash provided by (used in) operating activities	**(3,780,486)**	(3,217,557)	**1,128,786**	(1,621,832)
INVESTING ACTIVITIES				
Purchase of short-term investments	**(13,998,448)**	-	**(13,998,448)**	-
Investment in ENI [*note 8*]	**(1,096,292)**	-	**-**	-
Purchase of capital assets	**(108,985)**	(21,713)	**(5,319)**	(15,472)
Net cash received from contractual arrangement [*note 7*]	**254,996**	-	**-**	-
Cash used in investing activities	**(14,948,729)**	(21,713)	**(14,003,767)**	(15,472)
FINANCING ACTIVITIES				
Repayment of obligation under capital leases	**(10,109)**	(16,560)	**(833)**	(691)
Proceeds from issuance of common shares, net [*note 9[b]*]	**10,181,672**	15,092,068	**-**	14,617,743
Cash provided by (used in) financing activities	**10,171,563**	15,075,508	**(833)**	14,617,052
Net increase (decrease) in cash and cash equivalents during the period [*note 11*]	**(8,557,652)**	11,836,238	**(12,875,814)**	12,979,748
Cash and cash equivalents, beginning of period	**17,641,155**	6,857,576	**21,959,317**	5,714,066
Cash and cash equivalents, end of period	**9,083,503**	18,693,814	**9,083,503**	18,693,814

See accompanying notes

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. NATURE OF OPERATIONS AND BASIS OF PRESENTATION

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

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

These consolidated financial statements include the accounts of the Company's wholly-owned subsidiaries, Transition Therapeutics Leaseholds Inc., and Waratah Pharmaceuticals Inc. ["Waratah"], and Waratah's wholly-owned subsidiary, Waratah Pharmaceuticals Corporation. In addition, as further described in note 7, these consolidated financial statements also include the accounts of Stem Cell Therapeutics Inc. ["SCT"] until it was transferred under a contractual arrangement on October 4, 2004.

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

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

2. CHANGE IN ACCOUNTING POLICIES

Stock-based compensation plans

In November 2003, the Canadian Institute of Chartered Accountants ["CICA"] amended CICA Handbook Section 3870, "Stock-Based Compensation and Other Stock-Based Payments", to require the expensing of all stock-based compensation awards for fiscal years beginning on or after January 1, 2004. Effective July 1, 2004, the Company adopted the recommendations of the amended CICA Handbook Section 3870, which will result in the fair value method of accounting being used for all stock-based compensation. The standard has been applied on a retroactive basis. The consolidated statements of loss and deficit for the nine-month and three-month periods ended March 31, 2004 have not been restated. During the nine-month period ended March 31, 2005, the cumulative impact of stock-based compensation for the fiscal years ended June 30, 2004 and 2003 was recognized in the consolidated financial statements as an adjustment to opening deficit. The impact of the adoption was a one-time increase to deficit of $45,180, to stock options of $39,755 and to common shares of $5,425.

In the nine-month period ended March 31, 2005, the effect of the adoption of the fair value method of stock-based compensation expense was an increase to general and administrative expense of $234,435 and an increase to research and development, net, of $105,477 with the corresponding total included as an increase to stock options. In the three-month period ended March 31, 2005, the effect of the adoption of the fair value method of stock-based compensation expense was an increase to general and administrative expense of $83,457 and an increase to research and development, net, of $16,711 with the corresponding total included as an increase to stock options.

Stock-based compensation plans (continued)

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

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

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

The fair value of the options at the date of grant, for options granted during the nine-month period ended March 31, 2005, was estimated using the Black-Scholes option pricing model based on the following assumptions: expected option life between 2 to 4 years [nine-month period ended March 31, 2004 - 2 to 4 years], volatility of between 0.861 and 1.217 [nine-month period ended March 31, 2004 - 1.152 to 1.157], a risk-free interest rate of between 1.9% and 2.85% [nine-month period ended March 31, 2004 - 1.75% to 2.75%] and a dividend yield of 0% [nine-month period ended March 31, 2004 - 0%]. The weighted average grant date fair value of options granted during the nine-month period ended March 31, 2005 was $0.83 [nine-month period ended March 31, 2004 - $0.20].

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

	Nine-month period ended March 31, 2004 $	Three-month period ended March 31, 2004 $
Net loss		
As reported	7,852,545	2,985,493
Pro-forma	7,876,821	2,989,586
Basic and fully diluted net loss per common and Class B share		
As reported	$0.09	$0.03
Pro-forma	$0.09	$0.03

Consolidation of variable interest entities

In September 2004, the CICA issued Accounting Guideline 15 ["AcG-15"], "Consolidation of Variable Interest Entities", which applies to annual and interim periods beginning on or after November 1, 2004. AcG-15 requires that the assets, liabilities, and results of a Variable Interest Entity ["VIE"] be consolidated into the financial statements of the enterprise when that enterprise is the primary beneficiary of the VIE.

In general, an entity is classified as a VIE if: 1) total equity is not sufficient to permit the entity to finance its activities without additional subordinated financial support; 2) its equity investors lack the direct or indirect ability to make decisions about an entity's activities through voting rights; or 3) its equity investors do not absorb the expected losses of the entity if they occur or receive the expected residual returns of the entity if they occur. To determine if an investor in a VIE is the

Consolidation of variable interest entities (continued)

primary beneficiary, the investor must determine if it will absorb a majority of the VIE's expected losses, receive a majority of the VIE's expected returns, or both. An enterprise holding an interest in a VIE for which it is not the primary beneficiary does not consolidate the VIE, but is required to provide certain disclosures.

The Company has analyzed its interests in entities which it does not wholly-own and has determined that it has an interest in one VIE, SCT. The Company has determined that it is not the primary beneficiary of SCT. The nature of the Company's involvement with SCT is further described in note 7.

3. TECHNOLOGY

Technology consists of the following:

	March 31, 2005		
	Cost $	Accumulated amortization $	Net book value $
Acquired on acquisition of Waratah	**39,799,917**	**25,538,280**	**14,261,637**
Acquired from Biogenesys, Inc.	**137,000**	**91,328**	**45,672**
	39,936,917	**25,629,608**	**14,307,309**

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

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

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

4. DEFERRED REVENUE AND CHARGES

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

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

To date, under the Licensing Agreement, the Company has received a total of $2,282,955 [U.S. $1,750,000]. Of this total, $1,968,580 [U.S. $1,500,000] has been recorded as deferred revenue and will be recorded as licensing fee revenue over the term of the Licensing Agreement, which has been estimated as 15 years and $314,375 [U.S. $250,000] has been recorded as deferred revenue until the corresponding research expenses are incurred.

4. DEFERRED REVENUE AND CHARGES (continued)

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

5. CASH AND CASH EQUIVALENTS AND SHORT-TERM INVESTMENTS

Included in cash and cash equivalents at March 31, 2005 is cash denominated in U.S. dollars of U.S. $238,689 [June 30, 2004 - U.S. $26,078].

Short-term investments consist of term deposits totaling $13,998,448 at March 31, 2005, with interest rates of between 2.45% and 2.5% and maturity dates between July 20, 2005 and August 29, 2005.

6. INVESTMENT TAX CREDITS

For the nine-month period ended March 31, 2005, $189,388 [nine-month period ended March 31, 2004 - $217,000] and for the three-month period ended March 31, 2005, $99,388 [three-month period ended March 31, 2004 - $177,000] was recorded in research and development, net of investment tax credits for investment tax credits.

7. TRANSFER OF SCT

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

This transaction has not been recorded as a sale for accounting purposes as the risks and rewards of the ownership of SCT have not been transferred to the purchaser under the terms of the share purchase agreement. In addition, the Company does not anticipate that the transaction will qualify for sale accounting within the next twelve months. Therefore, the Company has not reclassified the assets and liabilities of SCT as held for sale as at March 31, 2005, but has reclassified the assets and liabilities as transferred under a contractual arrangement. The upfront cash payment received of $325,000, net of disposition costs, has been recorded against the assets transferred. In the future, if circumstances change such that a transfer of the risks and rewards to the purchaser is expected within the next twelve months, the Company will reclassify SCT's assets and liabilities as held for sale at that time.

The financial results of SCT were consolidated with the financial results of the Company until SCT was transferred on October 4, 2004. For the period of October 4, 2004 to March 31, 2005, the losses incurred by SCT of $98,546 were recorded as losses of company transferred under contractual arrangement with the corresponding amount reducing assets transferred under contractual arrangement.

8. INVESTMENT

The investment consists of the following:

	March 31, 2005 $	June 30, 2004 $
Investment in Ellipsis Neurotherapeutics Inc., opening balance	**2,305,192**	-
Equity basis pickup	**(125,959)**	-
Investment in Ellipsis Neurotherapeutics Inc., closing balance	**2,179,233**	-

Effective November 4, 2004, the Company acquired a 17% interest in Ellipsis Neurotherapeutics Inc. ["ENI"] with the potential to increase this interest to approximately 52% through a share

8. INVESTMENT (continued)

exchange at the option of certain ENI shareholders and consideration for the Company's management services. ENI is developing a series of compounds for the treatment of Alzheimer's disease.

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

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

In addition, through leading the development of the ENI products, the Company will also have the potential to earn up to 1,600,000 ENI common shares, over the 24 month period ending November 4, 2006, through the achievement of milestones. The fair value of any ENI common shares earned will be recorded as revenue at the time the milestone is achieved. The investment in ENI is accounted for using the equity method. Total consideration paid for the investment in ENI is as follows:

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

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

9. SHARE CAPITAL

[a] Authorized

As at March 31, 2005, the authorized share capital of the Company consists of unlimited common shares. The common shares are voting and are entitled to dividends if, as and when declared by the Board of Directors.

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

[b] Issued and outstanding and changes during the period

Common shares	#	$
Balance, June 30, 2004	**106,522,735**	**66,001,437**
Retroactive adjustment for stock-based compensation [*note 2*]	**-**	**5,425**
Issued pursuant to private placement, net [*i*]	**5,000,000**	**5,986,896**
Exercise of share purchase warrants [*note 9[c][i]*]	**5,337,289**	**3,724,306**
Exercise of Agents' Warrants [*note 9[c][ii]*]	**2,147,699**	**1,288,619**
Exercise of stock options [*note 9[d][i]*]	**143,300**	**217,018**
Shares issued to ENI [*note 8*]	**884,956**	**-**
Balance, March 31, 2005	**120,035,979**	**77,223,701**

[b] Issued and outstanding and changes during the period (continued)

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

[ii] The weighted average number of common and Class B shares used in the computation of basic and fully diluted net loss per common and Class B share for the nine-month period ended March 31, 2005 is 113,365,226 [nine-month period ended March 31, 2004 - 83,746,438] and for the three-month period ended March 31, 2005 is 119,316,805 [three-month period ended March 31, 2004 - 90,355,887].

For the nine-month period ended March 31, 2005, 739,854 [nine-month period ended March 31, 2004 - 1,090,906] and for the three-month period ended March 31, 2005, 719,174 [three-month period ended March 31, 2004 - 1,105,590] contingently returnable common shares were excluded from the basic and fully diluted net loss per common and Class B share calculation. The contingently returnable common shares relate to employment contracts and will be released from escrow based on the achievement of certain corporate milestones.

[c] Share purchase warrants and Agents' Warrants

Share purchase warrants	#	$
Share purchase warrants outstanding, June 30, 2004	**6,782,002**	**1,126,712**
Exercise of share purchase warrants [*i*]	**(5,337,289)**	**(628,678)**
Share purchase warrants outstanding, March 31, 2005	**1,444,713**	**498,034**

Agents' Warrants	#	$
Agents' Warrants outstanding, June 30, 2004	**1,431,800**	**329,314**
Exercise of Agents' Warrants [*ii*]	**(1,431,800)**	**(329,314)**
Agents' Warrants outstanding, March 31, 2005	**-**	**-**
Total warrants	**1,444,713**	**498,034**

[i] Share purchase warrants totaling 5,337,289 were exercised during the nine-month period ended March 31, 2005. These warrants had a recorded value of $628,678 and resulted in cash proceeds to the Company of $3,095,628.

[ii] Agents' Warrants totaling 1,431,800, as well as the underlying share purchase warrants, were exercised during the nine-month period ended March 31, 2005. These warrants had a recorded value of $329,314 and resulted in cash proceeds to the Company of $959,305.

[iii] The maximum possible cash proceeds to the Company from the exercise of the warrants outstanding as at March 31, 2005 is $1,403,846 [June 30, 2004 - $5,458,780].

[d] Stock options

Stock options	#	$
Stock options outstanding, June 30, 2004	**3,585,031**	**566,997**
Retroactive adjustment for stock-based compensation [*note 2*]	**-**	**39,755**
Stock options expired [*ii*]	**(246,069)**	**(122,324)**
Exercise of stock options [*i*]	**(143,300)**	**(77,175)**
Stock options issued [*note 2*]	**830,000**	**291,950**
Compensation expense for options issued in prior periods [*note 2*]	**-**	**47,962**
Stock options outstanding, March 31, 2005	**4,025,662**	**747,165**

[i] Stock options totaling 143,300 were exercised during the nine-month period ended March 31, 2005. These stock options had a recorded value of $77,175 and resulted in cash proceeds to the Company of $139,843.

[d] Stock options (continued)

[ii] Of the stock options that expired during the nine-month period ended March 31, 2005, 194,165 [year ended June 30, 2004 - 295,832] were included as part of the consideration for the acquisition of Waratah. Therefore, the consideration associated with these options which was $122,324 [June 30, 2004 - $184,874] was reclassified to contributed surplus.

[iii] The maximum possible cash proceeds to the Company from the exercise of the stock options outstanding as at March 31, 2005 is $4,828,900 [June 30, 2004 - $4,147,063].

[e] Exchange Rights

Exchange Rights	#	$
Exchange Rights outstanding, June 30, 2004	**-**	**-**
Exchange Rights issued [*note 8*]	**4,000,000**	**388,000**
Exchange Rights outstanding, March 31, 2005	**4,000,000**	**388,000**

10. CONSOLIDATED STATEMENTS OF CASH FLOWS

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

	Nine-month period ended March 31, 2005 $	Nine-month period ended March 31, 2004 $	Three-month period ended March 31, 2005 $	Three-month period ended March 31, 2004 $
Receivables	**200,703**	16,149	**3,321,920**	(38,374)
Investment tax credit receivable	**(15,033)**	210,579	**(73,565)**	28,115
Research inventory	**(1,527,420)**	125,651	**(515,173)**	105,558
Prepaid expenses and other assets	**(26,077)**	(59,252)	**56,899**	(55,063)
Long-term deposits	**13,395**	6,778	**(819)**	(1,596)
Deferred charges	**(127,248)**	-	**2,208**	-
Accounts payable and accrued liabilities	**581,176**	(459,838)	**(656,074)**	95,716
Deferred revenue	**1,285,816**	652,400	**281,564**	-
Provision for facility closure	**(220,020)**	(176,345)	**(63,432)**	(54,680)
	165,292	316,122	**2,353,528**	79,676
Supplemental cash flow information				
Interest paid	**4,170**	4,064	**152**	776
Income tax paid	**552**	133,796	**552**	107,154

11. NON-CASH TRANSACTIONS

During the nine-month period ended March 31, 2005, the Company entered into the following non-cash activity:

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

12. COMMITMENTS

[a] As at March 31, 2005, the Company is committed to aggregate expenditures of $74,789 [June 30, 2004 - $173,252] under its collaboration agreements. In addition, at March 31, 2005, the Company is committed to aggregate expenditures of $1,084,486 [June 30, 2004 - $151,763] for clinical and toxicity studies and $261,516 [June 30, 2004 - $78,215] for manufacturing agreements.

[b] The Company leases various premises under operating leases expiring at various dates to May 31, 2015 with certain options to renew. Future minimum annual lease payments under these operating leases, excluding Waratah's facility in Woburn, MA, which has been accrued for, in aggregate and over the next five years are as follows:

12. COMMITMENTS (continued)

	$
2006	59,693
2007	160,048
2008	160,048
2009	160,048
2010	160,048
	699,885

13. SEGMENTED INFORMATION

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

	Canada $	United States $
Net loss:		
Nine-month period ended March 31, 2005	**9,677,085**	**30,824**
Nine-month period ended March 31, 2004	7,768,311	84,234
Three-month period ended March 31, 2005	**3,466,555**	**37,872**
Three-month period ended March 31, 2004	2,887,610	97,883
Amortization of capital assets:		
Nine-month period ended March 31, 2005	**93,315**	**-**
Nine-month period ended March 31, 2004	80,843	5,475
Three-month period ended March 31, 2005	**34,007**	**-**
Three-month period ended March 31, 2004	29,998	-
Interest income (expense), net:		
Nine-month period ended March 31, 2005	**384,962**	**957**
Nine-month period ended March 31, 2004	166,405	(344)
Three-month period ended March 31, 2005	**141,532**	**957**
Three-month period ended March 31, 2004	69,309	-
Recovery of (provision for) income taxes - current:		
Nine-month period ended March 31, 2005	**-**	**-**
Nine-month period ended March 31, 2004	-	38,209
Three-month period ended March 31, 2005	**-**	**-**
Three-month period ended March 31, 2004	-	(15,709)
Recovery of (provision for) income taxes - future:		
Nine-month period ended March 31, 2005	**1,154,601**	**(87,311)**
Nine-month period ended March 31, 2004	2,293,717	(66,250)
Three-month period ended March 31, 2005	**-**	**(27,045)**
Three-month period ended March 31, 2004	915,743	-
Technology:		
March 31, 2005	**14,307,309**	**-**
June 30, 2004	22,436,674	-
Capital assets:		
March 31, 2005	**456,453**	**-**
June 30, 2004	440,783	-

14. GUARANTEES

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

15. COMPARATIVE CONSOLIDATED FINANCIAL STATEMENTS

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

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