



**CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2010 and 2009**

(expressed in Canadian dollars)

## **MANAGEMENT'S STATEMENT OF RESPONSIBILITY FOR FINANCIAL REPORTING**

The accompanying consolidated financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles and have been approved by the Board of Directors.

In support of this responsibility, management maintains a system of internal controls to provide reasonable assurance as to the reliability of financial information and the safeguarding of assets. The consolidated financial statements include amounts which are based on the best estimates and judgments of management.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal controls. The Board of Directors exercises this responsibility principally through the Audit Committee.

The Audit Committee consists of independent directors not involved in the daily operations of the Company. The Audit Committee meets with management and the external auditors to satisfy itself that management's responsibilities are properly discharged and to review the consolidated financial statements prior to their presentation to the Board of Directors for approval.

The external auditors, PricewaterhouseCoopers LLP, appointed by the shareholders of the Company, have examined the financial statements and have expressed an opinion on the statements. The external auditors have free and full access to the Audit Committee with respect to their findings concerning the fairness of financial reporting and the adequacy of internal controls. Their report is included with the consolidated financial statements.

A handwritten signature in black ink, appearing to read "James Szarko".

James Szarko, CA  
President, CEO & CFO

March 30, 2011

## INDEPENDENT AUDITOR'S REPORT

### To the Shareholders of SemBioSys Genetics Inc.

We have audited the accompanying consolidated financial statements of SemBioSys Genetics Inc. and its subsidiary, which comprise the consolidated balance sheets as at December 31, 2010 and 2009 and the consolidated statements of loss and deficit, comprehensive loss, accumulated other comprehensive loss and cash flows for the years then ended, and the related notes including a summary of significant accounting policies.

#### **Management's responsibility for the consolidated financial statements**

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with Canadian generally accepted accounting principles, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

#### **Auditor's responsibility**

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

#### **Opinion**

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of SemBioSys Genetics Inc. and its subsidiary as at December 31, 2010 and 2009 and the results of their operations and their cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

#### **Emphasis of matter**

Without qualifying our opinion, we draw attention to note 2 in the consolidated financial statements which describes matters and conditions that indicate the existence of a material uncertainty that may cast significant doubt about the company's ability to continue as a going concern.

*PricewaterhouseCoopers LLP*

Chartered Accountants

SemBioSys Genetics Inc.  
**CONSOLIDATED BALANCE SHEETS**

As at December 31,  
 (expressed in Canadian dollars)

**2010**                      2009  
**\$**                                \$

**ASSETS**

**Current assets**

Cash and cash equivalents	267,436	3,687,548
Investment (Note 4)	-	380,601
Accounts receivable	184,016	124,083
GST receivable	59,620	52,649
Prepaid expenses, deposits and other	229,590	175,894
	<u>740,662</u>	<u>4,420,775</u>

**Property and equipment** (Note 5)

	2,294,026	3,683,462
	<u>3,034,688</u>	<u>8,104,237</u>

**LIABILITIES**

**Current liabilities**

Accounts payable and accrued liabilities	1,014,857	1,291,023
Current portion of long-term debt (Note 6)	1,906,361	1,534,535
	<u>2,921,218</u>	<u>2,825,558</u>

**Long-term portion of convertible debenture** (Note 7)

	758,815	-
	<u>3,680,033</u>	<u>2,825,558</u>

**SHAREHOLDERS' (DEFICIENCY) EQUITY**

<b>Capital stock</b> (Note 8)	75,459,690	73,726,414
<b>Warrants</b> (Note 8b)	3,527,425	3,527,425
<b>Contributed surplus</b> (Note 8f)	14,312,965	13,764,398
<b>Accumulated other comprehensive loss</b>	-	(54,372)
<b>Deficit</b>	(93,945,425)	(85,685,186)
	<u>(645,345)</u>	<u>5,278,679</u>
	<u>3,034,688</u>	<u>8,104,237</u>

**Going concern** (Note 2)

**Commitments and Guarantees** (Note 12)

See accompanying notes.

Approved by the Board of Directors:



Richard Smith, Chairman and Director



Ian Brown, Director

# SemBioSys Genetics Inc.

## CONSOLIDATED STATEMENTS OF LOSS AND DEFICIT

For the years ended December 31,  
(expressed in Canadian dollars, except shares)

	2010 \$	2009 \$
<b>REVENUE</b>		
Licensing fees	315,789	307,048
Contract research	151,715	102,571
Royalty revenue	12,012	-
Licensing option fees	-	1,161,495
	<u>479,516</u>	<u>1,571,114</u>
<b>EXPENSES</b>		
Research and development ( <i>net of scientific research &amp; experimental tax credits \$318,994 (2009 - \$nil)</i> ).	3,512,564	6,093,515
General and administration	1,202,898	1,619,930
Intellectual property costs (Note 7)	1,643,015	941,583
Business development	443,423	518,955
Stock-based compensation	466,071	682,791
Amortization	1,366,501	1,471,361
Cost recoveries (Note 9c)	(325,258)	(57,805)
	<u>8,309,214</u>	<u>11,270,330</u>
<b>Loss before the undernoted</b>	<u>(7,829,698)</u>	<u>(9,699,216)</u>
Interest expense	(370,545)	(210,648)
Interest income	3,821	9,427
Foreign exchange gain	4,282	50,621
Gain on sale of property and equipment	179,723	
Gain on exchange of shares (Note 1)	-	2,941,981
Gain on sale of shares	-	415,445
Realized loss on disposal of investment (Note 4)	(247,822)	-
	<u>(430,541)</u>	<u>3,206,826</u>
<b>Net loss from continuing operations</b>	<u>(8,260,239)</u>	<u>(6,492,390)</u>
<b>Discontinued operations</b> (Note 10)	-	(96,492)
<b>Net loss</b>	<u>(8,260,239)</u>	<u>(6,588,882)</u>
<b>Deficit - Beginning of the year</b>	<u>(85,685,186)</u>	<u>(79,096,304)</u>
<b>Deficit - End of the period of the year</b>	<u>(93,945,425)</u>	<u>(85,685,186)</u>
<b>Loss per share</b>		
Basic and diluted from continuing operations	(0.17)	(0.19)
Basic and diluted from discontinued operations	-	(0.00)
Basic and diluted	<u>(0.17)</u>	<u>(0.19)</u>
<b>Weighted average shares outstanding</b> (Note 8c)	<u>49,505,621</u>	<u>33,869,094</u>

**Going concern** (Note 2)

See accompanying notes.

SemBioSys Genetics Inc.  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS**

For the years ended December 31,  
(expressed in Canadian dollars)

	<b>2010</b>	<b>2009</b>
	<b>\$</b>	<b>\$</b>
<b>Net loss for the year</b>	(8,260,239)	(6,588,882)
<b>Other comprehensive loss</b>		
Foreign currency translation adjustment	-	-
Foreign currency translation adjustment transferred to net income from discontinued operations during the year	-	-
Unrealized loss on investment	(193,450)	(54,372)
Realized loss on investment (Note 4)	247,822	-
<b>Comprehensive loss for the year</b>	<b>(8,205,867)</b>	<b>(6,643,254)</b>

**CONSOLIDATED STATEMENTS OF ACCUMULATED OTHER COMPREHENSIVE LOSS**

As at December 31,  
(expressed in Canadian dollars)

	<b>2010</b>	<b>2009</b>
	<b>\$</b>	<b>\$</b>
<b>Accumulated other comprehensive loss</b>		
<b>- beginning of the year</b>	(54,372)	-
<i>Foreign currency translation adjustments</i>		
Change in accounting policy	-	26,534
Adjustments during the year	-	(32,365)
Transferred to net income from discontinued operations during the year	-	5,831
	(54,372)	-
<i>Unrealized loss on Investment</i>	(193,450)	(54,372)
<i>Realized loss on investment (Note 4)</i>	247,822	-
<b>Accumulated other comprehensive loss</b>		
<b>- end of the year</b>	<b>-</b>	<b>(54,372)</b>

**Going concern** (Note 2)  
See accompanying notes.

SemBioSys Genetics Inc.  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

For the years ended December 31,  
(expressed in Canadian dollars)

	2010 \$	2009 \$
<b>Cash provided by (used in)</b>		
<b>Operating activities</b>		
Net loss for the period from continuing operations	(8,260,239)	(6,492,390)
Add items not affecting cash:		
Amortization	1,366,501	1,471,361
Stock-based compensation	466,071	682,791
Shares issued for services	113,635	152,985
Deferred share units issued	82,496	109,929
Unrealized foreign exchange loss	2,891	(60,952)
Non-cash interest expense	340,092	158,237
Gain on disposal of property and equipment	(179,723)	-
Loss on disposal of investment	247,822	-
Gain on disposal of shares	-	(415,445)
Gain on exchange of shares	-	(2,941,981)
Non-cash interest on convertible debentures (Note 7)	28,815	-
Non-cash license fees expensed (Note 7)	730,000	-
	<u>(5,061,639)</u>	<u>(7,335,465)</u>
Change in non-cash working capital and other balances related to operations	64,902	(138,221)
Cash used in operating activities	<u>(4,996,737)</u>	<u>(7,473,686)</u>
<b>Financing activities</b>		
Issuance of capital stock	1,778,595	3,531,801
Share issue costs	(163,709)	(303,609)
Issuance of warrants	-	2,454,668
Warrant issue costs	(6,340)	(333,223)
Proceeds related to the corporate reorganization (Note 1)	-	3,701,929
Costs related to the corporate reorganization (Note 1)	(255,572)	(443,933)
Proceeds from long-term debt	-	1,431,118
Repayment of long-term debt	(66,156)	(767,822)
Cash provided by financing activities	<u>1,286,818</u>	<u>9,270,929</u>
<b>Investing activities</b>		
Proceeds on disposition of investment	187,148	-
Purchase of Botaneco convertible debenture	-	(19,350)
Proceeds on disposition of property and equipment	102,659	-
Acquisition of property and equipment	-	(17,311)
Cash provided by (used in) investing activities	<u>289,807</u>	<u>(36,661)</u>
<b>Net change in cash from continuing operations</b>	<u>(3,420,112)</u>	<u>1,760,582</u>
<b>Cash flow from discontinued operations</b>		
<b>Operating activities</b>	-	(2,081,450)
<b>Financing activities</b>	-	951,576
<b>Investing activities</b>	-	(762,956)
<b>Net change in cash from discontinued operations</b>	<u>-</u>	<u>(1,892,830)</u>
<b>Decrease in cash and cash equivalents</b>	<u>(3,420,112)</u>	<u>(132,248)</u>
<b>Cash and cash equivalents - Beginning of the year</b>	<u>3,687,548</u>	<u>3,819,796</u>
<b>Cash and cash equivalents - End of the year</b>	<u>267,436</u>	<u>3,687,548</u>
<b>Supplemental Information (continuing operations)</b>		
Cash interest received	3,938	13,079
Cash interest paid	3,100	51,816
Non-cash transactions		
Capital items included in accounts receivable	100,000	-

**Going concern** (Note 2)

See accompanying notes.

# SemBioSys Genetics Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

### 1) CORPORATE REORGANIZATION AND NATURE OF OPERATIONS

#### *Corporate Reorganization*

SemBioSys Genetics Inc. ("SemBioSys"), ("the Company") ("New SemBioSys Amalco") was formed on December 18, 2009 when 1491277 Alberta Ltd. ("New SemBioSys") and 1491265 Alberta Ltd. ("New Subco") amalgamated.

On December 18, 2009, the predecessor entity to SemBioSys (also previously named SemBioSys Genetics Inc. and now named Cathedral Energy Services Ltd.) ("Old SemBioSys") completed a plan of arrangement (the "Arrangement") involving, amongst others, SemBioSys, Cathedral Energy Services Income Trust ("Cathedral"), Cathedral Energy Services Ltd., New SemBioSys and New Subco. Pursuant to the Arrangement, the assets and liabilities of Old SemBioSys, as they existed immediately prior to the Arrangement, with the exception of certain future tax assets were transferred to New Subco. The rights holders of Old SemBioSys exchanged their common shares, stock options, warrants and deferred stock units of Old SemBioSys for common shares, stock options, warrants, and deferred stock unit of New SemBioSys on a one-for-one basis. The Company carried on the business of Old SemBioSys as it existed immediately prior to the Arrangement. The board of directors and management of Old SemBioSys continued on as the board of directors and management of New SemBioSys.

The Company having all the same assets and liabilities, except Old SemBioSys' tax attributes and an additional \$3,670,629 in cash and marketable securities (received from Cathedral Energy Services Ltd. pursuant to the Arrangement), as they existed immediately prior to the Arrangement carried on the business of Old SemBioSys as it existed immediately prior to the Arrangement. The board of directors and management of Old SemBioSys continued on as the board of directors and management of New SemBioSys.

As the transfer of the business assets, liabilities and operations to SemBioSys (through the transfer of one of its predecessor companies, New Subco) pursuant to the terms of the Arrangement represented a transaction with no substantive change in shareholder ownership, the transaction was accounted for using continuity of interest accounting. Accordingly, the consolidated financial statement information included in these financial statements reflect that of the Company as if it had always carried on the business formerly carried on by Old SemBioSys.

Pursuant to continuity of interest accounting, the assets transferred and liabilities assumed have been recorded at their carrying values as reported by Old SemBioSys immediately prior to the Arrangement. Accordingly, for the year ended December 31, 2009, SemBioSys' financial statements combine the financial results for the business carried on by Old SemBioSys from January 1, 2009 to December 18, 2009 with those of SemBioSys from December 19, 2009 to December 31, 2009. The cash consideration of \$2,845,629, marketable securities of \$825,000 (immediately sold for net proceeds of \$856,300) and related transaction costs of \$759,948 were recorded as a gain on exchange of shares of \$2,941,981.

#### *Nature of Operations*

SemBioSys continues to carry on its primary business of manufacturing high-value proteins and oils in plant seeds using its unique proprietary platform. At SemBioSys' current stage of development, the

# **SemBioSys Genetics Inc.**

## **Notes to the Consolidated Financial Statements**

(expressed in Canadian dollars)

Company derives its revenues from licensing fees, licensing option fees and contract research for and in collaboration with third parties. In 2009 the Company disposed of its interest in Botaneco Specialty Ingredients Inc. ("Botaneco"), and as a result, it no longer controls or holds significant influence over that entity (see note 10). The Company, at its present stage of development, faces liquidity risks which are described in notes 2 and 15.

### **2) GOING CONCERN**

The consolidated financial statements have been prepared on a going concern basis, which assumes that the Company will continue in operation for the foreseeable future, and, accordingly, will be able to realize its assets and discharge its liabilities in the normal course of operations.

To date, the Company has had no net earnings, minimal revenue and negative operating cash flows. It has financed its activities primarily through issuances of securities, cost recoveries, licensing fees, licensing option fees, contract research revenues, investment tax credits, government funding, long-term debt and interest income. As such, the Company's ability to continue as a going concern is dependent on the achievement of successful partnership collaborations, obtaining additional investment capital, the realization of assets, obtaining grant monies and the improvement of cash flow from operations. Note 15 provides a more detailed description of the liquidity risks the Company is facing.

During the third quarter the Company announced that it was working on a number of strategic options potentially available to it including a corporate sale or merger, an accelerated strategic partnering transaction for either insulin or Apo, a significant restructuring and recapitalization or an orderly wind down of the Company's business. In conjunction with this, the company further downsized and reduced its monthly operating expenditures. Additionally, the Company has been able to secure \$4 million in financing (note 17). The \$4 million provides the Company with adequate cash to cover its near term cash requirements.

Based on the foregoing, the Company will continue to avail itself to strategic partnering activities and funding opportunities, however, no assurances can be made that it will be successful in raising additional investment capital, realizing assets, discharging liabilities or achieving successful partnership collaborations to generate sufficient cash flows to continue as a going concern. As a result, there is still significant risk regarding the Company's ability to continue as a going concern. These consolidated financial statements do not reflect the adjustments that might be necessary to the carrying amount of reported assets, liabilities, revenue and expenses and the balance sheet classification used if the Company was unable to continue operations in accordance with this assumption. Such adjustments could be material.

# **SemBioSys Genetics Inc.**

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

### **3) SIGNIFICANT ACCOUNTING POLICIES**

These consolidated financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles. The following is a summary of significant accounting policies:

#### **Use of 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 consolidated financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from management's best estimates as additional information becomes available. Significant estimates are made for the determination of recognized revenue, recoverability of accounts receivable, the useful life and impairment of property and equipment, stock-based compensation, warrants, ability to recognize future tax assets and the estimated timing of future milestone payments to estimate the interest rate of the AVAC Ltd. ("AVAC") long-term debt (note 6).

#### **Basis of consolidation**

These consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, SemBioSys Genetics Corporation, a non-operating U.S. subsidiary.

On July 29, 2009 SemBioSys disposed of the majority of its interest in Botaneco Specialty Ingredients Inc. (note 10), which the Company, under Accounting Guideline 15, previously determined to be a variable interest entity ("VIE") for which SemBioSys was the primary beneficiary. This determination required that SemBioSys consolidate Botaneco's operations with its results. As a result of the disposal on July 29, 2009, the Company reassessed whether Botaneco was a VIE and determined that SemBioSys was no longer the primary beneficiary of Botaneco. Consequently, effective July 29, 2009 the Company no longer consolidates Botaneco's operations with its results and Botaneco's operations are instead presented as discontinued operations in the Company's financial statements.

On November 20, 2009 the Company's remaining investment in Botaneco was sold. (note 4).

#### **Cash and cash equivalents**

Cash and cash equivalents consists of cash and demand short-term deposits of 90 days or less. Cash and demand short-term deposits are held with highly rated financial institutions. For the year ended December 31, 2009, the effective interest rate earned on the demand short-term deposits was 0.20% (2009 – 0.23%).

# SemBioSys Genetics Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

### Property and equipment

Property and equipment are recorded at cost less accumulated amortization. Amortization of property and equipment is provided over their estimated useful lives, on a straight-line basis at the following annual rates:

Leasehold improvements	10 years or lease term, if shorter
Laboratory equipment	10 years
Field and planting equipment	3 – 10 years
Process development and manufacturing equipment	10 years
Computer equipment	3 years
Furniture and fixtures	5 years

Management assesses the carrying amount of property and equipment when facts and circumstances indicate a potential impairment. If it is determined that the estimated net recoverable amount is less than the carrying amount, a write-down to the asset's fair value is recognized.

### Revenue recognition

Licensing fee revenue from arrangements that require no future significant involvement or obligation to perform under the arrangement are recognized at the date the license is granted, if there is persuasive evidence of an arrangement, collection of the resulting receivable is reasonably assured, the fee is fixed or determinable, delivery has occurred and the contract has commenced. Similarly, non-refundable milestone payments are recognized upon the achievement of specified milestones when the Company has no further significant involvement or obligation to perform under the arrangement.

Licensing fee revenue (initial fees and milestone payments) derived from collaborative licensing arrangements which require unspecified ongoing involvement of the Company are deferred and amortized into income on a straight-line basis over the expected period of the ongoing involvement of the Company. Licensing fee revenue (initial fees and milestone payments) derived from collaborative licensing arrangements which require specified ongoing involvement of the Company are deferred and recognized into income using the percentage completion method based on the ongoing involvement of the Company.

Contract research revenue for cost plus margin arrangements are recognized as the services are performed. Upfront payments under these arrangements are deferred and revenue is recognized over the life of the contract as services are performed. Contract research revenue related to milestone agreements are recorded based on the relative effort expended to achieve the specific milestone using the percentage completion method assuming the milestone is achieved and the probable economic benefits will flow to the entity. Under this method, the revenue recognized is the lower of the cash to be received upon achievement of the milestone and the results using a percentage completion model.

# **SemBioSys Genetics Inc.**

## **Notes to the Consolidated Financial Statements**

(expressed in Canadian dollars)

Royalty revenue is based on a percentage of sales of certain declared products sold by third parties, will be recorded when the Company has fulfilled the terms in accordance with the contractual agreement, has no future obligations, the amount of the royalty fee is determinable and collection is reasonably assured.

### **Cost recovery agreements and government assistance**

The contribution agreements (note 9) have specific milestones that must be completed under the terms of the agreements. Upfront payments are deferred and recognized into income using the percentage completion method. Milestone payments are recognized when the milestones have been achieved.

### **Stock-based compensation**

The Company recognizes the value of equity instruments awarded to employees and non-employees in the financial statements based on the estimated fair value at the date of grant. The Company calculates the value of stock options issued using the Black-Scholes option pricing model with consideration of factors specific to the Company. For options granted to employees and directors, the value is recognized at the date of grant and is deferred and expensed over the period the options vest, with a corresponding increase to contributed surplus. For options granted to consultants, an expense is recognized as services are provided.

In 2009, the Company adopted a Deferred Share Unit ("DSU") plan. Under this plan, units can be granted to officers, employees, consultants, and members of the Board, at the Company's option, to either receive a common share or cash equivalent in exchange for a vested unit. The DSU's are either classified as equity settled instruments or as liabilities. For DSU's classified as equity settled instruments, the expense related to the units granted is recognized over the vesting period, on a graded basis, based on the fair value of the units at the date of the grant and is charged as an expense on the income statement with the offset being recorded as contributed surplus. The contributed surplus balance is reduced as vested units are settled. For DSU's classified as liability settled instruments, the expense related to the units granted is recognized over the vesting period, on a graded basis, based on the fair value of the stock at each reporting date where they are "marked to market" based on the share price at the quarter end.

### **Loss per common share**

Loss per share is calculated using the weighted average number of common shares outstanding during the year. The Company uses the treasury method of calculating diluted loss per common share. Under this method, diluted loss per share is computed in a manner consistent with basic loss per share except that the weighted average shares outstanding are increased to include additional shares from the assumed exercise of options and warrants, if dilutive. The number of additional shares is calculated by assuming that any outstanding "in the money" options and warrants were exercised at the later of the beginning of the period or the date of issue and that the proceeds from such exercises were used to acquire shares of common stock at the average market price during the reporting period.

# **SemBioSys Genetics Inc.**

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

### **Investment tax credits**

The Company is entitled to investment tax credits ("ITCs") based on certain research and experimental development costs incurred. Refundable cash credits were credits recognized in prior years when there was reasonable assurance of their recovery using the cost reduction method. ITCs are subject to assessment and approval by the Canada Revenue Agency. Adjustments required, if any, are reflected in the year when such assessments are received. Federal ITCs relating to scientific research and development expenditures incurred after the completion of the public offering are no longer refundable and may only be used to reduce future income taxes payable, if any.

Investment tax credits and other cost recoveries related to property and equipment are credited against the book value of property and equipment and the credit is released to income on a straight-line basis as a reduction of amortization expense over the abovementioned estimated useful lives of the relevant assets. The remaining balance is recorded as a reduction of scientific research and development expenses.

### **Research and development costs**

Research costs are expensed as incurred. Development costs that meet specific criteria for deferral under Canadian generally accepted accounting principles will be capitalized. These criteria relate to technical, market and financial feasibility. To date, all development costs have been expensed, as they do not meet these criteria.

### **Intellectual property costs**

Intellectual property costs include patent costs and other costs such as legal opinions, licensing fees, royalties and trademarks. These costs are expensed as incurred.

### **Income taxes**

The Company uses the liability method of accounting for income taxes under which future tax assets and liabilities are recognized for differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Future tax assets and liabilities are measured using substantively enacted tax rates in effect in the period in which those temporary differences are expected to reverse. The effect on future tax assets and liabilities of a change in tax rates is recognized as part of the provision for income taxes in the period the substantive enactment occurs. A valuation allowance is recorded against the future tax asset to the extent it is more likely than not that some or all of the future tax asset will not be realized.

### **Foreign currency translation**

Transactions denominated in foreign currencies and the financial statements of the integrated foreign operations are translated into Canadian dollars using the temporal method. Under this method, monetary assets and liabilities are translated using the rate of exchange in effect at the balance sheet date, whereas other non-monetary assets and liabilities are translated at the rate of exchange in effect on the date of the transaction. Revenues and expenses are re-measured at monthly average

# SemBioSys Genetics Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

rates prevailing throughout the period, except for amortization which is re-measured at exchange rates prevailing when the related assets were acquired. Exchange gains and losses resulting from translation are included in the statement of loss and deficit.

### Financial instruments

All financial instruments are required to be measured at fair value on initial recognition of the instrument, except for certain related party transactions. Measurement in subsequent periods depends on whether the financial instrument has been classified as held-for-trading, available-for-sale, held-to-maturity, loans and receivables, or other financial liabilities as defined by the standard.

Financial assets and financial liabilities held-for-trading are measured at fair value with changes in those fair values recognized in net earnings (loss). Financial assets available-for-sale are measured at fair value, with changes in those fair values recognized in other comprehensive income (loss). Financial assets held-to-maturity, loans and receivables and other financial liabilities are measured at amortized cost using the effective interest method of amortization. Transactions costs are expensed when incurred. The methods used by the Company in determining the fair value of financial instruments are unchanged as a result of implementing the new standard.

The Company's cash and cash equivalents are designated as held-for-trading and are measured at carrying value, which approximates fair value due to the short-term nature of these instruments. Investments have been designated as available-for-sale and are measured at fair value. Any unrealized gains and losses recorded in other comprehensive income (loss) until they are realized at which point they are transferred from accumulated other comprehensive income (loss) and recognized in earnings. Accounts receivable is designated as loans and receivables which are accounted for at cost using the effective interest method. Any gains or losses on the realization of loans and receivables are included in earnings. The Company's measured amounts for accounts and interest receivable usually correspond to cost due to their short-term nature. Accounts payable and accrued liabilities, long-term debt and convertible debentures are designated as other liabilities and are accounted for at amortized cost using the effective interest method. Any gains or losses in the realization of other liabilities are included in earnings.

### Future accounting changes

The CICA confirmed that accounting standards in Canada will converge with International Financial Reporting Standards ("IFRS"), as issued by the International Accounting Standards Board. We will begin reporting under IFRS in the first quarter of 2011, with comparative data for the prior year, including an opening balance sheet as at January 1, 2010. IFRS uses a conceptual framework similar to Canadian generally accepted accounting principals, but there could be significant differences in recognition, measurement and disclosures that will need to be addressed. In order to meet the requirement to transition to IFRS, we have established a transition plan comprised of three phases:

- Diagnostic assessment phase – This phase involves performing a high level diagnostic assessment to identify key areas that may be impacted by the transition to IFRS. As a result of the diagnostic assessment, the potentially affected areas are ranked as high, medium or low priority.
- Education, evaluation and design phase – During this phase each area identified in the diagnostic

# SemBioSys Genetics Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

assessment phase will then be addressed in order of descending priority and will involve specifying changes required to existing accounting policies, information systems and business process, together with an analysis of policy alternatives allowed under IFRS.

- Implementation and integration phase – In this phase changes to information systems and business processes will be completed, including any changes required to ensure the integrity of internal control over financial reporting and disclosure controls and procedures. At the end of the implementation and integration phase we will be able to compile financial statements compliant with IFRS.

To date, we have started the initial assessment of the key areas where changes to current accounting policies may be required. While analysis will be required for all current accounting policies, the initial key areas identified for detailed analysis, which are also the areas we expect have the most significant impact on the financial statements of the Company include:

- IFRS 1
  - IFRS 1 provides the framework for the first-time adoption of IFRS and specifies that an entity shall apply the principals under IFRS retrospectively. Certain optional exemptions and mandatory exceptions to retrospective application are provided under this framework. We are currently working on our analysis of IFRS 1 with respect to the elective exemptions available.
- Stock option plans and share based payments
  - IFRS 2 “Share-based Payments” is substantially converged with Canadian GAAP. However, Canadian GAAP allows the use of either the straight-line or the accelerated methods to amortize graded-vesting features where as under IFRS only the accelerated or graded vesting methods are allowed. The Company uses the straight-line method for equity-classified awards issued and expects to adopt the graded vesting method. Also, Canadian GAAP permits companies to either estimate forfeitures at the time of grant, or record the entire expense as if all options vested at the time of grant and record forfeitures as they occur where as, IFRS 2 requires companies to estimate the forfeiture at the time of grant. These differences are expected to impact the accounting of the Company’s incentive plans.
- Cost recoveries and government funding
- Convertible debentures
- Financial Statement Presentation and Disclosure
- Property, plant and equipment

This list is not exhaustive and should not be regarded as complete. As we progress further into our analysis we may identify other areas that will have a significant impact on the financial statements of the Company. The Company expects to meet its reporting timelines for IFRS reporting.

### **Comparative figures**

Certain comparative figures have been reclassified to conform with the current year’s financial statements presentation.

# SemBioSys Genetics Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

### 4) INVESTMENT

Advitech Inc. ("Advitech"), a public company listed on the TSX Venture Exchange, entered into a definitive agreement dated October 19, 2009 to acquire all of the issued and outstanding shares of Botaneco Specialty Ingredients Inc. ("Botaneco") held by SemBioSys and Avrio Ventures Limited Partnership ("Avrio"). The transaction closed on November 20, 2009 and as a result 5,437,157 post-consolidation common shares were issued to SemBioSys in exchange for their current share holdings. In 2009, this resulted in a gain of \$415,445, in 2009, being recorded on the sale of Botaneco shares. At December 31, 2009 Advitech's shares trading at \$0.07 per share. As a result of adjusting the investment in Advitech to fair market value at December 31, 2009 (\$380,601) an unrealized loss of \$54,372 was recorded in other comprehensive loss.

During the year, the Company disposed of its remaining investment in Advitech resulting in a realized loss on investment of \$247,822.

### 5) PROPERTY PLANT AND EQUIPMENT

	December 31, 2010		
	Cost	Accumulated amortization	Net
	\$	\$	\$
Leasehold improvements	3,082,964	2,882,363	200,601
Laboratory equipment	3,549,431	2,571,010	978,421
Field and planting equipment	3,254,579	2,726,195	528,384
Process development and manufacturing equipment	1,939,059	1,307,359	631,700
Computer equipment	735,360	732,493	2,867
Furniture and fixtures	173,145	168,450	4,695
Less:			
Investment tax credits	(326,000)	(306,058)	(19,942)
Government assistance	(1,149,976)	(1,117,276)	(32,700)
	11,258,562	8,964,536	2,294,026

# SemBioSys Genetics Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

December 31, 2009

	Cost \$	Accumulated amortization \$	Net \$
Leasehold improvements	3,082,964	2,611,091	471,873
Laboratory equipment	3,549,431	2,231,950	1,317,481
Field and planting equipment	3,579,498	2,316,953	1,262,545
Process development and manufacturing equipment	1,939,059	1,147,400	791,659
Computer equipment	735,360	715,471	19,889
Furniture and fixtures	173,145	152,888	20,257
Less:			
Investment tax credits	(326,000)	(273,458)	(52,542)
Government assistance	(1,149,976)	(1,002,276)	(147,700)
	11,583,481	7,900,019	3,683,462

### 6) LONG-TERM DEBT

	December 31, 2010 \$	December 31, 2009 \$
Loan payable, bearing interest at 5.24%, repayable in blended monthly instalments of \$6,646, due April 2010	-	26,298
Loan payable, bearing interest at 5.24%, repayable in blended monthly instalments of \$4,295, due April 2011	16,992	-
Loan payable, bearing interest at 7.79%, repayable in blended monthly instalments of \$4,709, due September 2011	41,040	-
Loans Payable	58,032	26,298
AVAC Ltd. ("AVAC") funding	1,848,329	1,508,237
	1,906,361	1,534,535
Less: Current portion of long-term debt	(1,906,361)	(1,534,535)
Balance - End of period	-	-

On May 11, 2009, SemBioSys entered into an agreement with AVAC for a non-dilutive investment for the development of our Apo AI<sub>Milano</sub>. Under this agreement, AVAC will invest up to \$1,500,000 to cover costs relating to our Apo AI<sub>Milano</sub> program in the form of a \$950,000 upfront payment, and \$550,000 of additional payments based on the achievement of specific milestones. The investment

# **SemBioSys Genetics Inc.**

## **Notes to the Consolidated Financial Statements**

(expressed in Canadian dollars)

was secured by a general security agreement charging all present and future acquired property. The investment was to be repaid in the form of a lump sum royalty in the amount of \$2.0 million within 18 months of the date of execution of the agreement or unless agreed to otherwise by the parties. Prior to year-end negotiations were initiated with AVAC regarding the repayment of the outstanding investment and accrued royalties of \$1,848,329. An amending agreement comprising repayment of the outstanding investment through royalties earned from the commercialization of certain non-pharma product revenue streams is being concluded between the Company and AVAC. Additionally, AVAC has agreed to subordinate its security interest with respect to the Company's intellectual property assets to Concept Capital Management Ltd. The advances are not forgivable, however the Company has the option to prepay all advances plus 20% interest compounded annually from the date each advance was received, less royalties paid to date. At December 31, 2010, \$1,350,000 (December 31, 2009 - \$1,350,000) had been received from AVAC and is recorded as a long-term liability using an imputed interest rate of 22.87%.

### **7) CONVERTIBLE DEBENTURES**

On June 7, 2010, SemBioSys renegotiated certain terms of our existing technology license agreement with UTI Limited Partnership ("UTI"). The renegotiated license agreement provides SemBioSys the unilateral right to assign the agreement to another company in the event of the sale of the Company. In exchange for this right and other concessions, the Company agreed to pay an upfront fee of \$110,000, transfer a portion of its existing investment in Advitech and issued \$730,000 of convertible debentures to UTI all of which was recorded as intellectual property costs.

The Company transferred 815,574 shares of Advitech to UTI at a fair value of \$36,701 which was recorded as an expense in intellectual property. As a result of the disposal of a portion of the investment in Advitech, a \$20,389 loss was realized in net income.

Three convertible debentures were issued to UTI, with an aggregate face value of \$730,000. The debentures accrue interest at an annual rate of 7% (non-compounding) and mature on April 12, 2013. The interest is repayable upon maturity of the debentures.

The debentures and accrued interest thereon are convertible at any time, at the holder's option, into common shares of the Company. The number of shares to be issued is determined by dividing the outstanding principal and interest by the five day volume weighted average price of the Common Shares on the TSX. However, the maximum number of common shares that can be issued upon the conversion of the Debentures is 10,200,647 common shares.

Given that the number of equity instruments to be delivered upon conversion of the debentures varies based on the current price of the Company's shares, the conversion right is deemed to be nil. As a result, the Debentures have been recorded at their face value at an effective interest rate of 7%. For the year ended December 31, 2010 an interest expense of \$28,815 (2009 - \$nil) has been recorded.

# SemBioSys Genetics Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

### 8) CAPITAL STOCK

#### a) Authorized

Unlimited number of Common Shares without nominal or par value

Unlimited number of First Preferred Shares without nominal or par value

#### b) Issued

	Common Shares		Warrants	
	Number	Amount \$	Number	Amount \$
Balance - December 31, 2008	25,938,294	70,428,431	2,390,000	2,550,880
Issuance of shares and units	14,715,298	3,297,983	12,105,341	2,010,519
Expiry of warrants	-	-	(1,840,000)	(1,033,974)
Balance - December 31, 2009	40,653,592	73,726,414	12,655,341	3,527,425
Issuance of shares	10,720,944	1,733,276	-	-
Balance - December 31, 2010	51,374,536	75,459,690	12,655,341	3,527,425

In June 2006, the Company issued warrants pursuant to the acquisition of certain intellectual property, to purchase an aggregate of 550,000 common shares of the Company at an exercise price of \$13.21 per share. The warrants expire five years from the effective date and were valued at \$1,516,906 using the Black-Scholes option pricing method, assuming a life of 5 years, 70% volatility and an average risk-free interest rate of 4.22%.

In November 2007, pursuant to a private placement, the Company issued 1,840,000 warrants. The warrants were exercisable at a price of \$3.45 and expired unexercised on November 14, 2009. Upon expiry of the warrants \$1,033,974 was reclassified from warrants to contributed surplus.

On January 5, 2009, pursuant to a private placement, the Company issued from treasury 2,400,000 units. Each unit was granted for US\$0.83 (\$1.00 CDN) and comprises one common share and one tenth of a common share purchase warrant. The shares issued pursuant to the private placement were valued at \$1,752,000 CDN before issue costs of \$43,312 CDN. The warrants issued were valued at \$81,600 CDN before issue costs of \$2,017 CDN using the Black-Scholes option pricing model, assuming a life of 3 years, 136% volatility and average risk-free interest rate of 1.18%. The warrants are exercisable at \$6.00 CDN per warrant and expire on January 5, 2012.

On March 12, 2009 the Company issued 449,957 common shares from treasury at \$0.34 each. The shares were valued at \$152,985, before issue costs of \$11,892. The shares were issued to

# **SemBioSys Genetics Inc.**

## **Notes to the Consolidated Financial Statements**

(expressed in Canadian dollars)

certain vendors for the provision of services during the period as well as in lieu of cash payment for outstanding charges.

On July 24, 2009, pursuant to a public offering, the Company issued 11,865,341 units at a price of \$0.35 per unit for total gross proceeds of \$4,152,869. Each unit is comprised of one common share of the Corporation and one common share purchase warrant ("Warrant"). Each Warrant entitles the holder to purchase one common share for 36 months after the closing of the offering at a price of \$0.55 per common share. Total issue costs for this offering were \$773,731, which includes non-cash costs of \$177,980 related to compensation options granted to agents, as described below.

As part of the public offering, the Company granted the agents compensation options equal to 6.0% of the number of units sold under the offering. Each compensation option entitled the agent to purchase one unit until July 24, 2011 at the Offering Price of \$0.35. These options were valued at \$177,980 using the Black-Scholes option pricing model, assuming a life of 2 years, 150% volatility and an average risk-free rate of 1.33%.

The shares issued pursuant to the public offering were valued at \$1,779,801 before issue costs of \$331,599. The warrants issued pursuant to the public offering were valued at \$2,373,068 before issue costs of \$442,132 using the Black-Scholes option pricing model, assuming a life of 3 years, 140% volatility and an average risk free rate of 1.95%.

On March 3, 2010, pursuant to a private placement, the Company issued 10,163,398 shares at a price of \$0.175 per share for total gross proceeds of \$1,778,595 before issue costs of \$147,196.

On March 11, 2010, the Company issued 442,546 common shares from treasury at \$0.22 each. The shares were valued at \$92,935, before issue costs of \$6,339. The shares were issued to certain vendors for the provision of services during the year as well as in lieu of cash payment for outstanding charges.

On July 2, 2010, the Company issued 115,000 common shares from treasury at \$0.22 each. The shares were valued at \$20,700, before issue costs of \$5,419. The shares were issued to a certain vendor in lieu of cash payment for outstanding charges.

### **c) Per share amounts**

The effects of potentially dilutive instruments such as stock options and warrants on loss per share are anti-dilutive and therefore have been excluded from the calculation of diluted loss per share.

# SemBioSys Genetics Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

### d) Stock options

The following table summarizes stock option activity of the Company during the period:

	Number of Options	Weighted Average Exercise Price \$
Balance - December 31, 2009	2,731,678	1.59
Granted	3,330,000	0.21
Forfeited	(1,399,643)	0.93
Expired	(19,380)	0.62
Balance - December 31, 2010	<u>4,642,655</u>	<u>0.80</u>

The fair value of the stock options granted during the year ended December 31, 2010 was estimated on the date of grant by reference to the Black-Scholes option pricing model using the following weighted average assumptions:

	2010	2009
Risk-free interest rate	2.95%	2.45%
Expected hold period to exercise	7 years	7 years
Volatility in the price of the Company's shares	103%	84%
Dividend yield	0%	0%
Weighted average fair value of options	<u>\$0.16</u>	<u>\$0.24</u>

The following table summarizes information about the Company's stock options outstanding at December 31, 2010:

Range of exercise prices \$	Options outstanding	Weighted average remaining term (years)	Weighted average exercise price \$	Weighted average exercise price	
				Options exercisable	\$
0.20	2,824,000	6.48	0.20	206,250	0.20
0.30 - 0.35	707,225	5.56	0.33	400,475	0.34
0.63	170,898	4.44	0.63	58,398	0.63
1.03 - 1.10	484,282	4.52	1.10	425,212	1.10
2.00 - 2.97	44,600	3.71	2.53	44,600	2.53
3.01 - 4.50	151,300	3.09	3.22	98,300	3.29
5.00 - 6.50	260,350	1.84	6.44	241,400	6.44
	<u>4,642,655</u>	<u>5.66</u>	<u>0.80</u>	<u>1,474,635</u>	<u>1.81</u>

# SemBioSys Genetics Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

### e) Deferred share units

The following table summarizes deferred share unit activity of the Company during the year ended December 31, 2010:

	2010 \$	2009 \$
Balance - beginning of year	385,717	-
Issued	679,750	385,717
Balance - end of year	1,065,467	385,717

It is management's intention to redeem the Units in Common Shares, and as a result there is no liability recorded in the financial statements. The expense related to the units granted is recognized on the date the units granted (as they vest immediately) and is based on the market price of the common shares at the date of the grant. The cost is charged as an expense to General and administration on the income statement with the offset being recorded as contributed surplus.

### f) Contributed Surplus

The following table summarizes the change in contributed surplus for the year ended December 31, 2010:

	2010 \$	2009 \$
Balance - beginning of year	13,764,398	11,802,064
Stock based compensation expense	466,071	682,791
DSU compensation expense	82,496	109,929
Agent compensation expense	-	177,980
Expiration of warrants	-	1,033,974
Discontinued operations	-	(42,340)
Balance - end of year	14,312,965	13,764,398

## 9) COST RECOVERIES

- a) In March 2001, the Company entered into a repayable contribution agreement with Technology Partnerships Canada ("TPC"), an agency of the Government of Canada. The Company received the maximum contribution amount of \$5,484,637 by December 31, 2003. The contribution is repayable at a rate of 1.5% of gross revenues arising from commercialization of the technology developed by the Company. The royalty period will continue until the cumulative royalty payments equal \$16.7 million or until December 31, 2014, whichever comes first. After December 31, 2014, the contribution is forgiven. Under the agreement, the Company must obtain permission from TPC to assign certain intellectual property to parties outside of Canada. At December 31, 2010 royalties of \$11,703 (2009 – \$9,299) were included in accounts payable.

# SemBioSys Genetics Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

The cumulative amount of royalty payments made to December 31, 2010 totalled \$168,209 (2009 – \$158,911).

- b) In June 2001, the Company entered into an agreement with AVAC to provide funding for the Company's antibodies research. Under the terms of the agreement, AVAC advanced approximately \$2.4 million on the basis of achieving specific predetermined milestones between June 2001 and May 2004. The advance is repayable in the form of a 3% royalty on gross revenues attributable to the commercialization of the antibody products. The cumulative royalty repayable is equal to two times the amount of funding received by the Company. No royalties have been paid to date under this agreement.
- c) In March 2003, the Company entered into an agreement with AVAC to provide funding for the Company's Protein A research. Under the terms of the agreement, AVAC was to advance up to \$2.5 million on the basis of achieving specific predetermined milestones between March 2003 and March 2006.

In 2006, the agreement with AVAC was amended such that AVAC would provide the remaining amount of the \$2.5 million on the basis of achieving specific predetermined milestones under the Company's Insulin research program, rather than under the Protein A program.

In November 2010, the agreement with AVAC was amended such that AVAC would provide an additional \$500,000 of funding on the basis of achieving specific predetermined milestones. The repayment terms were also amended, which resulted in all advances being repayable in the form of a 3% royalty on all gross revenues until the total royalties paid to AVAC reach \$6 million.

The first \$250,000 was received in the fourth quarter of 2010 and the second \$250,000 was received subsequent to year-end. Amounts received under this agreement are deferred and recognized as the Company performs the work required under the contract and milestones are achieved. During the year ended December 31, 2010, \$250,000 (2009 – \$nil) was recorded as cost recoveries and no amounts were recorded as deferred cost recoveries.

### 10) DISCONTINUED OPERATIONS

During the third quarter of 2009, the Company's management made the decision to dispose of the majority of its interest in Botaneco Specialty Ingredients Inc ("Botaneco"), which comprised our entire Specialty Ingredients segment. Botaneco had incurred accumulated losses and had negative cash flow since inception and management determined that Botaneco's activity was unlikely to improve in the near term without substantial additional investment. As a result, on July 29, 2009 the Company completed a transaction with Botaneco and Avrio Ventures for the purpose of amending the capital structure of Botaneco to facilitate discussions related to a the merger between Botaneco and Advitech Inc., a company listed on the TSX Venture Exchange. Effective July 29, 2009, the Company sold all of the issued and outstanding common shares of Botaneco to Avrio for nominal consideration.

Comparative figures have been adjusted to remove Botaneco related activities from statements of loss and deficit, statements of comprehensive loss, statements of accumulated other comprehensive loss, and statements of cash flows and to report those amounts as discontinued operations.

# SemBioSys Genetics Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

There were no balance sheet amounts related to discontinued operations at December 31, 2010 or December 31, 2009.

The year ending December 31, 2010 does not contain any operating results of the Discontinued Operations. The comparable 2009 year contains the operating results of this business 210 days. The following amounts have been included the December 31, 2009 Consolidated Statements of Loss and Deficit, Consolidated Statements of Comprehensive Loss and Accumulated Other Comprehensive Loss:

	<b>2009</b>
Revenue	\$ 378,970
Expenses	2,774,345
<b>Loss before the undernoted</b>	<b>(2,395,375)</b>
Interest income	4,730
Interest and accretion expense	(675,967)
Cumulative translation adjustment	(32,365)
Foreign exchange gain	20,362
Gain on disposal of subsidiary	2,982,123
	2,298,883
<b>Net loss from discontinued operations</b>	<b>(\$96,492)</b>

# SemBioSys Genetics Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

### 11) INCOME TAXES

The Company's income tax provision has been determined as follows:

	2010	2009
	\$	\$
Net loss for the year - continuing operations	(8,260,239)	(6,492,390)
Combined basic federal and provincial income tax recovery of 28.07% (2009 - 29.00%) - continuing operations	(2,318,649)	(1,882,793)
Permanent non-deductible expenses	247,233	(1,154,028)
Effect of rate changes	214,218	12,730
Investment tax credits on scientific research and experimental development	(288,872)	-
Valuation allowance and other	2,146,070	79,558
Net tax benefits attributable to Old SemBioSys (Note 1)	-	2,944,533
	-	-

Based on an expected future tax rate for public companies of 25% (2009 – 29%), the significant components of the Company's future income tax assets are summarized as follows:

	2010	2009
	\$	\$
Future tax liabilities		
Amortization	(226,723)	-
Future tax assets		
Benefit of unclaimed current and capital scientific research and experimental development expenditures	1,326,889	-
Non-capital loss carryforwards	962,999	66,472
Benefit of investment tax credit	301,202	-
Share issuance costs	31,791	-
Capital assets	-	214,594
Capital losses	30,978	-
Net future income tax asset	2,427,136	281,066
Less Valuation allowance	(2,427,136)	(281,066)
	-	-

In assessing the realizable benefit from future tax assets, the Company considers whether it is more likely than not that some portion or all of the future tax assets will be realized. The realization of future tax assets is dependent on the generation of future taxable income. The Company considers

# SemBioSys Genetics Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

projected future taxable income and tax planning strategies in making this assessment. Due to the Company's stage of development and operations and history of operating losses, the tax benefit of the above amounts has been completely offset by a valuation allowance.

In connection with the corporate reorganization referred to in note 1, the tax benefits of Old SemBioSys' non-capital losses, scientific research and experimental development pool of undeducted expenditures, undepreciated capital costs as well as the federal non-refundable investment tax credits generated from the business through December 18, 2009 are not available to SemBioSys. The balance to December 31, 2009 represents the balance available to New SemBioSys.

The unutilized scientific research and experimental development expenditures may be carried forward indefinitely by the Company to reduce taxable income in future years. The non-capital loss carryforwards can be applied to reduce taxable income in the future. As at December 31, 2010 the Company has non-capital losses of \$3,851,996 (2009 – \$265,889), if unutilized these losses will expire as follows:

2028	\$	6,400
2029		259,489
	\$	<u>265,889</u>

## 12) COMMITMENTS AND GUARANTEES

### a) Commitment

In March 1996, the Company entered into a technology licensing agreement with UTI Limited Partnership ("UTI") which was amended in May 2006 and June 2010. Under the terms of the amended agreement, UTI granted the Company the exclusive worldwide rights to the oilbody-oleosin technology and worldwide right to sublicense products produced using the oilbody-oleosin technology. In return, the Company is required to pay a minimum annual fee to UTI in the amount of \$45,000 in 2009 and 2010, and \$55,000 per annum thereafter creditable to the royalties otherwise payable by the Company. At December 31, 2010, \$nil (2009 – \$35,083) was included in accounts payable. Under the agreement, royalties will equal 2% of net sales of products produced using the oilbody-oleosin technology and will be paid until all issued patents falling under this license expire. The Company must also pay UTI 15% to 25% of all royalties earned from sublicenses, depending upon the percentage royalty the Company receives from the sublicensee. During the year, \$118,385 in royalties expense was been recorded (2009 – \$71,188).

### b) Indemnity Agreement

Under the Arrangement (note 1), the Company agreed to indemnify Old SemBioSys and its directors, officers, employees and subsidiaries, subject to certain conditions and limitations, for all losses, which it may suffer, sustain, pay or incur arising out of, resulting from, attributable to or connected with any debts, liabilities, commitments or obligations of any nature (whether matured or unmatured, accrued, fixed, contingent or otherwise) of any kind whatsoever resulting from any matters, actions, events, facts or circumstances related to the activities, affairs or

# SemBioSys Genetics Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

business of SemBioSys which occurred prior to December 18, 2009, or relating to New Subco or New SemBioSys which occur on or after December 18, 2009.

Any material breach the representations and warranties of SemBioSys under the Arrangement Agreement, may be subject to a maximum liability of \$3.6 million.

There have been no claims under this indemnification agreement to date, nor can the future claims or amounts payable be reasonably estimated; therefore, no liability has been recorded in these financial statements in respect of the indemnity agreement.

### c) License Fees & Contracts

The Company periodically enters into technology license agreements to enable it and its partners to commercialize certain products using its technology platform.

In February 2010, the Company entered into a specific commercial license agreement whereby under the terms of the agreement the Company was granted a non-exclusive license for specific patent rights and technology that further enables its proprietary technology platform. In return, the Company is required to pay an upfront fee and an annual fee each year there after, until the expiration of the last patent falling within the licensed patent rights.

Under a licensing agreement previously entered into, the Company is required to pay an amount upon the commercial launch of certain products specified in the agreement. As the Company has not commercially launched any products specified under the agreement to date, timing of these payments are undeterminable.

### d) Operating leases

The Company has entered into operating leases for office space, warehouse space and photocopiers. The minimum lease payments for the next five years and thereafter are as follows:

	\$
2011	498,297
2012	3,987
Thereafter	-
Total minimum lease commitments	<u>502,284</u>

## 13) SEGMENTED INFORMATION

The Company manufactures high-value proteins and oils in plant seeds using its unique proprietary platform. Prior to July 29, 2009 the company operated in two reportable segments: (i) Biopharmaceuticals and Bioproducts and (ii) Specialty Ingredients. Effective July 29, 2009 the Company divested the majority of its interest in Botaneco Specialty Ingredients Inc., and as a result, it no longer controls or holds significant influence over that entity (see note 10). Botaneco Specialty

# SemBioSys Genetics Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

Ingredients Inc. comprised the entire Specialty Ingredients segment, therefore in the opinion of management, the Company now has only one business segment.

All assets are located in Canada and revenues from external customers are attributable to the following countries, based on the customer's country of domicile:

	<b>For the years ended December 31,</b>	
	<b>2010</b>	<b>2009</b>
	<b>\$</b>	<b>\$</b>
<b>Licensing option fees</b>		
United States		1,161,495
<b>Licensing fees</b>		
United States	315,789	252,048
Argentina		55,000
<b>Contract research</b>		
Canada and other	151,715	98,957
<b>Royalty revenue</b>		
Canada and other	11,704	
United States	308	3,614
	<u>479,516</u>	<u>1,571,114</u>

### 14) CAPITAL DISCLOSURES

The Company includes cash and cash equivalents, investment and shareholders' equity in the definition of capital.

The Company's objectives when managing its capital structure are to:

- Safeguard the company's ability to continue as a going concern,
- Maintain sufficient cash and cash equivalents to last a minimum of one to two years in order to finance its planned research and development activities, clinical trials, corporate administration, capital expenditures and intellectual property expansion and protection and;
- Minimize dilution to existing shareholders whenever possible.

In managing capital, the Company estimates its future cash requirements by preparing a budget and a multiyear forecast annually for review and approval by the Company's Board of Directors (the "Board"). The budget establishes the approved activities for the upcoming year and estimates the costs associated with these activities. The forecast estimates future activity along with the potential cash requirements and is based on the Company's expected results from the coming year's activity. Budget to actual variances are prepared monthly for review by the Company's management and are presented quarterly to the Board.

The Company manages the capital structure and makes adjustments to it in light of changes in economic conditions and the risk characteristics of the underlying assets. To maintain or adjust the capital structure, the Company may attempt to issue new equity, issue new debt, or acquire or

# SemBioSys Genetics Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

dispose of assets. Financing decisions are based on the timing and extent of expected operating and capital cash outlays. When non-dilutive government or non-government sources (licensing option fees, licensing fees, contract research and interest income) are not available, new long-term debt or equity issuances are used. Factors considered when determining whether to take on new debt or to issue equity include the amount of cash sought, the availability of these sources and their terms, and the need to balance value creation for shareholders against the increased liquidity risks associated with debt. The Company is not subject to any financial covenants under its current debt arrangements. The Company works toward managing its capital objectives to the extent possible while facing the challenges of market conditions and the public's assessment of the Company's risk profile.

As discussed in note 2, the going concern risk contemplates management not achieving the objective of maintaining a minimum of one to two years cash flow on hand. The Company's utmost objective is to execute initiatives that will enhance the Company's ability to continue as a going concern. As a result, the Company is aggressively pursuing a number of alternatives to raise additional capital in the near term including: issuing new equity, seeking additional government and partnership funding, the potential monetization of some of our assets and other initiatives.

### 15) FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

The Company's financial assets and liabilities are comprised of cash and cash equivalents, investment, accounts receivable, accounts payable and accrued liabilities, short-term debt, and convertible debentures.

#### a) Fair Value of Financial Assets and Liabilities

During 2009, CICA Handbook Section 3862 Financial Instruments – Disclosures was amended to require disclosures about the inputs to fair value measurements, including their classification within a hierarchy that prioritizes the inputs to fair value measurement. The three levels of the fair value hierarchy are:

- Level 1 – Unadjusted quoted prices in active markets for identical assets or liabilities
- Level 2 – Inputs other than quoted prices that are observable for the asset or liability either directly or indirectly; and
- Level 3 – Inputs that are not based on observable market data

The Company classifies cash and cash equivalents (\$267,436) as Level 2 financial instruments within the fair value hierarchy as at December 31, 2010. The Company has no financial instruments classified as Level 1 or 3.

The fair values of cash and cash equivalents, accounts receivable and accounts payable and accrued liabilities approximate their carrying amounts due to the short-term maturity of those instruments.

The current portion of long-term debt is carried at amortized cost using the effective interest method. At December 31, 2010, the fair value of short-term debt approximates its carrying value due to the short-term maturity, as well; the effective interest rate used to calculate the interest of

# SemBioSys Genetics Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

the AVAC funding approximates the Company's estimated current fair value interest rate for that type of funding.

The convertible debentures were recorded at fair value and are carried at amortized cost using the effective interest rate method. The fair value of the short-term and long-term portion of the convertible debentures approximates its carrying value as they were recently issued.

### b) Risks Associated with Financial Assets and Liabilities

The Company is exposed to financial risks arising from the normal course of business operations and its financial assets and liabilities. The financial risks include liquidity risk, market risk relating to foreign exchange rates and interest rates and credit risk.

#### i) Liquidity Risk

Liquidity risk is the risk that the Company will encounter difficulties in meeting its financial liability obligations. The Company manages its liquidity risk by keeping surplus cash in highly liquid securities of highly-rated financial institutions. This allows the Company to earn modest interest rates on surplus cash while also having access to it in a very short time frame.

As discussed in note 14, the Company forecasts its cash needs on a regular basis and seeks additional financing based on those forecasts. Since inception, the Company has financed its cash requirements primarily through issuances of securities, cost recoveries, licensing fees, licensing option fees, contract research revenues, investment tax credits, government funding, long-term debt, and interest income. Our expenditures are expected to decrease as compared to those incurred this year. The Company's ability to accomplish all of its future strategic plans is dependent upon obtaining additional financing or executing other strategic options, however, there is no assurance that the Company will achieve these objectives (see note 2).

The timing of cash outflows relating to financial liabilities are outlined in the table below:

	< 1 year	1-3 years	Total
Accounts payable and accrued liabilities	1,014,857	-	1,014,857
Loans payable	58,032	-	58,032
AVAC funding, including interest	1,848,329	-	1,848,329
Convertible debentures, including interest	-	758,815	758,815
<b>Total</b>	<b>2,921,218</b>	<b>758,815</b>	<b>3,680,033</b>

#### ii) Market Risk

Market risk is the risk that the fair value or future cash flows of financial instruments will fluctuate as a result of changes in market prices and is comprised of the following:

- *Foreign Exchange Risk*

The Company earns certain revenue and incurs certain operating expenses and capital expenditures in U.S. dollars. At December 31, 2010, the Company had U.S. denominated

# SemBioSys Genetics Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

payables of \$261,535 (December 31, 2009 – U.S. \$267,018). Accordingly, fluctuations in the exchange rate between the U.S. and Canadian dollar can have an effect on the Company's reported results.

The Company's foreign exchange gain/loss is primarily comprised of unrealized foreign exchange gains and losses on the translation of the U.S. dollar payables. A \$0.01 change in the U.S. to Canadian dollar exchange rate, at the balance sheet date, would have resulted in a \$2,588 change in foreign exchange gain/loss at December 31, 2010 (December 31, 2009 - \$2,925).

The Company's policy with respect to foreign currency risk management, as approved by the Board of Directors, is to obtain natural hedges of revenue and expenses to the extent possible. The Company does not speculate and remains at risk to the market where natural hedges are not in place.

- *Interest Rate Risk*

Interest rate risk is the risk that the value of a financial instrument will fluctuate as a result of changes in market interest rates. The Company is exposed to interest rate risk as the cash flows generated from its cash and cash equivalents will fluctuate in response to changes in market interest rates. The cash and cash equivalents are comprised of cash and short term deposits with a Canadian Chartered Bank. All of the Company's short-term debt and convertible debenture are at fixed rates.

For the year ended December 31, 2010, an increase or decrease in net earnings for each one percent per annum change in interest rates on cash and cash equivalents amounts to \$2,674 as compared to \$36,875 for the year ended December 31, 2009.

With respect to interest rate risk management, the Company is at risk to the open market for interest rates received on deposits.

iii) **Credit Risk**

Credit risk is the risk that the counterparty to a financial asset will default, resulting in the Company incurring a financial loss. The Company is exposed to credit risk on its cash and cash equivalents, investment, and accounts receivable, to a maximum of the carrying value of the aforementioned items at year end.

*Cash and cash equivalents:*

The Company mitigates its exposure to credit risk by maintaining its Canadian domiciled bank accounts with a Canadian Chartered Bank.

*Investment:*

The investment is at risk to the open market as the Company has not taken any measures to mitigate its exposure to credit risk on this investment.

*Accounts receivable:*

The Company has policies and procedures in place to govern the credit risk it will assume. A significant portion of the Company's accounts receivable balance at December 31, 2010 is

# **SemBioSys Genetics Inc.**

## **Notes to the Consolidated Financial Statements**

(expressed in Canadian dollars)

due from a two customers. The first amount (\$100,000) relates to the sale of an asset and the second amount (\$47,250) arose from contract research we performed. The remainder of the balance comprises items of a low risk nature such as amounts owed from customers with whom we have a history of payment, wage subsidies and interest receivable from a Canadian Chartered Bank. Management has reviewed the items comprising the accounts receivable balance and determined that all accounts are collectible; accordingly there has been no allowance for doubtful accounts recorded.

For the year ended December 31, 2010, most of the Company's revenue was mainly earned from two customers. Revenue from the two customers for the year ended December 31, 2010 was \$315,789 and \$151,715. The Company's licensing option fee revenue of \$1,161,495 for the year ended December 31, 2009 all related to a single customer.

### **16) RELATED PARTY TRANSACTION**

Legal services were provided by a law firm in which a director of the Company is counsel to the firm. The director left the firm effective July 15, 2010 and subsequent to that date is no longer considered a related party. During the period ended July 15, 2010, the Company incurred legal expenses of \$20,063 (year ended December 31, 2009 - \$533,559). These transactions were in the normal course of business and thus are recorded at the exchange amount, which is the amount agreed to by the related parties.

### **17) SUBSEQUENT EVENT**

Subsequent to the end of the year, the Company closed a \$4 million financing. The financing consists of bonds with an aggregate face value of \$4 million (the "Bonds") and detachable warrants (the "Warrants") to purchase common shares of the Company. The exercise price of the Warrants is initially \$0.06 per share, subject to adjustment.

The Bonds issued in the transaction bear interest at a rate of 7% per annum, compounded annually, have a maturity date of 10 years from the date of issuance and are secured by certain intellectual property assets of SemBioSys. The Bonds include a "call" provision that provides that they can be called by the holder after three years or redeemed at 120% of their face value, plus accrued interest, at any time by SemBioSys.

The Warrants entitle the holder to purchase, with either all or a combination of, cash, Bonds and/or accrued interest (at 7% compounded annually), the equivalent of \$4 million, plus accrued interest, worth of common shares of SemBioSys for a period of 10 years after the closing of the proposed financing at an initial exercise price of \$0.06 (the "Initial Exercise Price") per common share. The Initial Exercise Price can be reduced on each six month anniversary of the date of issuance of the Bonds if the simple average daily closing price of the common shares on the Toronto Stock Exchange for the previous six month period is less than \$0.06, subject to a floor price of \$0.05 (the "Floor Price") per common share. If the Initial Exercise Price is adjusted downward in accordance with the previous sentence, it shall not thereafter be adjusted upwards, except in connection with proportional price adjustments required in connection with, for example, a share consolidation. In the event the Company undertakes certain dilutive common share issuances, the Floor Price may be adjusted downwards and the maximum number of common shares issuable may be increased.