# SERNOVA CORP.

# CONSOLIDATED FINANCIAL STATEMENTS

# OCTOBER 31, 2011

DAVIDSON & COMPANY LLP Chartered Accountants A Partnership of Incorporated Professionals

# INDEPENDENT AUDITORS' REPORT

To the Shareholders of
Sernova Corp.

We have audited the accompanying consolidated financial statements of Sernova Corp. which comprise the consolidated balance sheets as at October 31, 2011 and 2010 and the consolidated statements of operations and deficit, and cash flows for the years then ended, and a summary of significant accounting policies and other explanatory information.

***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.

***Auditors' 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 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 auditors' 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 auditors consider 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, these consolidated financial statements present fairly, in all material respects, the financial position of Sernova Corp. as at October 31, 2011 and 2010 and the results of its operations and its cash flows for years then ended in accordance with Canadian generally accepted accounting principles.

NEXIA INTERNATIONAL

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***Emphasis of Matter***

Without qualifying our opinion, we draw attention to Note 1 in the consolidated financial statements which describes conditions and matters that indicate the existence of a material uncertainty that may cast significant doubt about the ability of Sernova Corp. to continue as a going concern.

**"DAVIDSON & COMPANY"**

Vancouver, Canada — Chartered Accountants

February 28, 2012

**SERNOVA CORP.**
CONSOLIDATED BALANCE SHEETS
AS AT OCTOBER 31

| | 2011 | 2010 |
|---|---|---|
| **ASSETS** | | |
| **Current** | | |
| Cash | $ 309,991 | $ 735,142 |
| Short term investment | 1,208,119 | - |
| Receivables (Note 4) | 59,108 | 113,521 |
| Prepaid expenses | 14,889 | 30,996 |
| | 1,592,107 | 879,659 |
| **Equipment** (Note 5) | 6,498 | 5,461 |
| **Intangible assets** (Note 6) | 2,378,786 | 3,149,366 |
| | $ 3,977,391 | $ 4,034,486 |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| **Current** | | |
| Accounts payable and accrued liabilities | $ 119,067 | $ 143,997 |
| **Shareholders' equity** | | |
| Capital stock (Note 7) | 20,811,715 | 19,160,911 |
| Contributed surplus (Note 7) | 2,473,364 | 2,139,589 |
| Deficit | (19,426,755) | (17,410,011) |
| | 3,858,324 | 3,890,489 |
| | $ 3,977,391 | $ 4,034,486 |

**Nature and continuance of operations** (Note 1)
**Commitments and contingencies** (Note 8)
**Subsequent events** (Note 15)

**On behalf of the Board:**

"Dr. George Adams" Director "Dr. Philip Toleikis" Director

The accompanying notes are an integral part of these consolidated financial statements.

**SERNOVA CORP.**
CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT
YEAR ENDED OCTOBER 31

| | 2011 | 2010 |
|---|---|---|
| **GENERAL AND ADMINISTRATIVE EXPENSES** | | |
| Amortization of equipment | $ 3,201 | $ 5,387 |
| Amortization of intangible assets | 870,403 | 846,918 |
| Consulting fees and wages | 194,476 | 264,216 |
| Patent fees and costs | 67,797 | 125,072 |
| Office and miscellaneous | 202,753 | 180,178 |
| Professional fees | 70,091 | 54,454 |
| Research | 415,250 | 276,760 |
| Stock-based compensation (Note 7) | 209,740 | 91,717 |
| | (2,033,711) | (1,844,702) |
| **OTHER ITEMS** | | |
| Foreign currency gain (loss) | 3,927 | (2,227) |
| Interest and other income | 13,040 | 558 |
| | 16,967 | (1,669) |
| **Loss and comprehensive loss for the year** | (2,016,744) | (1,846,371) |
| **Deficit, beginning of year** | (17,410,011) | (15,563,640) |
| **Deficit, end of year** | $ (19,426,755) | $ (17,410,011) |
| **Basic and diluted loss per common share** | $ (0.02) | $ (0.03) |
| **Weighted average number of common shares outstanding** | 86,675,816 | 73,624,754 |

The accompanying notes are an integral part of these consolidated financial statements.

**SERNOVA CORP.**
CONSOLIDATED STATEMENTS OF CASH FLOWS
YEAR ENDED OCTOBER 31

| | 2011 | 2010 |
|---|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES** | | |
| Loss for the year | $ (2,016,744) | $ (1,846,371) |
| Items not affecting cash: | | |
| Accrual of government grant | (17,131) | (61,287) |
| Amortization of equipment | 3,201 | 5,387 |
| Amortization of intangible assets | 870,403 | 846,918 |
| Stock-based compensation | 209,740 | 91,717 |
| Interest accrued on short term investment | (8,119) | - |
| Changes in non-cash working capital items: | | |
| Decrease in receivables | 71,544 | 62,613 |
| Decrease in prepaid expenses | 16,107 | 1,897 |
| (Decrease) increase in accounts payable and accrued liabilities | (30,180) | 73,397 |
| Net cash used in operating activities | (901,179) | (825,729) |
| **CASH FLOWS FROM FINANCING ACTIVITIES** | | |
| Issue of share capital | 1,983,925 | 1,282,569 |
| Share issuance costs | (209,086) | (78,394) |
| Share purchase loan | - | 32,000 |
| Net cash provided by financing activities | 1,774,839 | 1,236,175 |
| **CASH FLOWS FROM INVESTING ACTIVITIES** | | |
| Short term investment | (1,200,000) | - |
| Intangible assets | (94,573) | (72,267) |
| Equipment | (4,238) | - |
| Net cash used in investing activities | (1,298,811) | (72,267) |
| **Change in cash during the year** | (425,151) | 338,179 |
| **Cash, beginning of year** | 735,142 | 396,963 |
| **Cash, end of year** | $ 309,991 | $ 735,142 |

**Supplemental disclosure with respect to cash flows** (Note 9)

The accompanying notes are an integral part of these consolidated financial statements.

## 1. NATURE AND CONTINUANCE OF OPERATIONS

Sernova Corp. (the "Company") was incorporated under the Company Act (British Columbia) on August 19, 1998. Effective May 29, 2001, the Company was continued under the Canada Business Corporations Act.

Pursuant to the definitive agreement for the sale of its proprietary technology in fiscal 2004, the Company retains a graduated royalty on worldwide sales of the fertility monitor and any related products stemming from the Fertilité-OV™ fertility monitor and accompanying technology and patents until the earlier of expiry of the patents or 2014.

In fiscal 2006, the Company acquired a sublicense to certain patents (Note 6) and a subsidiary, Sertonex Inc. ("Sertonex"), and became engaged in the research and development of a commercially viable treatment for insulin-dependent human diabetes and other metabolic, blood and neurological diseases with therapeutic cells placed into implanted prevascularized medical devices. The Company is focused on manufacture and near term clinical evaluation of the Cell Pouch™ for insulin-dependent diabetes. At this date no products are in commercial production or use.

### Going concern

These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles assuming the Company will continue on a going-concern basis. The Company has incurred losses and negative operating cash flows since inception. The ability of the Company to continue as a going-concern depends upon its ability to develop profitable operations and to continue to raise adequate financing. Management is actively targeting sources of additional financing which would assure continuation of the Company's operations and research programs. In order for the Company to meet its liabilities as they come due and to continue its operations, the Company is solely dependent upon its ability to generate such financing.

While the Company has been successful in obtaining the required financing in the past there can be no assurance that the Company will be able to continue to raise funds in which case the Company may be unable to meet its obligations. Should the Company be unable to realize on its assets and discharge its liabilities in the normal course of business, the net realizable value of its assets may be materially less than the amounts recorded on the balance sheets. The financial statements do not include adjustments to amounts and classifications of assets and liabilities that might be necessary should the Company be unable to continue operations.

| | 2011 | 2010 |
|---|---|---|
| Working capital | $ 1,473,040 | $ 735,662 |
| Deficit | (19,426,755) | (17,410,011) |

## 2. SIGNIFICANT ACCOUNTING POLICIES

### Principles of consolidation

These consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries Sertocell Biotechnology (US) Corp. ("Sertocell") and Sertonex. All significant inter-company balances and transactions have been eliminated.

## 2. SIGNIFICANT ACCOUNTING POLICIES (cont'd…)

### Use of estimates

The preparation of consolidated financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the period. Actual results could differ from these estimates. Significant accounts that require estimates relate to the impairment of the intangible assets, valuation allowance for future income tax assets, stock-based compensation and valuation of warrants in private placements.

### Financial instruments

Financial instruments are classified into one of five categories: held-for-trading, held-to-maturity investments, loans and receivables, available-for-sale financial assets or other financial liabilities. All financial instruments and derivatives are measured in the balance sheet at fair value except for loans and receivables, held-to maturity investments and other financial liabilities which are measured at amortized cost. Subsequent measurement and changes in fair value will depend on their initial classification. Held-for-trading financial assets are measured at fair value and changes in fair value are recognized in net income. Available-for-sale financial instruments are measured at fair value with changes in fair value recorded in other comprehensive income until the instrument is derecognized or impaired.

The Company has classified its cash and short term investments as held-for-trading. Receivables are classified as loans and receivables. Accounts payable and accrued liabilities are classified as other liabilities, which are measured at amortized cost.

The Company provides information about its financial instruments measured at fair value at one of three levels according to the relative reliability of the inputs used to estimate the fair value. 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.

### Short term investments

Short term investments consist of highly liquid investments with original maturity of greater than three months.

### Computer equipment

Computer equipment is recorded at cost less accumulated amortization and related investment tax credits and government grants. Amortization is provided annually on assets placed in use on a 30% declining balance basis.

### Intangible assets

Costs incurred in obtaining patent licenses and non-patented intellectual property associated with the patents are capitalized and amortized on a straight-line basis over the remaining legal life of the respective patent licenses, or their economic life, if shorter. The cost of servicing the Company's patent licenses is expensed as incurred.

## 2. SIGNIFICANT ACCOUNTING POLICIES (cont'd…)

### Impairment of long-lived assets

The Company reviews long-lived assets for impairment whenever events or circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the undiscounted future net cash flows expected to be generated by the asset. When the carrying amount of an asset exceeds such cash flows, an impairment charge is recognized for the excess.

### Research and development

All research costs are charged to operations in the year of expenditure. Development costs are capitalized if they meet the criteria for capitalization and amortized over the period of the expected life. Development costs are written off when there is no longer an expectation of future benefits.

### Investment tax credits and government grants

The Company follows the cost reduction method of accounting for investment tax credits. Investment tax credits related to acquisition of equipment are deducted from the related asset with amortization being calculated on the net amount. Investment tax credits related to current expenditures are included in the determination of net income as the expenditures are incurred when there is reasonable assurance they will be realized.

Non-refundable government grants are recorded as a reduction of expenditures when directly related to such expenditures. Grants in excess of expenditures are deferred to future periods, to be offset against any future expenditure to be incurred or credited to development costs if they exceed future expenditures on that project.

### Escrow shares

Company shares placed in escrow to be released upon achievement of certain performance criteria in connection with an acquisition are considered to be contingently issuable and compensatory in nature. Accordingly, the fair value of these shares upon satisfaction of the performance criteria is accounted for as compensation expense in the period of satisfaction.

### Stock-based compensation

The Company uses the fair value based method of accounting for stock options granted to employees and directors and compensatory warrants issued on private placements. Under this method, the fair value of the stock options at the date of the grant, as determined using the Black-Scholes option pricing model, is recognized to expense over the vesting period, and the fair value of compensatory warrants at the date of issuance, as determined using the Black-Scholes model, is recognized as share issuance costs, with the offsetting credit to contributed surplus. If the stock options or warrants are exercised, the proceeds are credited to share capital and the fair value of the options or warrants exercised are reclassified from contributed surplus to share capital.

## 2. SIGNIFICANT ACCOUNTING POLICIES (cont'd…)

### Future income taxes

Future income taxes are recorded using the asset and liability method whereby future tax assets and liabilities are recognized for the future tax consequences attributable to 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 the enacted or substantively enacted tax rates expected to apply when the asset is realized or the liability settled. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the year that substantive enactment or enactment occurs. Valuation allowances have been established to reduce the Company's future tax asset to $nil, as the Company does not consider it more likely than not that a future tax asset will be recovered.

### Foreign currency translation

The Company's subsidiaries are integrated foreign operations and are translated into Canadian dollar equivalents using the temporal method. The monetary assets and liabilities of the Company that are denominated in foreign currencies are translated at the rate of exchange at the balance sheet date and non-monetary items are translated at historical rates. Revenues and expenses are translated at rates approximating those in effect at the time of the transaction. Exchange gains and losses arising on translation are included in the statement of operations.

### Loss per share

The Company uses the treasury stock method to compute the dilutive effect of options, warrants and similar instruments. Under this method the dilutive effect on earnings per share is recognized on the use of the proceeds that could be obtained upon exercise of options, warrants and similar instruments. It assumes that the proceeds would be used to purchase common shares at the average market price during the year. For the years presented, this calculation proved to be anti-dilutive.

Basic loss per share is calculated using the weighted average number of common shares outstanding during the year. The performance escrow shares outstanding and the shares purchased with the loan as of October 31, 2009 (Note 7) have been excluded from the weighted average number of shares because they are contingently returnable.

## 3. NEW ACCOUNTING PRONOUNCEMENTS

*Business Combinations, Non-controlling Interest and Consolidated Financial Statements*

In January 2009, the CICA issued Handbook Sections 1582 "Business Combinations", 1601 "Consolidated Financial Statements" and 1602 "Non-controlling Interests" which replace CICA Handbook Sections 1581 "Business Combinations" and 1600 "Consolidated Financial Statements". Section 1582 establishes standards for the accounting for business combinations that is equivalent to the business combination accounting standard under IFRS. Section 1582 is applicable for the Company's business combinations with acquisition dates on or after January 1, 2011. Early adoption of this Section is permitted. Section 1601 together with Section 1602 establishes standards for the preparation of consolidated financial statements. Section 1601 is applicable for the Company's interim and annual consolidated financial statements for its fiscal year beginning November 1, 2011. Early adoption of this Section is permitted and all three Sections must be adopted concurrently.

## 3. NEW ACCOUNTING PRONOUNCEMENTS (cont'd...)

*International financial reporting standards ("IFRS")*

In 2006, the Canadian Accounting Standards Board ("AcSB") published a new strategic plan that will significantly affect financial reporting requirements for Canadian companies. The AcSB strategic plan outlines the convergence of Canadian GAAP with IFRS over an expected five year transitional period. In February 2008, the AcSB announced that 2011 is the changeover date for publicly-listed companies to use IFRS, replacing Canada's own GAAP. The date is for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. The transition date for the Company will be November 1, 2010 and will require the restatement for comparative purposes of amounts reported for the year ended October 31, 2011. The Company is currently assessing the accounting policy choices under IFRS.

## 4. RECEIVABLES

| | 2011 | 2010 |
|---|---|---|
| Government grant receivable | $ 17,131 | $ 61,287 |
| Subscriptions receivable | 1,500 | 40,500 |
| Other | 40,477 | 11,734 |
| | $ 59,108 | $ 113,521 |

## 5. EQUIPMENT

| | 2011 | | | 2010 | | |
|---|---|---|---|---|---|---|
| | Cost | Accumulated Amortization | Net Book Value | Cost | Accumulated Amortization | Net Book Value |
| Computer equipment | $ 14,970 | $ 8,472 | $ 6,498 | $ 21,156 | $ 15,695 | $ 5,461 |

## 6. INTANGIBLE ASSETS

| | 2011 | | | 2010 | | |
|---|---|---|---|---|---|---|
| | Cost | Accumulated Amortization | Net Book Value | Cost | Accumulated Amortization | Net Book Value |
| Patent licenses | $ 4,432,303 | $ 2,824,421 | $ 1,607,882 | $ 4,332,480 | $ 2,234,348 | $ 2,098,132 |
| Intellectual property | 2,191,856 | 1,420,952 | 770,904 | 2,191,856 | 1,140,622 | 1,051,234 |
| | $ 6,624,159 | $ 4,245,373 | $ 2,378,786 | $ 6,524,336 | $ 3,374,970 | $ 3,149,366 |

## 7. CAPITAL STOCK AND CONTRIBUTED SURPLUS

| | Number of Shares | Capital Stock | Contributed Surplus |
|---|---|---|---|
| Authorized | | | |
| An unlimited number of common shares, without par value | | | |
| Balance as at October 31, 2009 | 74,456,358 | $ 17,942,879 | $ 2,042,559 |
| Stock-based compensation | - | - | 91,717 |
| Shares issued under warrant exercise | 450,000 | 27,044 | (4,545) |
| Shares issued under offering memorandum | 8,847,466 | 1,260,070 | - |
| Share issuance costs | - | (69,082) | 9,858 |
| Balance as at October 31, 2010 | 83,753,824 | 19,160,911 | 2,139,589 |
| Stock-based compensation | - | - | 209,740 |
| Shares issued under warrant exercise | 264,807 | 29,608 | (2,560) |
| Shares issued under stock option exercise | 14,063 | 2,786 | (1,013) |
| Shares issued under offering memorandum | 11,114,583 | 1,848,346 | 106,758 |
| Share issuance costs | - | (229,936) | 20,850 |
| Balance as at October 31, 2011 | 95,147,277 | $ 20,811,715 | $ 2,473,364 |

In December 2009, the Company completed a private placement offering of 1,341,000 units at $0.10 per unit for gross proceeds of $134,100. Each unit consisted of one common share of the Company and one common share purchase warrant. Each warrant entitles the holder to acquire one additional common share at an exercise price of $0.20 per share for a period of 24 months from the closing date. Share issue costs totaled $6,167 including agents' fees of $1,920.

In April, 2010, the Company completed a non-brokered private placement offering of 2,701,666 units at $0.15 per unit for gross proceeds of $405,250, of which $1,500 is included in receivables. Each unit consists of one common share of the Company and one-half of one share purchase warrant. Each whole warrant entitles the holder to acquire one additional common share at $0.20 for a period of 24 months from closing. The Company granted 46,923 finders' warrants valued at $4,064 and paid $7,038 as finders' fees. Each finder's warrant entitles the holder to purchase one common share at $0.15 per share for a period of 24 months from closing.

In June, 2010, the Company completed a non-brokered private placement offering of 1,004,800 units at $0.15 per unit for gross proceeds of $150,720. Each unit consists of one common share of the Company and one-half of one share purchase warrant. Each whole warrant entitles the holder to acquire one additional common share at a price of $0.20 for a period of 24 months from closing. The Company granted 33,880 finders' warrants valued at $2,934 and paid $5,082 as finders' fees. Each finder's warrant entitles the holder to purchase one common share at $0.15 per share for a period of 24 months from closing.

In October, 2010, the Company completed a non-brokered private placement offering of 3,800,000 units at $0.15 per unit for gross proceeds of $570,000, of which $39,000 was received during fiscal 2011. Each unit consists of one common share of the Company and one-half of one share purchase warrant. Each whole warrant entitles the holder to acquire one additional common share at a price of $0.20 for a period of 24 months from closing. The Company granted 37,333 finders warrants valued at $2,860 and paid $2,800 as finders' fees. Each finder's warrant entitles the holder to purchase one common share at $0.20 per share for a period of 24 months from closing.

## 7. CAPITAL STOCK AND CONTRIBUTED SURPLUS (cont'd…)

In November, 2010, the Company completed a private placement of 2,866,667 units at a price of $0.15 per unit for gross proceeds of $430,000. Each unit consisted of one common share of the Company and one-half of one common share purchase warrant. Each whole warrant entitles the holder to acquire one additional common share for a period of two years at an exercise price of $0.20 per share. The Company granted 21,000 warrants valued at $2,358 and paid $11,150 as finders' fees. Each warrant entitles the holder to purchase one common share at $0.20 per share for a period of 24 months from closing.

In December, 2010, the Company completed a private placement of 1,400,000 units at a price of $0.16 per unit for gross proceeds of $224,000. Each unit consisted of one common share of the Company and one half of one common share purchase warrant. Each whole warrant entitles the holder to acquire one additional common share for a period of two years at an exercise price of $0.20 per share.

In June, 2011, the Company completed a brokered private placement of 5,337,914 units at a price of $0.19 per unit for gross proceeds of $1,014,204. Each unit consisted of one common share of the Company and one common share purchase warrant. Each warrant entitles the holder to acquire on additional common share for a period of two years, at an exercise price of $0.20 per share in the first year and at a price of $0.35 per share in the second year. The Company granted 195,950 broker warrants valued at $14,500 and paid $54,693 as finders' fees. Each warrant entitles the holder to purchase one common share at $0.19 per share for a period of 18 months from closing. The Company also paid other closing costs of $125,915 in connection with the private placement.

In September, 2011, the Company completed a non-brokered private placement of 1,510,002 units of the Company at a price of $0.19 per unit for gross proceeds of $286,900. Each unit consists of one common share of the Company and one common share purchase warrant. Each warrant entitles the holder to purchase one additional common share for a period of two years at a price of $0.20 per share in the first year and at a price of $0.35 per share in the second year. The Company granted 90,410 warrants valued at $3,992 and paid $17,328 as finders' fees. Each warrant entitles the holder to purchase one common share at $0.19 per share for a period of 18 months from the date of closing.

### Share purchase loan

In fiscal 2009, the Company advanced $32,000 to an officer in connection with the private placement completed in May, 2009 to purchase 1,066,667 common shares. The loan was fully repaid with interest in fiscal 2010.

### Escrow shares

Included in issued capital stock at October 31, 2011 are 3,472,500 (2010 - 3,472,500) common shares held in escrow which were subject to time release escrow agreements and will not be released, transferred or assigned without the consent of the regulatory authorities.

### Performance escrow shares

Included in issued capital stock and part of the escrow shares mentioned above at October 31, 2011 are 3,472,500 (2010 - 3,472,500) common shares also subject to a performance based release as follows:

a) 1,736,250 common shares on the date the Company receives approval from authorities for the initiation of human trials for a licensed product;

## 7. CAPITAL STOCK AND CONTRIBUTED SURPLUS (cont'd…)

**Performance escrow shares** (cont'd…)

b) 1,736,250 common shares on the date the Company enrolls the first patient in a Phase 3 human clinical efficacy trial for a licensed product.

Any remaining performance escrow shares will be cancelled and returned to treasury upon the earlier of (i) August, 2016, (ii) the Company ceasing to hold an interest in the intellectual property, or (iii) the mutual agreement of the Company and the shareholder.

**Warrants and stock options**

The Company has a stock option plan whereby, from time to time, at the discretion of the Board of Directors, stock options are granted to directors, officers, employees, and certain consultants. The exercise price of each option is based on the market price of the Company's common stock at the date of grant less an applicable discount. The options can be granted for a maximum term of five years with vesting provisions determined by the Board of Directors.

Stock option and warrant transactions are summarized as follows:

| | Stock Options | | | Warrants | | |
|---|---|---|---|---|---|---|
| | Number of Shares | | Weighted Average Exercise Price | Number of Shares | | Weighted Average Exercise Price |
| Balance outstanding, October 31, 2009 | 3,658,875 | $ | 0.29 | 4,362,467 | $ | 0.18 |
| Granted | 2,587,083 | | 0.15 | 5,212,369 | | 0.20 |
| Cancelled/expired | (262,500) | | 0.13 | (450,000) | | 0.05 |
| Balance outstanding, October 31, 2010 | 5,983,458 | | 0.24 | 9,124,836 | $ | 0.20 |
| Granted | - | | - | 9,288,610 | | 0.20 |
| Exercised | (14,063) | | 0.13 | (264,807) | | 0.10 |
| Cancelled/expired | (1,372,187) | | 0.36 | - | | |
| Balance outstanding, October 31, 2011 | 4,597,208 | $ | 0.20 | 18,148,639 | $ | 0.20 |
| Exercisable, October 31, 2011 | 3,816,791 | $ | 0.21 | 18,148,639 | $ | 0.20 |

## 7. CAPITAL STOCK AND CONTRIBUTED SURPLUS (cont'd…)

The following table summarizes information about the stock options outstanding at October 31, 2011:

| | Number of Shares | Exercise Price | Expiry Date |
|---|---|---|---|
| **Options** | 300,000 | $ $0.40 | November 22, 2011 |
| | 80,000 | 0.88 | June 22, 2012 |
| | 150,000 | 1.00 | June 22, 2012 |
| | 130,000 | 0.30 | March 13, 2013 |
| | 50,000 | 0.12 | October 15, 2013 |
| | 700,000 | 0.10 | April 28, 2014 |
| | 349,500 | 0.14 | June 8, 2014 |
| | 471,875 | 0.14 | June 8, 2014 |
| | 530,000 | 0.12 | September 9, 2015 |
| | 250,000 | 0.20 | October 28, 2015 |
| | 1,585,833 | 0.15 | October 28, 2015 |
| Total | 4,597,208 | | |
| **Warrants** | 3,659,000 | $ 0.20 | October 30, 2011, extended to April 30, 2012 |
| | 1,341,000 | 0.20 | December 23, 2011 |
| | 1,350,833 | 0.20 | April 28, 2012 |
| | 35,583 | 0.15 | April 28, 2012 |
| | 502,400 | 0.20 | June 4, 2012 |
| | 33,880 | 0.15 | June 4, 2012 |
| | 1,900,000 | 0.20 | October 18, 2012 |
| | 37,333 | 0.20 | October 18, 2012 |
| | 1,433,334 | 0.20 | November 3, 2012 |
| | 21,000 | 0.20 | November 3, 2012 |
| | 700,000 | 0.20 | December 5, 2012 |
| | 5,337,914 | 0.20 | June 24, 2012 |
| | | then at 0.35 | June 24, 2013 |
| | 195,950 | 0.19 | December 24, 2012 |
| | 1,510,002 | 0.20 | September 1, 2012 |
| | | then at 0.35 | September 1, 2013 |
| | 90,410 | 0.19 | March 1, 2013 |
| Total | 18,148,639 | | |

The Company used the Black-Scholes option pricing model to determine the fair value of agents' warrants issued as part of the private placements. During fiscal 2011, the Company issued 307,360 agents and broker warrants (2010 - 118,136). The total expense of $20,850 has been charged to share issuance costs (2010 - $9,858).

As part of the brokered private placement completed on June 24, 2011, the company issued 5,337,914 warrants which warrants were ascribed a value of $106,758 representing the difference between the issue price of the Unit and the fair market value of the shares at that time received as part of the offering.

## 7. CAPITAL STOCK AND CONTRIBUTED SURPLUS (cont'd…)

The fair value of warrants has been estimated with the following assumptions:

| Year ended October 31 | 2011 | 2010 |
|---|---|---|
| Dividend yield | 0% | 0.00% |
| Expected volatility | 90% | 110% |
| Risk free interest rate | 2.50% | 2.24% |
| Expected life of warrants | 18 months | 4 years |

**Stock-based compensation**

The Company used the Black-Scholes option pricing model to determine the fair value of options granted. During fiscal 2011, the Company granted Nil (2010 – 2,587,083) options with a weighted average fair value of $Nil (2010 - $0.09) per option, which is being recognized over the vesting periods of the options. Total stock-based compensation expense was $209,740 (2010 – $91,717). This amount represents the value of vested options.

In the current fiscal year, 14,063 (2010 – Nil) stock options were exercised and an equivalent number of common shares issued at a weighted average price of $0.12 for gross proceeds of $1,772 (2010- $Nil).

The fair value of stock options has been estimated with the following assumptions:

| Year ended October 31 | 2011 | 2010 |
|---|---|---|
| Dividend yield | 0.00% | 0.00% |
| Expected volatility | 118% | 110% |
| Risk free interest rate | 2.83% | 2.24% |
| Expected life of options | 5 years | 4 years |

## 8. COMMITMENTS AND CONTINGENCIES

The Company has exclusive rights to use certain patents and technology utilized in the Fertilité-OV ™. Under the agreement, the Company is required to pay a royalty of 2% of cumulative royalties in excess of $1,500,000 to a maximum lifetime royalty of $570,000.

On September 13, 2010, the Company was awarded a second non-repayable financial contribution of up to $275,000 from the National Research Council of Canada Industrial Research Assistance Program, along with technical and business orientated advisory services, to support a study of the potential islet-sparing effect and optimal doses of islets to provide a long-term treatment for diabetic patients using the Company's Cell Pouch System device in a pre-clinical allograft model of diabetes. The Company was reimbursed for 97% of designated salary costs to a maximum of $182,000, and 75% of contractor fees to a maximum of $93,000, which amount has been fully recognized in these financial statements.

The Company is committed to an estimated payment of $60,000 USD in fees to maintain the patents in good standing for the year ending October 31, 2011. Similar payments will be required for subsequent years.

## 9. SUPPLEMENTAL DISCLOSURE WITH RESPECT TO CASH FLOWS

| | 2011 | 2010 |
|---|---|---|
| Cash paid during the year for interest | $ - | $ - |
| Cash paid during the year for income taxes | $ - | $ - |

Significant non-cash transactions for the year ended October 31, 2011 included:

a) accruing $17,131 (2010 - $61,287) in receivables for a government grant.
b) accruing $5,250 (2010 - $Nil) in patent costs.
c) issuing agents warrants valued at $20,850 (2010 - $9,858).

## 10. RELATED PARTY TRANSACTIONS

During fiscal 2011 the Company paid or accrued $75,000 (2010 - $76,923) in consulting fees and wages to a company controlled by an officer and $Nil (2010 - $18,537) to a former director.

The Company advanced $32,000 to an officer in connection with the private placement in May 2009, with interest due at a rate of 1% per annum, to purchase 1,066,667 common shares. The loan was fully repaid with interest on July 19, 2010.

These transactions are in the normal course of operations and are measured at the exchange amount, which is the amount of consideration established and agreed to by the parties.

## 11. INCOME TAXES

A reconciliation of income taxes at statutory rates with the reported taxes is as follows:

| | 2011 | 2010 |
|---|---|---|
| Loss before income taxes | $ (2,016,744) | $ (1,846,371) |
| Expected income tax recovery at statutory rates | $ 582,000 | $ 480,000 |
| Excess of amortization over capital cost allowance | (409,000) | (194,000) |
| Other items | - | (90,000) |
| Unrecognized benefits of losses | (173,000) | (196,000) |
| Income tax recovery | $ - | $ - |

## 11. INCOME TAXES (cont'd...)

The significant components of the Company's future income tax assets and liabilities are as follows:

| | 2011 | 2010 |
|---|---|---|
| Future income tax assets: | | |
| Losses available for future periods | $ 2,210,000 | $ 1,954,000 |
| Share issuance costs | 58,000 | 20,000 |
| Research and development costs | 399,000 | 587,000 |
| Other items | 327,000 | 1,153,000 |
| | 2,994,000 | 3,714,000 |
| Less: valuation allowance | (2,944,000) | (3,714,000) |
| Net future income tax assets | $ - | $ - |

The Company has Canadian non-capital losses of approximately $4,079,000 and United States operating losses of approximately $3,500,000 available to reduce future years' taxable income. In addition, the Company has federal-investment tax credits available of approximately $481,000 and a Scientific and Research Expenditure pool available of approximately $2,495,000. These losses and federal tax credit, if not utilized, will expire through to 2031. Future tax benefits, which may arise as a result of these non-capital losses and other items have not been recognized in these financial statements and have been offset by a valuation allowance.

## 12. SEGMENTED INFORMATION

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by management, in deciding how to allocate resources in assessing performance. All of the Company's operations are within research and development in the biotechnology sector with all of the Company's capital assets located in Canada.

The Company's intangible assets are located in the United States.

## 13. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

Fair value estimates of financial instruments are made at a specific point in time, based on relevant information about financial markets and specific financial instruments. As these estimates are subjective in nature, involving uncertainties and matters of significant judgment, they cannot be determined with precision. Changes in assumptions can significantly affect estimated fair values.

The fair value of cash is measured using level 1 of the fair value hierarchy.

The carrying value of receivables and accounts payable and accrued liabilities approximate their fair value because of the short term nature of these instruments.

## 13. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (cont'd...)

### Financial risk factors

The Company's risk exposures and the impact on the Company's financial instruments are summarized below:

*Credit risk*

Credit risk is the risk of loss associated with a counterparty's inability to fulfill its payment obligations. The Company's credit risk is primarily attributable to short term investments included in cash. Management believes that the credit risk concentration with respect to financial instruments included in cash is remote. Receivables are due primarily from a government agency.

*Liquidity risk*

The Company's approach to managing liquidity risk is to ensure that it will have sufficient liquidity to meet liabilities when they come due. As at October 31, 2011, the Company had a cash and short term investments balance of $1,518,110 (2010 - $735,142) to settle current liabilities of $119,067 (2010 - $143,997). All of the Company's financial liabilities are subject to normal trade terms.

*Market risk*

Market risk is the risk of loss that may arise from changes in market factors such as interest rates, foreign exchange rates, and commodity and equity prices. These fluctuations may be significant.

a) Interest rate risk

The Company has cash balances and no interest-bearing debt. The Company's current policy is to invest excess cash in investment-grade short term deposit certificates issued by its banking institutions. The Company periodically monitors the investments it makes and is satisfied with the credit ratings of its banks. The short term investments as at October 31, 2011 of $1,200,000 are held on interest-bearing guaranteed investment certificates with banks. A 1% change in interest rates would have an effect of $12,000 on interest income.

b) Foreign currency risk

The Company is exposed to foreign currency risk on fluctuations related to cash, receivables and accounts payable and accrued liabilities that are denominated in United States Dollars. However management believes the risk is not currently significant as less than 0.1% of the Company's assets and none of its liabilities as at October 31, 2011 are denominated in United States Dollars.

c) Price risk

The Company is exposed to price risk with respect to equity prices. Equity price risk is defined as the potential adverse impact on the Company's earnings due to movements in individual equity prices or general movements in the level of the stock market. The Company closely monitors individual equity movements, and the stock market to determine the appropriate course of action to be taken by the Company. Fluctuations in pricing may be significant.

## 13. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (cont'd...)

**Financial risk factors** (cont'd…)

*Market risk* (cont'd…)

Management reviews its capital management approach on an ongoing basis and believes that this approach, given the relative size of the Company, is reasonable.

## 14. CAPITAL MANAGEMENT

The Company's objectives when managing capital are to safeguard the Company's ability to continue as a going concern and to maintain a flexible capital structure which optimizes the costs of capital as an acceptable risk.

The Company manages its capital structure and makes adjustments to it, based on the funds available to the Company, in order to support research activities and the prosecution of its intangible assets. The Board of Directors does not establish quantitative return on capital criteria for management, but rather relies on the expertise of the Company's management to sustain future development of the business. The Company defines capital that it manages as share capital, and cash.

The intellectual properties in which the Company currently has an interest are in the development stage; as such the Company has historically relied on the equity markets to fund its activities. The Company will continue to assess new sources of financing available and to manage research and administrative expenditures to reflect current financial resources in the interest of sustaining long term viability.

## 15. SUBSEQUENT EVENTS

Subsequent to October 31, 2011, the Company received subscriptions in advance of $3,437,120 relating to a non-brokered private placement of units at $0.18 per unit. Each unit will consist of one common share of the Company and one common share purchase warrant. Each warrant entitles the holder to acquire one additional common share at an exercise price of $0.20 per share for a period of 24 months from the closing date. The Company paid no finders' fees in connection with this offering.