

# KANE BIOTECH

Biofilm Solutions

LOOKING → BEYOND

KANE BIOTECH  
2005 Annual Report

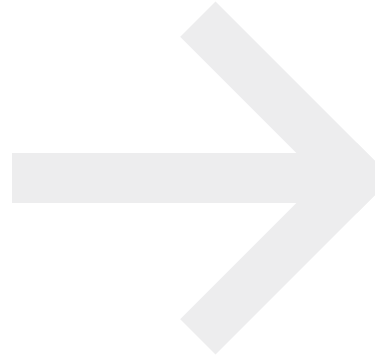




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# COMPANY PROFILE

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Kane Biotech is developing solutions to problems that cost industries, cities and hospitals over \$500 billion each year in equipment damage, energy loss and medical expenses.

These solutions will be innovative products to prevent and disperse biofilms.

Biofilms develop when bacteria, and other microorganisms, form a protective matrix that acts as a shield against attack. When in a biofilm, bacteria become highly resistant to antibiotics, high temperatures and host immune responses.

The Company has a growing technology portfolio based upon leading research and relationships with prominent academic institutions, and is developing products that address human health

problems such as tooth decay or hospital-acquired urinary tract and blood stream infections caused by medical devices.





LOOKING → CLOSER

  
KANE BIOTECH INC.

# PRESIDENT'S LETTER

2005 was a very productive year for Kane Biotech, as we made significant research and development progress in our two key markets—medical devices and oral care. As a result of biofilms, the cost and consequences of infectious diseases continues to increase worldwide and the opportunity for Kane Biotech to develop unique products that have a positive impact on human health is clear. I am proud to be a part of the very talented Kane team as we bring our innovative technologies forward.

Based upon our expertise and understanding of biofilms and their role in causing human infections, our strategy includes both in-licensing and internally developing technologies and products that meet a critical need in our identified markets. This approach, in conjunction with dialogue with leading commercial companies in the field, allows us to make informed decisions on where to focus our efforts for each product at each stage of development. We believe this approach maximizes the potential value of our commercialization opportunities.

An example of this approach is KBI-5898, our anti-microbial coating technology for urinary catheters. The product was developed internally at Kane and after preliminary testing it was further evaluated for its in vitro performance

against common urinary pathogens. Based on solid results, we coated KBI-5898 onto urinary catheters and advanced the product into in vivo testing against the current clinical standard products. The results of this study, discussed later in this report, combined with feedback from market leading catheter companies, provided us with strong support for the continued development of KBI-5898 and we are now advancing the product into more rigorous in vivo testing. We expect to see the results of these studies in the latter part of this year.

Simultaneously, we are advancing products based upon technologies in-licensed from other leading institutions, such as our CSP technology for the oral care market, in order to fuel our discovery stage pipeline.



Mirroring our approach to development, we have continued to build corporate value at each stage, while remaining diligent in maximizing shareholder value.

With a strong research and development team, our products continue to take shape along with our patent estate—now at 15 patents. We are a technology based company, focused and committed to returning value to our shareholders through the development of innovative products for significant unmet needs. On behalf of our board of directors, scientific advisors and employees, I wish to thank you for your confidence in our ability to bring value to the marketplace and to those who invest in us.

Sincerely,

A handwritten signature in black ink, appearing to read 'Gord Froehlich'. The signature is written in a cursive style and is positioned above the printed name and title.

**Gord Froehlich**  
**PRESIDENT**



LOOKING → FORWARD



MEDICAL DEVICES

## URINARY CATHETERS

There is an urgent need to control and reduce the number of infections acquired by patients after their admission to the hospital. These hospital acquired (nosocomial) infections, many of which are caused by indwelling medical devices, pose a threat to any patient admitted to a hospital and contribute considerably to the costs and morbidity associated with hospitalization.

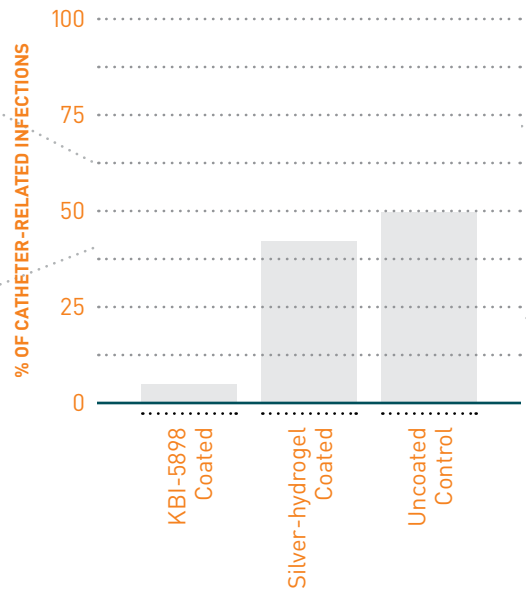
Indwelling medical devices are responsible for the vast majority of nosocomial infections. The most common cause of device related infection is the urinary catheter. Urinary catheterization is involved with up to 90% of all nosocomial urinary tract infections (UTI), as the catheter surface serves as a platform for the growth of bacteria as biofilm. As the duration of catheterization increases, catheter associated UTI rates approach 100%.

Patients who acquire a UTI will stay in hospital an average of six days longer than those who do not, and will contribute an extra \$1.8 billion in hospital costs.

A recent meta-analysis of studies available in the literature found abundant evidence to show that anti-microbial catheters provided benefits when compared to standard uncoated catheters. Furthermore, there is vast support for the assertion that the increased cost of

an effective coated catheter is justified with even a modest reduction in the rate of UTI. In the wake of these facts, and the Centers for Disease Control and Prevention's recommendation for the use of anti-microbial coated catheters, there is growing market demand for these types of products. The current \$175 million US anti-microbial coating market is forecast to grow to over \$500 million in 2012.

Effect of KBI-5898 coating on catheter-related infection due to *E.coli in vivo* (N=28)



Kane Biotech is building a pipeline of non-antibiotic catheter coatings for the prevention of catheter-associated infections. The Company’s lead coating for urinary catheters is called KBI-5898.

In a recent study conducted on behalf of Kane Biotech, KBI-5898 was compared to silver-hydrogel coated and uncoated commercially available catheters in a recognized *in vivo* model. Study results demonstrated that KBI-5898 coated urinary catheters were significantly

less likely to be colonized by bacteria than either the silver-hydrogel coated or uncoated catheters. Furthermore, the study showed that KBI-5898 coated urinary catheters were also significantly less likely to cause catheter related infections than either the silver-hydrogel coated or uncoated catheters. All the results comparing KBI-5898 to other test groups were statistically significant.

There are a limited number of coated urinary catheters on the market today, predominantly made up of those coated with silver. Although the anti-microbial activity of silver is documented, the use of silver on medical devices is continually debated based upon lack of conclusive evidence supporting its ability to reduce infection. The results of the Kane Biotech study were consistent with the concerns cited in the literature regarding the efficacy of silver.

Of even greater concern, multi-drug resistant bacterial strains continue to increase their prevalence in the hospital environment. According to work by leading experts, catheter associated UTI are perhaps the prime “reservoir” for antibiotic resistant pathogens.

There is an opportunity for Kane Biotech’s non-antibiotic coating, KBI-5898, to positively impact the antibiotic resistance problem by reducing the need for systemic antibiotics, while preventing the ability of dangerous resistant pathogens to take hold through the formation of biofilm on the catheter surface.





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MEDICAL DEVICES

## CENTRAL VENOUS CATHETERS

The use of central venous catheters (CVCs) is common in today's medical world. While the CVC is a necessary part of treatment, its use also puts patients at serious risk of local and systemic complications due to infection. There are more than five million CVCs used in the US each year, and each blood stream infection in an intensive care unit costs the healthcare system more than \$35,000 per episode.

Hospitals are under pressure to reduce these infections, and the use of antibiotic coatings is prevalent based upon the immediate health risks posed by these types of infections. Similar to UTI, the infection rate is linked to catheterization, as the catheter provides the platform for bacterial adherence and biofilm formation.

Kane Biotech is presently executing a strategy to develop a CVC coating based upon its expertise in non-antibiotic antimicrobial agents for coating catheters. This includes studies evaluating the efficacy of KBI-5898 in a CVC model along with other products in the Company's pipeline.



## DISPERSIN B

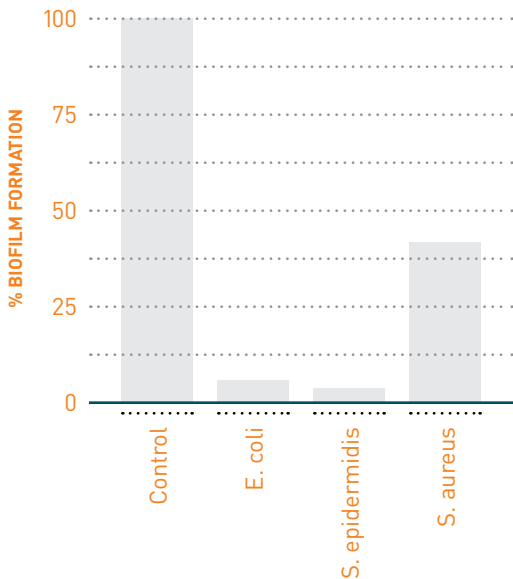
DispersinB is a novel enzyme responsible for inhibition and dispersal of bacterial biofilms. Kane Biotech has a worldwide exclusive license to all human and industrial applications of dispersinB from the University of Medicine and Dentistry of New Jersey (UMDNJ).

The discovery of dispersinB was made by Dr. Jeffrey Kaplan who was able to show that dispersinB can be used to

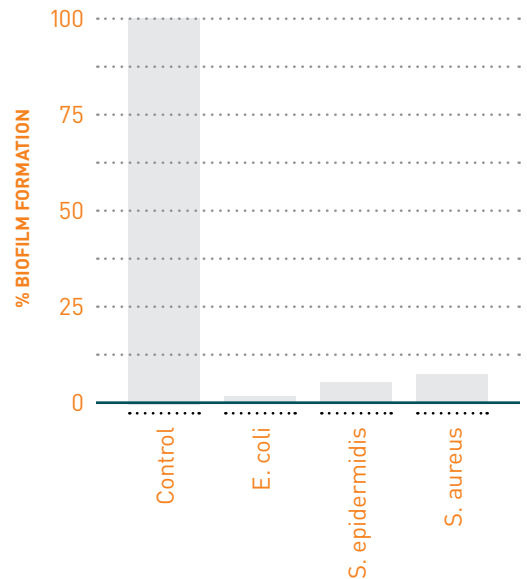
inhibit and disperse biofilms formed by *Staphylococcus epidermidis*, *Staphylococcus aureus* and *Escherichia coli*, among the most common causes of infections associated with indwelling medical devices including catheters. *Staphylococcus epidermidis* is a frequent contaminant of medical devices and many of its isolates are antibiotic resistant, so infection by this bacteria is very serious and can be fatal.

Kane Biotech is presently evaluating dispersinB alone, and in combination with other antimicrobial agents, to develop a proprietary catheter coating. The Company continues to evaluate and develop cutting edge technologies independently, and in cooperation with leading academic institutions.

**In vitro effect of dispersinB on biofilm formation**



**In vitro effect of dispersinB in combination on biofilm formation**



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KANE BIOTECH INC.

# ANTI-DENTAL CAVITY TECHNOLOGY



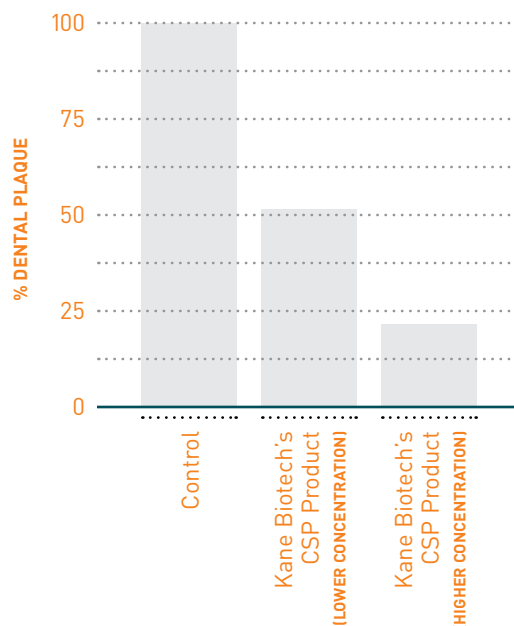
Perhaps the most notorious of all biofilms, dental plaque is one of the most common human infections: *Streptococcus mutans*, a bacterial strain that thrives in the biofilm environment, is recognized as the primary bacterium responsible for dental cavities.

The oral care market in the United States is over \$70 billion per year, with nearly \$2 billion spent on over the counter toothpaste and mouthwash products. The toothpaste market in particular is one characterized by a high level of competition, and a lack of recent innovation.

Kane Biotech is developing an anti-dental cavity product based upon the breakthrough CSP technology invented by Dr. Dennis Cvitkovitch at the University of Toronto. The lead application for this technology is expected to be a novel toothpaste or mouthwash additive.

The Company has positive proof-of-principle data for this technology from studies sponsored by Kane Biotech in a well recognized multi-species dental plaque model. The data showed that Kane Biotech's technology was able to reduce or inhibit the formation of dental plaque.

### Effects of CSP Technology based product on dental plaque



As the Company advances this technology through in vitro and in vivo testing, it continues to evaluate its opportunities through complimentary studies using CSP in combinations, and in additional product areas. The priority patent for the CSP technology has been issued in the United States, and Kane Biotech has the exclusive global rights to this technology from the University of Toronto.



LOOKING → BACK



KANE BIOTECH INC.

## MANAGEMENT'S DISCUSSION AND ANALYSIS & FINANCIAL STATEMENTS

Years ended December 31, 2005 and 2004



The following management's discussion and analysis ("MD&A") should be read in conjunction with the audited financial statements and related notes included therein that are prepared in accordance with Canadian generally accepted accounting principles taking into account material events up to April 21, 2006. All amounts are expressed in Canadian Dollars unless otherwise noted. Annual references are to the Company's fiscal years, which end on December 31.

## OVERVIEW

Kane Biotech Inc. (the "Company") is a biotechnology company engaged in the development of products to prevent and disperse bacterial biofilms. Biofilms develop when bacteria and other microorganisms form a protective matrix that acts as a shield against attack. When in a biofilm, bacteria become highly resistant to antibiotics, high temperatures and host immune responses. This resiliency contributes to numerous human health problems such as recurrent urinary tract infections, medical device associated infections and tooth decay.

According to the Center for Disease Control in Atlanta, biofilms are estimated to be responsible for 65% of all human infections and cost industry, cities and hospitals in excess of \$500 billion each year.

Kane Biotech Inc. has a growing portfolio of compounds and patents built upon technology acquired from leading research institutions and the Company's own biofilm research expertise. This arsenal of compounds that prevent and disperse bacterial biofilms has grown from the Company's ability to screen for factors affecting biofilm formation and has resulted in a number of candidate products that are being developed based on the significant demand for safe and effective anti-biofilm compounds.

The Company's lead product for the prevention of catheter associated urinary tract infections is KBI-5898. The product has both in vitro and in vivo data that demonstrates its ability to inhibit the activity of numerous catheter associated pathogens, and protect against urinary catheter related infections.

In addition, the Company is developing its technology for the prevention of infections caused by central venous catheters. Catheter related infections cost the United States healthcare system over US\$2 billion per year.

Kane Biotech Inc. is also developing toothpaste enhancements for the prevention of dental plaque. These enhancements are based on the Company's novel and patent protected technology which targets cavity causing bacteria. The U.S. dental market is over US\$70 billion per year.

## CRITICAL ACCOUNTING ESTIMATES AND CHANGES IN ACCOUNTING POLICIES

The preparation of financial statements in conformity with Canadian generally accepted accounting principles ("Canadian GAAP") requires the Company to select from possible alternative accounting principles and to make estimates and assumptions that determine the reported amounts of assets and liabilities at the balance sheet date, and reported costs and expenditures during the reporting period. Management believes that the estimates and assumptions upon which the Company relies are reasonable based upon information available at the time these estimates and assumptions are made. Estimates and assumptions may be revised as new information is acquired, and are subject to change. Areas of significant estimates include research costs and stock-based compensation.

### Research costs

All costs of research activities are expensed in the period in which they are incurred. Development costs are charged as an expense in the period incurred unless a development project meets stringent criteria for cost deferral and amortization. The Company assesses whether these costs have met the relevant criteria for deferral and amortization at each reporting date. No development costs have been deferred to date.

### Stock-based compensation

The Company follows accounting guidelines in determining the value of stock-based compensation, as disclosed in Note 2 of the Financial Statements. This calculated amount is not based on historical cost, but is based on subjective assumptions which are inputted into an option pricing model. The model requires that management make several assumptions as to future events including: 1) estimating the average future hold period of issued stock options before exercise, expiry or cancellation; 2) estimating future volatility of the Company's share price in the expected hold period (using historical volatility as a reference); 3) and calculating an appropriate risk free rate of interest. The resulting value is not necessarily the value which the holder of the option could receive in an arm's length transaction, given that there is no market for the options and they are not transferable. It is management's view that the value derived is highly subjective and dependent entirely on the input assumptions made. The Company recorded stock-based compensation expense in fiscal 2005 of \$147,857 (2004 - \$40,861).

### Changes in Accounting Policies

There were no changes in Accounting Policies during the period.

## SELECTED ANNUAL INFORMATION

The following is selected financial information about the Company, for its 2005, 2004 and 2003 fiscal years:

	2005	2004	2003
Revenue	\$ 22,115	\$ 13,414	\$ 19,752
Research expenses	(430,950)	(275,483)	(149,228)
General and administrative expenses	(564,804)	(324,528)	(296,174)
Loss for the year	(1,009,650)	(602,562)	(405,542)
Loss per share	(0.07)	(0.05)	(0.05)
Total assets	1,152,053	526,372	1,012,298
Total liabilities	134,623	99,724	57,024
Deficit	(2,292,126)	(1,282,476)	(679,914)
Total capital stock and contributed surplus	3,309,556	1,709,124	1,635,188

## QUARTERLY FINANCIAL INFORMATION FOR 2005 AND 2004

The following quarterly financial information about the Company, for its years ended December 31, 2005 and December 31, 2004:

	Q4 2005		Q3 2005		Q2 2005		Q1 2005	
Revenue	\$	2,442	\$	3,980	\$	6,820	\$	8,873
Loss for the period		(280,034)		(255,549)		(264,113)		(209,954)
Loss per share		(0.02)		(0.02)		(0.02)		(0.02)

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	Q4 2004		Q3 2004		Q2 2004		Q1 2004	
Revenue	\$	2,854	\$	2,189	\$	2,277	\$	6,094
Loss for the period		(247,905)		(99,164)		(148,460)		(107,033)
Loss per share		(0.02)		(0.01)		(0.01)		(0.01)

The Company's increasing quarterly loss over the past two years relates primarily to the expansion of the Company's research program. Specifically, expenses increased as compared to prior periods due to an increase in payroll, contract research, consumables, rent and recording stock-based compensation related to options granted to investor relations firms, consultants, employees and directors.

### FOURTH QUARTER

The increased loss in the fourth quarter of fiscal 2005 as compared to the third quarter of fiscal 2005 and to the fourth quarter of fiscal 2004 is mainly driven by an increase in scientific consulting and contract research.

### RESULTS OF OPERATIONS

Year Ended December 31, 2005 as Compared to Year Ended December 31, 2004

The Company has been a research company since inception. Due to expenditures related to its research, the Company anticipates that losses will continue at least until market approval of the Company's first product, which may never occur. During the year ended December 31, 2005, the Company had a loss of \$1,009,650 compared to \$602,562 for the year ended December 31, 2004.

#### Interest Income

The changes in interest income for the fiscal year ended December 31, 2005 and December 31, 2004 are reflected in the following table:

YEAR ENDED	2005		2004		INCREASE
Interest income	\$	22,115	\$	13,414	\$ 8,701

Interest income in fiscal 2005 was slightly higher than fiscal 2004, primarily due to higher average cash balances throughout the year as compared to the prior year. The Company anticipates that investment income will continue to fluctuate in relation to cash and short term investment balances and interest yields.

### Research

Research expenditures include costs associated with the Company's research and product development program, the major portion of which are salaries paid to research staff, equipment rental, consumables, and consulting. The Company is in the development stage and devotes a significant portion of its financial resources to research activities.

The changes in research expenditures for the fiscal years ended December 31, 2005 and December 31, 2004 are reflected in the following table:

YEAR ENDED	2005	2004	INCREASE
Research	\$ 430,950	\$275,483	\$ 155,467

As expected, research expenditures were higher in fiscal 2005 as compared to the same period in fiscal 2004. This increase in spending was the result of higher research salaries, scientific consulting, contract research and consumables. In addition, the Company relocated to larger facilities in fiscal 2005.

### Catheter Coating Products

The Center for Disease Control in Atlanta has reported that one in ten patients in the United States will acquire an infection after admission to a hospital and up to 80% of all hospital acquired infections are medical device related. The result is prolonged hospital stays, an additional US\$5 billion in annual health costs and numerous deaths.

The Company has recently selected KBI-5898 as its lead product for coating urinary catheters and in November announced the positive results of an in vivo study comparing urinary catheters coated with KBI-5898 to those coated with silver-hydrogel and uncoated catheters. Study results demonstrated with statistical significance that catheters coated with KBI-5898 were less likely to be colonized by bacteria or cause device related infection than those coated with silver-hydrogel or uncoated catheters.

Kane Biotech's technology has further applications in the coating of central venous catheters (CVCs) for the prevention of CVC related infections. The Company is presently evaluating a number of its proprietary agents, including KBI-5898, for the selection of its lead product for coating CVCs.

### Oral Care Product

Dental cavities are one of the most common infectious diseases in humans. Approximately, 50% of adults have at least four cavities that have been treated or require treatment. *Streptococcus mutans* (*S. mutans*) is the principal bacteria responsible for dental cavities in humans and is recognized as the primary initiator of dental cavities when it exists in the biofilm environment of dental plaque.

Kane Biotech Inc.'s Competence Stimulating Peptide (CSP) technology is being engaged for the development of a novel anti-cavity product. CSP is responsible for the ability of *S. mutans* to form dental plaque, as well as many factors in the ability of bacteria to cause damage to the host. Kane Biotech has tested several peptides that have been shown to interfere with the CSP system. These peptides represent a novel approach to the prevention of dental cavities by specifically preventing the formation of *S. mutans* biofilms. There are numerous applications for a product derived from these peptides including use in toothpaste, mouthwash, chewing gum, candies, and soft drinks; along with dental office and veterinary applications.

Kane Biotech is presently in the final stages of selecting the most promising product for further development, and developing it into a prototype form suitable for further testing as part of the first proposed product application of this technology.

### General and Administrative

General and administrative expenses include those costs not directly related to research activities. This includes expenses associated with management services and professional fees such as legal, audit and investor and public relations activities.

The changes in general and administrative expenditures for the fiscal years ended December 31, 2005 and December 31, 2004 are reflected in the following table:

YEAR ENDED	2005		2004		INCREASE
General and administrative	\$	564,804	\$	324,528	\$ 240,276

The overall increase in costs during the fiscal year ended December 31, 2005 compared to the similar period in fiscal 2004 is primarily attributable to the recognition of stock-based compensation, an increase in administrative and consulting fees, investor relations activities, and rent. The Company expects similar levels of general and administrative expenditures in the fiscal year ending December 31, 2006 as compared to fiscal 2005.

### Results

The loss for fiscal years ended December 31, 2005 and December 31, 2004 is reflected in the following table:

YEAR ENDED	2005		2004		INCREASE
Loss	\$	1,009,650	\$	602,562	\$ 407,088
Loss per share		0.07		0.05	0.02

As discussed above, the loss resulted mainly from the recognition of stock-based compensation, an increase in administrative and consulting fees, investor relations activities and from the expansion of the Company's research program. The Company expects to incur a loss next year as it continues its research programs.

## LIQUIDITY AND CAPITAL RESOURCES

Since inception, the Company has financed its operations from public and private sales of equity, the exercise of warrants and stock options, interest income on funds available for investment and government grants and tax credits. As at December 31, 2005, the Company had cash and cash equivalents totaling \$381,994 compared with \$276,034 at the previous year-end.

### Cash used in operating activities

Cash used in operating activities totaled \$808,870 in 2005, compared to \$503,499 in the previous year as the Company's research programs were expanded in 2005.

### Cash used in investing activities

Cash used in investing activities totaled \$300,145 in 2005, primarily due to the acquisition of property and equipment and from patent costs. In the previous year, cash used in investing activities totaled \$77,971, mainly due to patent and technology license costs.

### Cash from financing activities

In fiscal 2005, cash provided from financing activities totaled \$1,214,975. In January 2005, the Company strengthened its cash position by raising gross proceeds of \$1,200,000 (before share issuance costs of approximately \$10,191) through a private placement of 3,000,000 common shares at a purchase price of \$0.40 per common share. In addition, stock options were exercised for gross proceeds of \$25,166. In the previous year, 100,000 stock options were exercised for gross proceeds to the Company of \$30,000.

The total number of common shares issued and outstanding at December 31, 2005 was 14,623,156 as compared to 11,210,937 at December 31, 2004. As at April 21, 2006, the Company had 14,623,156 common shares outstanding and 1,023,875 stock options outstanding.

On April 20, 2006, the Company announced an offering by way of a non-brokered private placement of up to 2,000,000 common shares at a price of \$0.60 per common share for aggregate proceeds of up to \$1,200,000. If the private placement closes, the proceeds will be used for research and development and working capital purposes. There is no guarantee that the private placement will close.

### CONTRACTUAL OBLIGATIONS

The Company leases its premises and equipment under various operating leases. The Company has the following cash resource requirements:

	PAYMENTS DUE BY PERIOD				
	TOTAL COMMITMENTS	WITHIN 1 YEAR	2-3 YEARS	4-5 YEARS	AFTER 5 YEARS
Operating leases	\$ 98,281	\$ 23,125	\$ 46,250	\$ 28,906	\$ -

### OFF-BALANCE SHEET ARRANGEMENTS

The Company does not have any off-balance sheet arrangements.

### FINANCIAL INSTRUMENTS

The fair values of cash and cash equivalents, accounts receivable, and accounts payable and accrued liabilities approximate their carrying values due to their short term to maturity. The Company has not entered into any futures or forward contracts or other derivative instruments as at December 31, 2005.

## CONTROLS

### Effectiveness of disclosure controls and procedures

Management has established and maintained disclosure controls and procedures for the Company in order to provide reasonable assurance that material information relating to the Company is made known to management in a timely manner and that information required to be disclosed by the Company is reported within time periods prescribed by applicable securities legislation. Management has evaluated the effectiveness of the Company's disclosure controls and procedures, as at the date of this "MD&A", and as a result of that review, the Company's President and Chief Financial Officer believe them to be effective in providing such reasonable assurance.

## RELATED PARTY TRANSACTIONS

During the year ended December 31, 2005, the Company paid a shareholder a total of \$149,796 (2004 - \$148,626) for consulting fees and \$28,218 (2004 - \$10,609) under a sublease rental agreement. The Company also paid a company controlled by an officer \$3,000 (2004 - \$3,000) for rental of equipment and received \$15,000 (2004 - nil) for the sale of leasehold improvements from a company controlled by an officer.

These transactions are measured at the exchange amount which is the amount of consideration established and agreed to by the related parties.

## OUTLOOK

The strategic direction of the Company is centered on developing solutions to biofilm related problems. Specifically, Kane Biotech is developing products for the prevention of catheter associated infections. Concurrently, the Company is developing products in the areas of anti-cavity toothpaste enhancements. In order to advance these programs, Kane Biotech expects to continue incurring operating losses. Based on current projections and strategic plans, it is expected that total expenses will increase in fiscal 2006 compared to fiscal 2005. This increase in expenditures is expected to result from the continued advancement of our present research activities.

The Company recently initiated a financing that, if it closes, the Company believes will provide sufficient resources to fund operations into fiscal 2007. However, funding requirements may change as a result of numerous factors including progress of the Company's research, commercialization arrangements with partners, and changes or expansions to the Company's research programs. As such, the Company may consider raising additional capital during fiscal 2006 to fund operations over the long term. In addition, the Company will be approaching various potential partners to pursue alliances with regards to its urinary catheter product, which may provide additional funding for research.

The Company may decide to accelerate, terminate or reduce its focus in certain research areas, or commence research in new areas as a result of the Company's research progress and the availability of financial resources. These decisions are made with the goals of managing the Company's cash resources and optimizing the Company's opportunities. Management is not presently aware of any factors that would change its strategy over the next year.

## RISKS AND UNCERTAINTY

The Company's products and technology are currently in the research stage. The Company does not, and may never have, a commercially viable product approved for marketing. To date, the Company has not generated any revenue from sales. The timing of revenue generation is uncertain. The Company's business, financial condition and results of operations will depend on its ability to obtain additional funding through the capital markets, which may not be available under favourable terms, if at all. The ability of the Company to arrange such financing in the future will depend in part upon the prevailing capital market conditions as well as the business performance of the Company.

Other potential risk factors facing the Company include: the performance of key personnel, competition from other companies, and the ability to obtain patent protection and regulatory approvals.

This "Management's Discussion and Analysis" contains forward-looking statements which may not be based on historical fact, including without limitation statements containing the words "believes," "may," "plan," "will," "estimate," "continue," "anticipates," "intends," "expects," and similar expressions. Such forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause the actual results, events or developments to be materially different from any future results, events or developments expressed or implied by such forward-looking statements. Such factors include, among others, the Company's stage of development, lack of product revenues, additional capital requirements, risks associated with the completion of clinical trials and obtaining regulatory approval to market the Company's products, the ability to protect its intellectual property and dependence upon collaborative partners. These factors should be considered carefully and readers are cautioned not to place undue reliance on such forward-looking statements. The forward-looking statements are made as of the date hereof, and the Company disclaims any obligation to update any such factors or to publicly announce the result of any revisions to any of the forward-looking statements contained herein to reflect future results, events or developments.

# AUDITORS' REPORT

To the Shareholders of Kane Biotech Inc.

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We have audited the balance sheets of Kane Biotech Inc. as at December 31, 2005 and December 31, 2004 and the statements of operations and deficit and cash flows for the years then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the company as at December 31, 2005 and December 31, 2004 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Signed "KPMG LLP"

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Chartered Accountants

WINNIPEG, CANADA  
MARCH 3, 2006, EXCEPT AS TO NOTE 11,  
WHICH IS AS OF APRIL 20, 2006

**KPMG LLP**  
Chartered Accountants

Suite 2000 – One Lombard Place  
Winnipeg MB R3B 0X3 Canada

Telephone: 204 957.1770  
Fax: 204 957.0808  
Internet: [www.kpmg.ca](http://www.kpmg.ca)

Balance Sheets

December 31, 2005 and 2004

	2005	2004
<b>Assets</b>		
<b>Current assets:</b>		
Cash	\$ 381,994	\$ 276,034
Accounts receivable	59,183	37,077
Prepaid expenses	9,163	5,800
	-----	-----
	450,340	318,911
Property and equipment <i>(note 3)</i>	145,861	58,585
Patents, net of accumulated amortization of \$1,347 (2004 - \$436)	276,437	118,876
Technology licenses <i>(note 4)</i>	279,415	30,000
	-----	-----
	\$ 1,152,053	\$ 526,372
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<b>Liabilities and Shareholders' Equity</b>		
<b>Current liabilities:</b>		
Accounts payable and accrued liabilities	\$ 134,623	\$ 99,724
<b>Shareholders' equity:</b>		
Capital stock <i>(note 5)</i>	3,101,921	1,646,405
Contributed surplus	207,635	62,719
Deficit	(2,292,126)	(1,282,476)
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	1,017,430	426,648

Commitments *(note 7)*

Subsequent event *(note 11)*

See accompanying notes to financial statements.

On behalf of the Board:



.....  
Director



.....  
Director

# KANE BIOTECH INC.

## Statements of Operations and Deficit

Years ended December 31, 2005 and 2004

	2005	2004
<b>Revenue:</b>		
Interest	\$ 22,115	\$ 13,414
<b>Expenses:</b>		
Amortization	39,389	15,965
General and administration	564,804	324,528
Research	430,950	275,483
	1,035,143	615,976
<b>Other:</b>		
Foreign exchange gain	3,378	-
Loss for the year	(1,009,650)	(602,562)
Deficit, beginning of year	(1,282,476)	(679,914)
Deficit, end of year	\$ (2,292,126)	\$ (1,282,476)
Basic and diluted loss per share	\$ (0.07)	\$ (0.05)

See accompanying notes to financial statements.

## Statements of Cash Flows

Years ended December 31, 2005 and 2004

	2005	2004
<b>Cash provided by (used in):</b>		
<b>Operating activities:</b>		
Loss for the year	\$ (1,009,650)	\$ (602,562)
<b>Adjustments for:</b>		
Amortization of property and equipment	32,229	15,652
Amortization of patents	911	313
Write-down of patents	10,334	-
Loss on disposal of property and equipment	19	-
Non-cash compensation recognized from stock options	147,857	40,861
<b>Change in the following:</b>		
Accounts receivable	(22,106)	(13,858)
Prepaid expenses	(3,363)	13,395
Accounts payable and accrued liabilities	34,899	42,700
	(808,870)	(503,499)
<b>Financing activities:</b>		
Issuance of common shares, net of share issue costs	1,214,975	33,075
<b>Investing activities:</b>		
Purchase of property and equipment	(134,524)	(4,099)
Proceeds on disposal of property and equipment	15,000	-
Patent costs	(168,806)	(43,872)
Addition to technology licenses	(11,815)	(30,000)
	(300,145)	(77,971)
Increase (decrease) in cash	105,960	(548,395)
Cash, beginning of year	276,034	824,429
Cash, end of year	\$ 381,994	\$ 276,034
<b>Supplementary information:</b>		
Non-cash transactions:		
Value assigned to shares issued as consideration for acquisition of technology license from UTIF	\$ 237,600	\$ -

See accompanying notes to financial statements.

## 1. Nature of operations and basis of presentation:

Kane Biotech Inc. (the company) was initially established to use a patent protected technology intended to find compounds which prevent or disrupt biofilms in medical and industrial applications. To date, the company has no products currently in commercial production or use. Accordingly, the company is considered to be a development stage enterprise for accounting purposes. Since May 17, 2001, the date of incorporation of Kane Biotech Inc., through to December 31, 2005, the company has expended approximately \$921,918, net of government assistance, on research.

These financial statements have been prepared in accordance with Canadian generally accepted accounting principles on a going concern basis which presumes the realization of assets and discharge of liabilities in the normal course of business for the foreseeable future. The company has experienced operating losses and cash outflows from operations since incorporation. The company needs to raise additional capital in order to fund ongoing operations through fiscal 2006, and in this regard, announced an offering of shares on April 20, 2006.

The company's ability to continue as a going concern, is dependent on its ability to obtain sufficient funds to conduct its research and development and to successfully commercialize its products. The outcome of these matters cannot be predicted at this time. These financial statements do not reflect adjustments to the carrying values on the assets and liabilities which may be required should the company be unable to continue as a going concern.

## 2. Significant accounting policies:

### (a) Cash and cash equivalents:

Cash and cash equivalents include cash on hand and balances with banks as well as highly liquid short-term investments. The company considers all highly liquid short-term investments with terms to maturity when acquired of three months or less to be cash equivalents.

### (b) Property and equipment:

Property and equipment are stated at cost, net of government assistance. Amortization is recorded over the estimated useful lives of the assets at the following rates:

ASSET	BASIS	RATE
Computer equipment	Diminishing balance	30%
Scientific equipment	Diminishing balance	20%
Office equipment	Diminishing balance	20%
Leasehold improvements	Straight-line	5 years

## 2. Significant accounting policies (continued):

### (c) Patents:

Costs incurred in obtaining patents are capitalized and amortized on a straight-line basis over the legal life of the respective patents, being approximately twenty years, or its economic life, if shorter. The cost of servicing the company's patents is expensed as incurred. The company commenced amortization of patent costs during fiscal 2003 for those patent applications approved in the year.

### (d) Technology licenses:

Technology licenses are recorded at cost. The license fee paid to the University of Toronto Innovations Foundation consists of the initial fee paid and a value assigned to shares issued as consideration for acquisition of the technology license (*note 4*). The cost will be amortized over a three year period commencing in the period in which sales of the licensed product is first earned.

In addition, a license initiation fee paid to the University of Medicine and Dentistry of New Jersey is included in technology license.

### (e) Impairment of long-lived assets:

On a regular basis, management reviews the valuation of long-lived assets, which includes property and equipment and patent costs, taking into consideration any events and circumstances which may impact recoverable value. Section 3063 of the CICA Handbook, Impairment of Long-Lived Assets, effective for fiscal 2004, prescribes revised and more rigorous principles for the recognition, measurement and disclosure of any impairment of long-lived assets. Management has reviewed the carrying value of the long-lived assets using this amended guidance and determined no impairment currently exists.

### (f) Stock-based compensation:

The company has a stock option plan (*note 5(c)*) for its directors, management, employees, management company employees and consultants. The company uses the fair value based method to account for all stock-based compensation and other stock-based payments. The fair value is estimated at measurement date using the Black-Scholes option pricing model. For all options granted to directors, management, employees, management company employees and consultants under the company's stock option plan, compensation expense is recognized over the period(s) in which the related services were rendered.

## 2. Significant accounting policies (continued):

### (g) Research and development:

All costs of research activities are expensed in the period in which they are incurred. Development costs are charged as an expense in the period incurred unless the company believes a development project meets stringent criteria for deferral and amortization. No development costs have been deferred to date.

### (h) Government assistance and investment tax credits:

Government assistance toward current expenses is recorded as a reduction against the related expenses in the period they are incurred. Government assistance towards capital assets is deducted from the cost of the related capital asset. Investment tax credits relating to scientific research and development are recorded as either a reduction of the applicable capital assets or credited in the statement of operations depending on the nature of the expenditure which gave rise to the credits. The investment tax credits are recorded in the period that the credit has been approved by Canada Revenue Agency.

### (i) Income taxes:

The company uses the asset and liability method to provide for income taxes in the financial statements. Under the asset and liability method, 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 enacted or substantively enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the date of enactment or substantive enactment. When realization of future income tax assets does not meet the more likely than not criterion then a valuation allowance is provided for the difference.

### (j) Per share amounts:

Per share amounts are computed using the weighted average number of shares outstanding during the period including contingently issuable shares where the contingency has been resolved. The diluted per share amounts are calculated based on the weighted average number of common shares outstanding during the period, plus the effect of dilutive common share equivalents such as options and warrants. This method requires that diluted per share amounts be calculated using the treasury stock method, as if all the common share equivalents where the average market price for the period exceeds the exercise price had been exercised at the beginning of the reporting period, or at the date of issue, if later, as the case may be, and that the funds obtained thereby were used to purchase common shares of the company at the average trading price of the common shares during the period.

2. Significant accounting policies (continued):

(k) Foreign currency translation:

Monetary assets and liabilities denominated in foreign currencies are translated at the prevailing rates of exchange at the balance sheet date. Revenue and expenses are translated at the exchange rates prevailing on the transaction date. Realized and unrealized exchange gains and losses are included in earnings.

(l) Use of estimates:

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the year. Actual results could differ from those estimates.

3. Property and equipment:

2005	COST	ACCUMULATED AMORTIZATION	NET BOOK VALUE
Computer equipment	\$ 5,009	\$ 2,462	\$ 2,547
Scientific equipment	108,360	36,104	72,256
Office equipment	3,999	1,374	2,625
Leasehold improvements	82,789	14,356	68,433
	\$ 200,157	\$ 54,296	\$ 145,861

2004	COST	ACCUMULATED AMORTIZATION	NET BOOK VALUE
Computer equipment	\$ 3,260	\$ 1,684	\$ 1,576
Scientific equipment	59,647	20,990	38,657
Office equipment	2,726	942	1,784
Leasehold improvements	30,992	14,424	16,568
	\$ 96,625	\$ 38,040	\$ 58,585

#### 4. Technology licenses:

The company has the worldwide exclusive rights to a number of patents and technologies from the University of North Texas Health Sciences Center. The company is obligated to pay all costs of filing and maintaining patents, pay a royalty of a stipulated percentage on the net sales of licensed products, and pay a stipulated percentage of any sublicense fee. Fees payable, if any are to be paid quarterly. The agreement terminates on the expiration or invalidity of the last patent issued under the agreement.

On December 31, 2004, the company acquired the worldwide exclusive rights to the Competence Stimulating Peptide (CSP) technology from the University of Toronto. The company's license to the CSP technology expands its focus and broadens its technology portfolio. Under the terms of the agreement, the company paid an initial license fee of \$30,000 to University of Toronto Innovations Foundation (UTIF) and, in fiscal 2005, issued 165,000 common shares to each of UTIF and the Governing Council of University of Toronto for an aggregate of 330,000 common shares at deemed consideration of \$0.72 per share or \$237,600. The company is also obligated to pay \$20,000 to UTIF for each patent issued as a result of this license agreement to a maximum of \$40,000 as well as pay for all costs of filing and maintaining the patents. In further consideration of the granting of the license, the company will pay a royalty to UTIF of a stipulated percentage of the net sales of the licensed products. If the company sub-licenses any rights under the agreement to a third party, the company shall pay UTIF a stipulated percentage of a sub-license fee and sub-license royalty fee. The royalty, sub-license and sub-license royalty fees, if any, are to be paid quarterly. The agreement terminates on the expiration or invalidity of the last patent issued under the agreement.

On April 1, 2005, the company acquired the worldwide exclusive license to all human and industrial applications of the dispersin B enzyme from the University of Medicine and Dentistry of New Jersey (UMDNJ) and paid a license fee of \$11,815. Under the terms of the agreement, the company has committed to: pay all costs of filing and maintaining the patents; pay a license initiation fee of US\$10,000 during the first year; and, additional negotiated milestone payments throughout the term of the agreement. The company will pay an annual royalty payment beginning on the third anniversary date of the agreement. The company will also pay a royalty to UMDNJ of a stipulated percentage of the net sales of the licensed products. If the company sub-licenses any rights under the agreement to a third party, the company shall pay UMDNJ a stipulated percentage of a sub-license fee and sub-license royalty fee. The royalty, sub-license and sub-license royalty fees, if any, are to be paid quarterly. This agreement terminates on the expiration or invalidity of the last patent issued under the agreement.

**5. Capital stock:****(a) Authorized:**

The company has authorized share capital of an unlimited number of common voting shares.

**(b) Shares issued and outstanding are as follows:**

	NUMBER OF SHARES	AMOUNT
Balance at December 31, 2003	11,110,937	\$ 1,613,330
Refund of share issue costs	-	3,075
Exercise of stock options	100,000	30,000
Balance at December 31, 2004	11,210,937	1,646,405
Private placement of shares for cash, net of share issue costs of \$10,191 (1)	3,000,000	1,189,809
Shares issued to UTIF on January 27, 2005 (2)	330,000	237,600
Exercise of stock options	82,219	28,107
Balance at December 31, 2005	14,623,156	\$ 3,101,921

(1) On January 20, 2005, the company closed a private placement offering (the Offering) of 3,000,000 common shares (the shares) at a price of \$0.40 per share, for aggregate gross proceeds to the company of \$1,200,000. The shares were subject to a four-month hold period in accordance with applicable securities laws and the policies of the TSX Venture Exchange. The Offering was non-brokered and no commissions or finder's fees were paid to any party in connection with the Offering.

In concert with the private placement, certain insiders of the company arranged for the prior sale of an aggregate of 355,834 common shares at a price of \$0.45 per share through the facilities of the TSX Venture Exchange. A portion of the proceeds raised through the sale of the common shares was used by certain insiders of the company to purchase 373,334 common shares under the Offering.

(2) On January 27, 2005, the company issued 165,000 common shares to each of UTIF and the Governing Council of University of Toronto for an aggregate of 330,000 common shares at deemed consideration of \$0.72 per share or \$237,600.

**(c) Options:**

The company has a stock option plan which is administered by the Board of Directors of the company with stock options granted to directors, management, employees, management company employees and consultants as a form of compensation. The number of common shares reserved for issuance of stock options is limited to a maximum of 10 percent of the issued and outstanding shares of the company at any one time. The vesting period is determined by the Board of Directors at the time the options are granted.

## 5. Capital stock (continued):

A summary of the company's stock option plan is as follows:

	2005		2004	
	SHARES	WEIGHTED AVERAGE EXERCISE PRICE	SHARES	WEIGHTED AVERAGE EXERCISE PRICE
Balance, beginning of year	811,094	\$ 0.38	830,521	\$ 0.33
Granted	295,000	0.57	285,000	0.43
Exercised	(82,219)	0.31	(100,000)	0.30
Cancelled or expired	-	-	(204,427)	0.31
Balance, end of year	1,023,875	\$ 0.44	811,094	\$ 0.38
Options exercisable, end of year	1,011,375	\$ 0.43	526,094	\$ 0.35
Weighted average fair value per unit of options granted during the year		\$ 0.30		\$ 0.30

During fiscal 2005, 50,000 stock options were granted to an investor relations firm with a strike price of \$0.80 per common share. Also during the year, 100,000 stock options were granted to certain employees and officers with a strike price of \$0.55 per common share. An additional 145,000 stock options were granted to certain employees, management company employees and officers with a strike price of \$0.50 per common share.

During the year, a director exercised 72,219 stock options for gross proceeds to the company of \$21,666. In addition, an employee exercised 10,000 stock options for gross proceeds to the company of \$3,500.

Options outstanding at December 31, 2005 consist of the following:

RANGE OF EXERCISE PRICES	NUMBER OUTSTANDING	WEIGHTED AVERAGE REMAINING CONTRACTUAL LIFE	OPTIONS OUTSTANDING WEIGHTED AVERAGE EXERCISE PRICE	NUMBER EXERCISABLE
\$ 0.30 - 0.80	1,023,875	3.48	\$ 0.44	1,011,375

At December 31, 2005, 12,500 (2004 - 285,000) stock options remain unvested. These options vest on January 21, 2006.

**5. Capital stock (continued):**

The compensation expense related to stock options granted under the stock option plan during fiscal 2005 to employees, management company employees, consultants and directors aggregated \$147,857 (2004 - \$40,861). The compensation expense was determined based on the fair value of the options at the date of measurement using the Black-Scholes option pricing model with the following weighted average assumptions:

	2005	2004
Expected option life	5 years	5 years
Risk-free interest rate	3.25%	2.70%
Dividend yield	-	-
Expected volatility	70%	70%

The cost of stock-based payments that are fully vested and non-forfeitable at the measurement date is measured and recognized at that date. For awards that vest at the end of the vesting period, compensation cost is recognized on a straight-line basis over the period of service.

**(d) Contributed surplus:**

Changes in contributed surplus are as follows:

Balance, December 31, 2003	\$	21,858
Options granted		40,861
Balance, December 31, 2004		62,719
Options granted		147,857
Options exercised		(2,941)
Balance, December 31, 2005	\$	207,635

**(e) Escrowed shares**

The company's issued share capital includes 5,669,450 shares (2004 - 6,876,400 shares) which are currently held in escrow and will be released for trading in twelve instalments, releasable every six months in amounts ranging from 603,475 to 922,225 shares. The initial release of shares was September 30, 2003 and all shares will be released by September 30, 2009.

**(f) Per share amounts:**

The weighted average number of common shares outstanding for the years ended December 31, 2005 and 2004 were 14,408,064 and 11,144,817, respectively. The dilution created by options has not been reflected in the per share amounts as the effect would be anti-dilutive.

## 6. Income taxes:

Significant components of the company's future tax assets and liabilities are as follows:

	2005	2004
Future tax assets:		
Non-capital loss and scientific research and development expenditure carry forwards	\$ 835,000	\$ 495,000
Share issue costs	43,000	61,000
	878,000	556,000
Future tax liabilities:		
Property and equipment	(58,000)	(21,000)
	820,000	535,000
Less valuation allowance	(820,000)	(535,000)
	\$ -	\$ -

The reconciliation of the Canadian statutory rate to the income tax provision is as follows:

	2005	2004
Canadian federal and provincial income taxes at 37.1% (2004 - 37.6%)	\$ (373,570)	\$ (227,691)
Change in rates	33,242	33,230
Add permanent differences	55,328	15,461
	(285,000)	(179,000)
Less valuation allowance	285,000	179,000
	\$ -	\$ -

At December 31, 2005, the company has the following available for application in future years:

- unutilized Canadian non-capital loss carried forward balances for income tax purposes of \$1,646,000 (2004 - \$909,000), with expiry by 2015.
- unutilized scientific research and development expenditures of \$602,000 (2004 - \$406,000), with no expiry.
- scientific research and development investment tax credits of \$259,000 (2004 - \$140,000) which can be applied against income taxes otherwise payable, with expiry by 2015.

**7. Commitments:**

The company leases its premises under operating leases. Minimum annual rental payments to the end of the lease terms are as follows:

2006	\$	23,125
2007		23,125
2008		23,125
2009		23,125
2010		5,781

The company has a commitment to pay \$160,000 per year for consulting services to Genesys Venture Inc. This contract will automatically be renewed for subsequent one year periods unless one of the parties terminates the agreement. The total amount due under this contract is reduced by any payments made under the sublease agreement with Genesys Venture Inc.

The company has a commitment to pay US\$15,000 per year for consulting to a shareholder. The contract will automatically be renewed for a further one year period unless one of the parties provides written notice of termination 90 days prior to the end of the first term.

The company has a commitment to pay \$96,600 per year for consulting to an officer, payable on a monthly basis. The original agreement, dated February 1, 2005 was renewed on November 30, 2005. The renewal term will be for a period of two years commencing on December 1, 2005.

**8. Related party transactions:**

During the year ended December 31, 2005, the company paid Genesys Venture Inc., a shareholder, \$149,796 (2004 - \$148,626) for consulting fees and \$28,218 (2004 - \$10,609) under a sublease rental agreement. The company also paid \$3,000 (2004 - \$3,000) for rental of equipment to and received \$15,000 (2004 - nil) for the sale of leasehold improvements from a company controlled by an officer.

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

**9. Government assistance:**

During the year ended December 31, 2005, the company received \$52,584 (2004 - \$49,466) in government assistance for the purposes of research. The funding has been recorded against the related research expenditures.

**10. Financial instruments:**

The fair values of cash, accounts receivable, and accounts payable and accrued liabilities approximate their carrying values due to their short term to maturity.

**11. Subsequent event:**

On April 20, 2006, the company announced an offering of a private placement of 2,000,000 shares at \$0.60, for gross proceeds of \$1,200,000. The offering is subject to all necessary approvals, including the approval of the TSX Venture Exchange.

## MANAGEMENT TEAM

Gord Froehlich,  
PRESIDENT

April Manness, CGA,  
CHIEF FINANCIAL OFFICER

Marcus Enns,  
VICE-PRESIDENT, CORPORATE AFFAIRS

Dr. Tony Romeo,  
CHIEF SCIENTIFIC ADVISOR

Dr. Sri Madhyastha,  
DIRECTOR OF RESEARCH

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Dr. Albert D. Friesen, CHAIRMAN  
PRESIDENT AND CEO, MEDICURE INC.

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AND INFECTIOUS DISEASES,  
UNIVERSITY OF MANITOBA

David Filmon,  
PARTNER, AIKINS, MACAULAY & THORVALDSON, LLP

Peter de Visser, CA,  
FOUNDING PARTNER, DE VISSER GRAY  
CHARTERED ACCOUNTANTS

Dr. Geoffrey Grant,  
DIRECTOR, ARLINGTON TECHNOLOGY INCUBATOR

## AUDITOR

**KPMG LLP**  
One Lombard Place, Suite 2000  
Winnipeg, MB R3B 0X3

## TRANSFER AGENT

**CIBC Mellon Trust Company**  
600, 333 - 7th Avenue S.W.  
Calgary, AB T2P 2Z1

## CORPORATE COUNSEL

**Aikins, MacAulay & Thorvaldson LLP**  
30th Floor, 360 Main Street  
Winnipeg, MB R3C 4G1

## PATENT COUNSEL

**Ridout & Maybee LLP**  
1 Queen Street East, Suite 2400  
Toronto, ON M5C 3B1

**Merchant & Gould**  
3200 IDS Centre, 80 South Eighth Street,  
Minneapolis, MN 55402-2215

## TRADING SYMBOL

**TSX-V: KNE**

KANE BIOTECH / Biofilm Solutions

5-1250 Waverley Street  
Winnipeg, Manitoba  
R3T 6C6 Canada

Phone / 204.453.1301  
Fax / 204.453.1314  
Email / [info@kanebiotech.com](mailto:info@kanebiotech.com)  
Web / [kanebiotech.com](http://kanebiotech.com)

