



KANE BIOTECH INC.

ANNUAL REPORT

06

Turning novel discoveries into innovative  
health care solutions.

# Kane Biotech Inc.


is a research-based,  
growth oriented company  
with expertise in creating  
products that prevent and  
disperse bacterial biofilms.

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Biofilms develop when bacteria and other microorganisms form a protective environment 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 human health problems such as recurrent urinary tract infections, medical device related infections and tooth decay.



# CONTENTS

- 
- 2 Corporate profile
  - 4 President's message to shareholders
  - 6 Product pipeline
  - 8 Management's discussion and analysis
  - 19 Financial statements



**Kane Biotech Inc.** is dedicated to the research and development of products to prevent and disperse bacterial biofilms. The Company is developing products for the prevention and dispersal of biofilms based on molecular mechanisms of biofilm formation. Kane Biotech uses patented technologies for identifying compounds that inhibit or disrupt biofilms.

# CORPORATE PROFILE

Kane Biotech has evidence that this technology has potential to significantly improve the ability to prevent and remove biofilms in both medical and industrial applications.

Biofilms are estimated to be responsible for 80% of all human infections and cost industry, cities and hospitals in excess of \$500 billion each year.

Kane Biotech has a growing pipeline of products based on the Company's ability to screen for factors affecting biofilm formation and has resulted in the development of candidate products based on the demand for safe and effective anti-biofilm compounds.

## VISION

To develop innovative products that prevent infectious diseases and have a positive impact on human health.

## MISSION

We will contribute to the improvement of human health through our leadership in the research and development of innovative solutions that improve the standard of healthcare and contribute to the solution of problems that cost over \$500 billion each year in equipment damage, energy loss and medical expenses. These solutions will be innovative products to prevent and disperse biofilms.

## BUSINESS MODEL

Kane Biotech is a research and development company focused on the discovery and development of novel products to prevent and disperse bacterial biofilms. The objective of our business strategy is to create value for our shareholders by establishing partnerships for the optimal development and execution of our products.



- Internal discovery and development of several anti-microbial catheter coating products and dental care products
- Exclusive in-licensing of novel biofilm related targets

- Develop and test prototypes
- Conduct pre-clinical performance tests
- Examine durability, stability and biocompatibility
- Joint development agreements or partner assisted clinical trials

- Partnerships and licensing agreements are developed with leading health care companies to manufacture and commercialize products

## PRESIDENT'S MESSAGE



On April 18, 2007 we were very proud to announce an agreement granting worldwide rights for KBI-5898 to Harland Medical Systems for urinary, venous access and veterinary catheter use. KBI-5898 is the first of a number of patented and patent pending antimicrobial and antibiofilm technologies in our pipeline that we have targeted for commercialization.

2006 was a key turning point for Kane as we established the footprint for our future growth. Our recent success with KBI-5898 underscores the value of our growing pipeline of products that prevent and disperse biofilms in both human and industrial applications. We are pleased to be working with Harland Medical Systems, who will be integrating KBI-5898 with their surface coating to create value added medical devices. Kane will then receive royalties on the sales of products incorporating our technology. Harland is a great partner with a broad medical device customer base. Their business includes providing antimicrobial coating application equipment, process development, coating services and materials to medical device manufacturers. This unique business relationship affords Kane the opportunity to access Harland's established customer base and expertise.

**Our Company had a strong year in 2006.** We made solid progress on our research and development priorities, established ourselves as a leading biofilm company and set the stage for our first commercial license agreement in early 2007.

This agreement was also a clear stake in the ground signaling that the next phase for Kane Biotech had begun.

In 2003 and 2004 our focus was on discovering new technology and patenting our technologies. Following that, in 2005 and into 2006, we continued to discover new technologies and added a focus on developing prototypes and establishing evidence for them. During the last fiscal year, we moved from discovery to product development with our lead product, KBI-5898, and a pipeline of products building on our DispersinB technology, particularly KBI-4258.

As we look to 2007 and beyond, we will implement the next phase of our development – identifying industry partners and moving our products into the commercial stream. Therefore, we expect 2007 to be the most exciting and rewarding year in Company history.

What excites and motivates me and our entire team is the prospect of transforming Kane into a company that delivers on its promise to provide innovative products that prevent infectious disease and have a positive impact on human health. On behalf of our team at Kane Biotech, our board of directors, scientific advisors and employees, we look forward to continuing to meet the milestones we set forward and exceed shareholder expectations.

Sincerely,



**Gord Froehlich**  
PRESIDENT

# PRODUCT PIPELINE

Kane Biotech is a leader in research and development of technologies and products that prevent and disperse bacterial biofilms. The Company has a growing technology portfolio based on leading research and relationships with prominent academic institutions.

We are developing a strong pipeline of products that address human health problems such as hospital-acquired urinary tract and blood stream infections caused by medical devices.

Our two lead market areas are medical device coatings and oral care products.

PRODUCT/ TECHNOLOGY	INDICATION	PRODUCT	DISCOVERY	PRE-CLINICAL		PARTNER/CLINICAL
				IN VITRO	IN VIVO	
KBI-5898	Catheter associated urinary tract infection	Urinary catheter coating agent	[Progress bar]			
	Catheter related bloodstream infection	CV catheter coating agent	[Progress bar]			
	Veterinary uses	Coating agent	[Progress bar]			
KBI-4258	Catheter related bloodstream infection	CV catheter coating agent	[Progress bar]			
	Catheter associated urinary tract infection	Urinary catheter coating agent	[Progress bar]			
DISPERSINB	Various	Combinations	[Progress bar]			
CSP BASED	Denal plaque and cavities	Toothpaste and mouthwash additive	[Progress bar]			

# HIGHLIGHTS

## KBI-5898 LICENSING AGREEMENT

In April 2007, Kane announced a commercial license agreement with Harland Medical Systems granting Harland worldwide rights to Kane's KBI-5898 antimicrobial technology for use in coatings for urinary, vascular and veterinary catheters.

Kane has established considerable in vitro and in vivo evidence to illustrate the efficacy of KBI-5898 coated catheters at inhibiting the growth and colonization of numerous catheter associated microorganisms.

The agreement blends Harland's experience in automation system design, medical device manufacturing and surface modification applications with Kane's expertise in antimicrobial and antibiofilm agents. This provides Harland with a unique value-added solution for its customers as KBI-5898 offers broad spectrum protection against medical device related hospital infections such as urinary tract infections and bloodstream infections.

## DISPERSINB™ PROGRESS

During the previous year, Kane's DispersinB technology made considerable gains in terms of profile and scientific evidence.

The Company was pleased to see the academic and industrial community continue to recognize the value of the technology through its adoption in research studies.

In August of 2006, Kane identified KBI-4258 as its leading product incorporating the DispersinB technology. KBI-4258 is a product combining DispersinB, for biofilm control, with a broad spectrum antimicrobial. The Company conducted an in vivo study in September and in October announced the positive results of the study, which demonstrated that KBI-4258 coated central venous catheters (CVCs) performed better than both the market-leading coated catheters, and uncoated control catheters in preventing catheter colonization by the pathogen *Staphylococcus aureus* (*S. aureus*). More specifically, 29 of 30 (96.7%) catheter segments coated with KBI-4258 remained free of colonization by *S. aureus*, compared to 26 of 30 (86.7%) of the market leading coated catheters and only 1 of 30 (3.3%)

## PUBLICATIONS

2006 saw the publication of a number of discoveries made by the Kane research team, further cementing the Company's position as a leading biofilm researcher. First, a publication entitled "Antibiofilm Activity of GlmU Enzyme Inhibitors against Catheter-Associated Uropathogens", appeared in the scientific journal Antimicrobial Agents and Chemotherapy. Next, the Journal of Industrial Microbiology & Biotechnology published the Company's work entitled "A Microplate Spectrofluorometric Assay

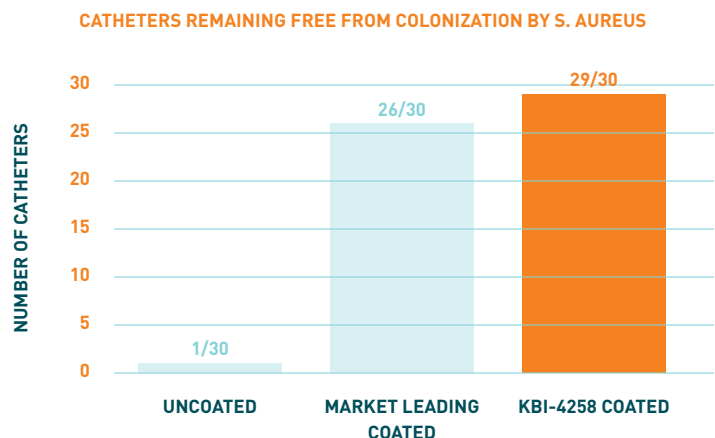
for Bacterial Biofilms". Following that, a publication entitled "Effect of ovotransferrin, protamine sulfate and EDTA combination on biofilm formation by catheter-associated bacteria" was published by the Journal of Applied Microbiology.

## FUND RAISING

In May 2006, Kane closed a \$1.47 million private placement. This allowed Kane to meet important milestones with KBI-5898 and KBI-4258 over the year and saw the Company realize its first commercial agreement.

of the uncoated catheters. Furthermore, the study showed that KBI-4258 coated CVCs were as good at reducing catheter colonization by *S. aureus* as the market leading coated CVC at its highest antimicrobial concentration level.

Kane continues to develop antimicrobial and antibiofilm products that leverage its novel DispersinB technology.



# KANE BIOTECH INC.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

The following management's discussion and analysis ("MD&A") should be read in conjunction with the audited financial statements for the year ended December 31, 2006, and related notes, which are prepared in accordance with Canadian generally accepted accounting principles taking into account material events up to April 24, 2007. All amounts are expressed in Canadian Dollars unless otherwise noted. Annual references are to the Company's fiscal years, which end on December 31. Additional information regarding the Company is available on SEDAR at [www.sedar.com](http://www.sedar.com) and on the Company's web site at [www.kanebiotech.com](http://www.kanebiotech.com).

### Overview

Kane Biotech Inc. ("Kane" or 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 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 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 April 2007, the Company announced that it had entered into a commercial license agreement with Harland Medical Systems. The agreement provides Harland with world-wide rights to Kane's KBI-5898 antimicrobial technology for use in coatings for urinary, venous access and veterinary catheters. Under the terms of the agreement, Harland will pay Kane a royalty on net sales of products which incorporate the proprietary agent. Financial terms of the agreement were not disclosed.

The next product in the Company's pipeline is KBI-4258. This technology is being developed for the prevention of infections caused by catheters. Approximately 20 million urethral catheters are sold in the U.S. annually and indwelling urinary catheters are used in approximately 15-25% of short term care patients and all patients in intensive care units. Additionally, in the U.S. alone, more than 150 million intravascular catheters are used and over 5 million central venous lines are inserted. This results in about 250,000 catheter related infections each year.

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

The Company has recently published research studies in the scientific journals *Antimicrobial Agents and Chemotherapy* and *Journal of Industrial Microbiology & Biotechnology*. Publication in peer-reviewed, reputed scientific journals is a positive external validation of the quality and caliber of the Company's research team.

# KANE BIOTECH INC.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

The Company has a number of Confidential Disclosure Agreements in place with multi-national companies in both the Medical Device and Oral Care Markets. Discussions that take place under these Confidential Disclosure Agreements, allow for confidential dialogue and direction on the best design of Kane's research activities. The Company views guidance from market leaders and potential partners as key to its development and as a positive external validation of the market potential for its products.

### 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's lead product for coating catheters is KBI-5898. A study comparing urinary catheters coated with KBI-5898 to those coated with silver-hydrogel and uncoated catheters 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.

KBI-5898 has been licensed to Harland Medical Systems under commercial license agreement. The agreement blends Harland's experience in automation system design, medical device manufacturing and surface modification applications with Kane's expertise in antimicrobial and antibiofilm agents. This combination provides Harland a unique value-added solution for its customers as KBI-5898 offers broad spectrum protection against medical device related hospital acquired infections such as urinary tract infections and blood stream infections.

Kane continues to develop its pipeline of patented anti-microbial, biofilm fighting technologies, including KBI-4258 its next agent targeted for commercialization. The Company is presently at an important stage in the candidate's development as it builds its scientific evidence and support for further development.

### 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'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 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 is presently in the process of conducting durability, stability and efficacy studies on various product formulations utilizing this technology, to enhance and maximize the product potential.

# KANE BIOTECH INC.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

### 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.

#### Intangible Assets

Costs incurred in obtaining patents are capitalized and amortized upon issuance on a straight-line basis over the remaining 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. On a regular basis, management reviews the valuation of intangible assets taking into consideration any events and circumstances which may impair their recoverable value including expected cash flows, the potential benefit the Company expects to derive from the costs incurred to date and ongoing development plans. During fiscal 2006, the Company engaged in a detailed review of its patent portfolio. As a result of this review, it was determined that a number of non-critical patents or patent applications could prudently be withdrawn from the applicable patent office. This resulted in a write-down of intellectual property in the amount of \$90,072 during the period.

#### Stock-based compensation

The Company has a stock option plan for its directors, management, consultants, and employees. Compensation expense is recorded for stock options issued to employees and non employees using the fair value method. The Company must calculate the fair value of stock options issued and amortize the fair value to stock-based compensation expense over the vesting period, and adjust the amortization for stock option forfeitures and cancellations. The Company uses the Black-Scholes model to calculate the fair value of stock options issued which requires that certain assumptions including the expected life of the option and expected volatility of the stock be estimated at the time the options are issued. The Company amortizes the fair value using the accelerated method over the vesting period of the options. The factors included in the Black-Scholes model are reasonably likely to change from period to period due to changes in the Company's stock price and external factors, as further stock options are issued and as adjustments are made to previous calculations for unvested stock option forfeitures and cancellations.

The stock-based compensation recorded by the Company is a critical accounting estimate because of the value of the compensation recorded, the volume of the Company's stock option activity, and the many assumptions that are required to be made to calculate the compensation expense.

# KANE BIOTECH INC.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

The Black-Scholes model is not the only permitted model to calculate the fair value of stock options. A different model, such as the binomial model, as well as any changes to the assumptions made may result in a different stock-based compensation expense calculation. The Company recorded stock-based compensation expense in fiscal 2006 of \$26,946 (2005 - \$147,857).

### Changes in Accounting Policies

There were no changes in Accounting Policies during the period.

### Selected Annual Financial Information

The following is selected financial information about the Company, for its 2006, 2005 and 2004 fiscal years:

	2006	2005	2004
Revenue	\$ 24,098	\$ 22,115	\$ 13,414
Research expenses	(415,820)	(430,950)	(275,483)
General and administrative expenses	(440,887)	(564,804)	(324,528)
Loss for the year	(955,759)	(1,009,650)	(602,562)
Loss per share	(0.06)	(0.07)	(0.05)
Total assets	1,517,608	1,152,053	526,372
Total liabilities	92,835	134,623	99,724
Deficit	(3,247,885)	(2,292,126)	(1,282,476)
Total capital stock and contributed surplus	4,672,658	3,309,556	1,709,124

### Quarterly Financial Information for 2006 and 2005

The selected financial information provided below is derived from our unaudited quarterly financial statements for each of the last eight quarters:

	Q4 2006	Q3 2006	Q2 2006	Q1 2006
Revenue	\$ 8,333	\$ 10,498	\$ 2,346	\$ 2,921
Loss for the period	(353,878)	(201,933)	(242,914)	(157,034)
Loss per share	(0.02)	(0.01)	(0.02)	(0.01)

	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	(0.01)	(0.02)	(0.02)	(0.02)

The Company's quarterly losses in 2006 relate primarily to the expansion of research programs and increasing general and administrative expenses such as professional fees, investor relations, and stock-based compensation. The increasing quarterly losses in fiscal 2005 are mainly due to the expansion of the Company's research programs. 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. The operations of the Company are not subject to any material seasonality or cyclicity factors.

# KANE BIOTECH INC.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

### Fourth Quarter

The increased loss in the fourth quarter of fiscal 2006 as compared to the third quarter of fiscal 2006 and the fourth quarter of fiscal 2005 is mainly driven by the write-down of several patents and the recognition of stock-based compensation.

### Results of Operations

#### Research

The Company is in the development stage and devotes a significant portion of its financial resources to research activities. 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 changes in research expenditures for the fiscal years ended December 31, 2006 and December 31, 2005 are reflected in the following table:

YEAR ENDED	2006	2005	INCREASE (DECREASE)
Research	\$ 415,820	\$ 430,950	(\$15,130)

The slight decrease in research expenditures in fiscal 2006 as compared to fiscal 2005 is due to a decrease in contract research and consumables. All other research expenditures have remained the same or increased slightly.

#### 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, 2006 and December 31, 2005 are reflected in the following table:

YEAR ENDED	2006	2005	INCREASE (DECREASE)
General and administrative	\$ 440,887	\$ 564,804	(\$123,917)

The overall decrease in costs during the fiscal year ended December 31, 2006 as compared to fiscal 2005 is primarily attributable to a decrease in stock-based compensation and a decrease in investor relations activities.

#### Interest Income

The change in interest income for the fiscal year ended December 31, 2006 and December 31, 2005 are reflected in the following table:

YEAR ENDED	2006	2005	INCREASE (DECREASE)
Interest income	\$ 24,098	\$ 22,115	\$ 1,983

Interest income in fiscal 2006 is higher than fiscal 2005 due to a higher average cash balance. The Company anticipates that investment income will continue to fluctuate in relation to cash and short term investment balances and interest yields.

# KANE BIOTECH INC.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

### Results

The loss for fiscal years ended December 31, 2006 and December 31, 2005 is reflected in the following table:

YEAR ENDED	2006	2005	INCREASE (DECREASE)
Loss	\$ 955,759	\$ 1,009,650	(\$53,891)
Loss per share	0.06	0.07	(0.01)

As discussed above, the loss resulted mainly from the expansion of the Company's research programs, general and administrative expenses, and the write-down of patents. 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, 2006, the Company had cash and cash equivalents totaling \$689,394 compared with \$381,994 at the previous year-end. On May 30, 2006, the Company strengthened its cash position by closing a private placement and raising gross proceeds of \$1,471,894 (before share issuance costs of \$159,604). A total of 2,676,171 common shares of Kane were issued at \$0.55 per share. Each unit was comprised of one common share and one-half of one common share purchase warrant. Each whole warrant entitles the holder to purchase one common share at a price of \$0.70 at any time within eighteen months of the closing date of the offering.

#### Cash used in operating activities

Cash used in operating activities totaled \$843,129 in fiscal 2006 compared to \$808,870 in fiscal 2005 as the Company's research programs were expanded in 2006.

#### Cash used in investing activities

Cash used in investing activities totaled \$185,627 in fiscal 2006 compared to \$300,145 in fiscal 2005. The decrease was primarily due to a decrease in the acquisition of property and equipment and a decrease in patent costs.

#### Cash from financing activities

Cash provided from financing activities in fiscal 2006 totaled \$1,336,156 from the issuance of 2,676,171 common shares. In the previous fiscal year, cash provided from financing activities totaled \$1,214,975 from the issuance of 3,000,000 common shares.

The total number of common shares issued and outstanding at December 31, 2006 and December 31, 2005 was 17,299,327 and 14,623,156 respectively. As at April 24, 2007, the Company had 17,299,327 common shares outstanding and 1,095,875 stock options outstanding.

# KANE BIOTECH INC.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

### 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	\$ 75,156	\$ 23,125	\$ 46,250	\$ 5,781	\$ -

### 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, 2006.

### 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. There has been no change in the Company's disclosure controls and procedures or in the Company's internal control over financial reporting that occurred during the most recently completed quarter that has materially affected, or is reasonably likely to materially affect, the Company's disclosure controls and procedures or internal control over financial reporting.

The President and Chief Financial Officer of the Company have evaluated the effectiveness of the Company's disclosure controls and procedures in place as at December 31, 2006. Based on this evaluation, it was determined that certain weaknesses existed in internal controls over financial reporting. In addition, the Company has not yet completed its review and evaluation of the design of internal control over financial reporting. The Company expects to complete its assessment in fiscal 2007. As is indicative of many small companies, the lack of segregation of duties and effective risk assessment were identified as areas where weaknesses existed. The existence of these weaknesses is to be compensated for by senior management monitoring which exists. The Company is taking steps to augment and improve the design of procedure and controls impacting these areas of weakness over internal control over financial reporting.

# KANE BIOTECH INC.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

### Related Party Transactions

During the year ended December 31, 2006, the Company paid a shareholder a total of \$157,449 (2005 - \$149,796) for consulting fees and \$34,267 (2005 - \$28,218) under a sublease rental agreement. The Company also paid \$3,000 (2005 - \$3,000) for rental of equipment from a company controlled by an officer.

During the year, the Company paid consulting fees of \$96,600 (2005 - \$72,016) to an officer of the Company. The Company also paid \$10,370 (2005 - \$18,303) in consulting fees to a shareholder of the Company.

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. In order to advance these programs, Kane expects to continue incurring operating losses. Based on current projections and strategic plans, it is expected that total expenses will increase in fiscal 2007 compared to fiscal 2006. This increase in expenditures is expected to result from the continued advancement of our present research activities.

The Company has 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 in fiscal 2007 to fund operations over the long term. The Company has a commercial license agreement with Harland Medical Systems and is in discussions with various other potential partners to pursue alliances with regards to its anti-microbial products, 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.

# KANE BIOTECH INC.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

### 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.

## MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING

The management of Kane Biotech is responsible for the preparation and fair presentation of the accompanying financial statements and Management's Discussion and Analysis (MD&A). The financial statements were prepared in accordance with Canadian generally accepted accounting principles, applied on a consistent basis. Financial information contained in the annual report is consistent with that shown in the financial statements.

The financial statements and information contained in the MD&A necessarily include amounts based on best estimates and careful judgments by management of the expected effects of current events and transactions with the appropriate consideration to materiality. The MD&A also includes information regarding the impact of current transactions and events, sources of liquidity and capital resources, operating trends, risks and uncertainties. Actual results may differ materially from our present assessment of this information because future events and circumstances may not occur as expected.

In meeting our responsibility for the timeliness of financial information, management has established systems of internal control to properly authorize and record transactions, produce reliable accounting records for the preparation of financial information, and to provide reasonable assurance that assets are safeguarded from loss or unauthorized use.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal control. The Board of Directors carries out this responsibility principally through its Audit Committee. The Audit Committee meets regularly with management of the Company and with the independent auditor to discuss internal controls, audit matters, financial reporting issues and reports to the Board of Directors thereon. The Audit Committee also reviews the Company's financial statements and MD&A before they are approved by the Board of Directors for inclusion in the annual report.

The Company's independent auditors, KMPG LLP, have been appointed by the shareholders to audit the financial statements and express an opinion thereon. The independent auditor has full and free access to the Audit Committee, and meets with the Committee at least annually to discuss audit and related matters.



**April Manness**  
CHIEF FINANCIAL OFFICER



**Gord Froehlich**  
PRESIDENT

MARCH 9, 2007

# AUDITORS' REPORT

## TO THE SHAREHOLDERS OF KANE BIOTECH INC.

We have audited the balance sheets of Kane Biotech Inc. as at December 31, 2006 and December 31, 2005 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, 2006 and December 31, 2005 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 9, 2007

# KANE BIOTECH INC.

## BALANCE SHEETS

DECEMBER 31, 2006 AND 2005

	2006	2005
<b>Assets</b>		
Current assets:		
Cash	\$ 689,394	\$ 381,994
Accounts and goods and services tax receivable	57,256	59,183
Prepaid expenses	9,567	9,163
	756,217	450,340
Property and equipment (note 3)	132,548	145,861
Patents, net of accumulated amortization of \$3,843 (2005 - \$1,347)	340,693	276,437
Technology licenses (note 4)	288,150	279,415
	\$ 1,517,608	\$ 1,152,053
<b>Liabilities and Shareholders' Equity</b>		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 92,835	\$ 134,623
Shareholders' equity:		
Capital stock (note 5)	4,414,211	3,101,921
Contributed surplus	258,447	207,635
Deficit	(3,247,885)	(2,292,126)
	1,424,773	1,017,430
Nature of operations (note 1)		
Commitments (note 7)		
	\$ 1,517,608	\$ 1,152,053

See accompanying notes to financial statements.

On behalf of the Board:



Albert Friesen  
DIRECTOR



Peter de Visser  
DIRECTOR

# KANE BIOTECH INC.

## STATEMENTS OF OPERATIONS AND DEFICIT

YEARS ENDED DECEMBER 31, 2006 AND 2005

	2006	2005
Revenue:		
Interest	\$ 24,098	\$ 22,115
Expenses:		
Amortization	35,877	29,055
Write-down of patents	90,072	10,334
General and administration	440,887	564,804
Research	415,820	430,950
	982,656	1,035,143
Other:		
Foreign exchange gain	2,799	3,378
Loss for the year	(955,759)	(1,009,650)
Deficit, beginning of year	(2,292,126)	(1,282,476)
Deficit, end of year	\$ (3,247,885)	\$ (2,292,126)
Basic and diluted loss per share	\$ (0.06)	\$ (0.07)

See accompanying notes to financial statements.

# KANE BIOTECH INC.

## STATEMENTS OF CASH FLOWS

YEARS ENDED DECEMBER 31, 2006 AND 2005

	2006	2005
Cash provided by (used in):		
Operating activities:		
Loss for the year	\$ (955,759)	\$ (1,009,650)
Adjustments for:		
Amortization of property and equipment	33,381	32,229
Amortization of patents	2,496	911
Write-down of patents	90,072	10,334
Loss on disposal of property and equipment	-	19
Non-cash compensation recognized from stock options	26,946	147,857
Change in the following:		
Accounts and goods and services tax receivable	1,927	(22,106)
Prepaid expenses	(404)	(3,363)
Accounts payable and accrued liabilities	(41,788)	34,899
	(843,129)	(808,870)
Financing activities:		
Issuance of common shares, net of share issue costs	1,312,290	1,214,975
Non-cash portion of share issue costs arising from issue of compensation warrants	23,866	-
	1,336,156	1,214,975
Investing activities:		
Purchase of property and equipment	(20,068)	(134,524)
Proceeds on disposal of property and equipment	-	15,000
Patent costs	(156,824)	(168,806)
Addition to technology licenses	(8,735)	(11,815)
	(185,627)	(300,145)
Increase in cash	307,400	105,960
Cash, beginning of year	381,994	276,034
Cash, end of year	\$ 689,394	\$ 381,994
Supplementary information:		
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.

# KANE BIOTECH INC.

## NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2006 AND 2005

### 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, 2006, the company has expended approximately \$1,337,738, 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 2007.

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

# KANE BIOTECH INC.

## NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2006 AND 2005

### (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.

The cost of the technology licenses will be amortized over a three year period commencing in the period in which sales of the licensed product is first earned.

### (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 further 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.

# KANE BIOTECH INC.

## NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2006 AND 2005

### (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.

# KANE BIOTECH INC.

## NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2006 AND 2005

### (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:

2006	COST	ACCUMULATED AMORTIZATION	NET BOOK VALUE
Computer equipment	\$ 6,267	\$ 3,265	\$ 3,002
Scientific equipment	127,171	51,638	75,533
Office equipment	3,999	1,861	2,138
Leasehold improvements	82,789	30,914	51,875
	\$ 220,226	\$ 87,678	\$ 132,548

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

# KANE BIOTECH INC.

## NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2006 AND 2005

### 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. 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. As further consideration for 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 (US\$10,000). 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. During fiscal 2006, the company achieved one of the milestones under the license agreement with UMDNJ and, as a result, paid an additional fee of \$8,735 (US \$7,500).

	2006	2005
UTIF license	\$ 267,600	\$ 267,600
UMDNJ license	20,550	11,815
	\$ 288,150	\$ 279,415

# KANE BIOTECH INC.

## NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2006 AND 2005

### 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, 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, December 31, 2004	11,210,937	1,646,405
Private placement of shares for cash, net of share issue costs of \$10,191 <sup>(1)</sup>	3,000,000	1,189,809
Shares issued to UTIF on January 27, 2005 <sup>(2)</sup>	330,000	237,600
Exercise of stock options	82,219	28,107
Balance, December 31, 2005	14,623,156	3,101,921
Private placement of shares for cash, net of share issue costs of \$159,604 <sup>(3)</sup>	2,676,171	1,312,290
Balance, December 31, 2006	17,299,327	\$ 4,414,211

(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.

# KANE BIOTECH INC.

## NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2006 AND 2005

(3) On May 31, 2006, the company closed a private placement offering (the Offering) of 2,676,171 units at a price of \$0.55 per share, for aggregate gross proceeds to the company of \$1,471,894. Each unit is comprised of one common share and one half of one share purchase warrant. Each whole warrant entitles the holder to purchase one common share at a price of \$0.70 at any time within eighteen months of the closing date of the Offering. The warrants will expire on November 30, 2007.

Certain individuals and companies assisted the company by introducing potential subscribers for the offering and received a finder's fee of eight percent of the total subscription proceeds received from subscribers introduced to the company by each particular individual and company. In addition, these individuals and companies were issued 187,333 compensation warrants, equivalent to seven percent of the units subscribed for by subscribers introduced to the company by each particular individual and company. Each compensation warrant entitles the holder to purchase one common share at a price of \$0.55 per share within one year of the closing date of the Offering. The warrants will expire on May 31, 2007.

### (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.

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

	2006		2005	
	SHARES	WEIGHTED AVERAGE EXERCISE PRICE	SHARES	WEIGHTED AVERAGE EXERCISE PRICE
Balance, beginning of year	1,023,875	\$ 0.44	811,094	\$ 0.38
Granted	127,000	0.35	295,000	0.57
Exercised	-	-	(82,219)	0.31
Cancelled or expired	(50,000)	0.80	-	-
Balance, end of year	1,100,875	\$ 0.41	1,023,875	\$ 0.44
Options exercisable, end of year	1,100,875	\$ 0.41	1,011,375	\$ 0.43
Weighted average fair value per unit of options granted during the year		\$ 0.21		\$ 0.30

During fiscal 2006, 127,000 stock options were granted to certain employees, management company employees, and officers with a strike price of \$0.35 per common share. In addition, 50,000 stock options with a strike price of \$0.80 per common share were cancelled.

# KANE BIOTECH INC.

## NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2006 AND 2005

Options outstanding at December 31, 2006 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 - 0.55	1,100,875	2.73	\$ 0.41	1,100,875

At December 31, 2006, no stock options remain unvested (2005 - 12,500).

The compensation expense related to stock options granted under the stock option plan during fiscal 2006 to employees, management company employees, consultants and directors aggregated \$26,946 (2005 - \$147,857). 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:

	2006	2005
Expected option life	5 years	5 years
Risk-free interest rate	3.95%	3.25%
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) Warrants:

	2006		2005	
	SHARES	WEIGHTED AVERAGE EXERCISE PRICE	SHARES	WEIGHTED AVERAGE EXERCISE PRICE
Balance, beginning of year	-	\$ -	-	\$ -
Granted, pursuant to private placement (note 5[b])	1,338,085	0.70	-	-
Granted	187,333	0.55	-	-
Balance, end of year	1,525,418	\$ 0.68	-	\$ -
Weighted average remaining contractual life (years)		0.85		-

The company granted 187,333 compensation warrants relating to the private placement offering of May 30, 2006, entitling the holders to purchase one common share at a price of \$0.55 for a period of one year commencing from the closing of the Offering. Share issue costs of \$23,866 were recorded to reflect the value of these warrants.

# KANE BIOTECH INC.

## NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2006 AND 2005

### (e) Contributed surplus:

Changes in contributed surplus are as follows:

Balance, December 31, 2004	\$	62,719
Options granted		147,857
Options exercised		(2,941)
Balance, December 31, 2005		207,635
Warrants granted		23,866
Options granted		26,946
Balance, December 31, 2006	\$	258,447

### (f) Escrowed shares

The company's issued share capital includes 3,825,000 shares (2005 - 5,669,450 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.

### (g) Per share amounts:

The weighted average number of common shares outstanding for the years ended December 31, 2006 and 2005 were 16,199,531 and 14,408,064, 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:

	2006	2005
Future tax assets:		
Non-capital loss and scientific research and development expenditure carry forwards	\$ 1,085,800	\$ 861,100
Share issue costs	61,700	43,000
	1,147,500	904,100
Future tax liabilities:		
Property and equipment	(59,700)	(37,700)
	1,087,800	866,400
Less valuation allowance	(1,087,800)	(866,400)
	\$ -	\$ -

# KANE BIOTECH INC.

## NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2006 AND 2005

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

	2006	2005
Canadian federal and provincial income taxes at 36.62% (2005 - 37.12%)	\$ (350,000)	\$ (374,580)
Change in rates	96,200	6,259
Add permanent differences	(1,200)	36,921
Difference between current and future tax rates	33,600	-
	(221,400)	(331,400)
Less valuation allowance	221,400	331,400
	\$ -	\$ -

At December 31, 2006, the company has the following available for application in future years:

- unutilized Canadian non-capital loss carried forward balances for income tax purposes of \$2,687,000 (2005 - \$2,048,300), with expiry by 2026.
- unutilized scientific research and development expenditures of \$602,000 (2005 - \$271,400), with no expiry.
- scientific research and development investment tax credits of \$260,000 (2005 - \$15,500) which can be applied against income taxes otherwise payable, with expiry by 2014.

## 7. Commitments:

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

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., a company controlled by a director. 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 \$99,750 per year for consulting to an officer, payable on a monthly basis. The agreement is renewable yearly and expires on November 30, 2007.

# KANE BIOTECH INC.

## NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2006 AND 2005

### 8. Related party transactions:

During the year ended December 31, 2006, the company paid Genesys Venture Inc., a shareholder, \$157,449 (2005 - \$149,796) for consulting fees and \$34,267 (2005 - \$28,218) under a sublease rental agreement. The company also paid \$3,000 (2005 - \$3,000) for rental of equipment to and received nil (2005 - \$15,000) for the sale of leasehold improvements from a company controlled by an officer.

During the year, the company paid consulting fees of \$96,600 (2005 - \$72,016) to an officer of the company. The company also paid \$10,370 (2005 - \$18,303) in consulting fees to a shareholder of the company.

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, 2006, the company received \$32,417 (2005 - \$52,584) 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. Comparative figures:

Certain comparative figures have been reclassified to conform with the financial statement presentation adopted for the current year.

## Executive Management

**Gord Froehlich**  
PRESIDENT

**April Manness, CGA**  
CHIEF FINANCIAL OFFICER

**Dr. Tony Romeo**  
CHIEF SCIENTIFIC ADVISOR

**Dr. Sri Madhyastha**  
VICE PRESIDENT, RESEARCH

**Marcus Enns**  
VICE PRESIDENT,  
CORPORATE AFFAIRS

## Board of Directors

**Dr. Albert D. Friesen**  
CHAIRMAN  
PRESIDENT & CEO,  
MEDICURE INC.

**Dr. George Zhanel**  
PROFESSOR, MEDICAL  
MICROBIOLOGY AND  
INFECTIOUS DISEASES,  
UNIVERSITY OF MANITOBA

**Peter de Visser, CA**  
FOUNDING PARTNER,  
DEVISSER GRAY  
CHARTERED ACCOUNTANTS

**Dr. Geoffrey Grant**  
INDUSTRY CONSULTANT

## Auditor

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