



# AR03

ANNUAL REPORT 2003

**PROCYON**  
BIOPHARMA | INC

Making a stand in the fight against cancer and HIV/AIDS

**Procyon Biopharma** is a publicly-traded Canadian biotechnology company actively engaged in the discovery and development of innovative therapeutics and diagnostics in the fields of oncology and infectious diseases. Procyon's products and technologies are steadily advancing from research through development, preclinical and clinical studies. As a result, today Procyon has two therapeutic drugs in Phase II, three therapeutic candidates lined up for an IND and two diagnostic products in clinical studies as medical devices. Procyon shares are listed on the Toronto Stock Exchange (TSX) under the ticker symbol PBP.

**Procyon's** mission is to identify leading-edge technologies, bring them quickly to advanced human clinical trials and license them to pharmaceutical companies for further development and commercialization. Procyon receives from licensee partners upfront and milestone payments, as well as royalty revenues upon commercialization. To date, Procyon has been successful in out-licensing two of its seven promising products, proving the viability and potential of its business model. Fibrostat®, a topical cream for hypertrophic scarring currently undergoing a Phase IIb clinical trial, is licensed to Biovail Corporation in North America, and IMI International Medical Innovations Inc. owns the worldwide rights to Colopath®/ColorectAlert™, a diagnostic test strip for colorectal cancer.

THERAPEUTIC	PRECLINICAL	PHASE I	PHASE II A B	INDICATION
PCK3145				Metastatic hormone refractory prostate cancer
Fibrostat®				Hypertrophic scars
PL-100				HIV/AIDS
ANsA				Various cancers
PL-2500				HIV/AIDS
DIAGNOSTIC	PROOF-of-CONCEPT	PMA or 510(k)		INDICATION
PSP <sup>94</sup> Serum-based Immunoassay				Prostate cancer
Colopath®/ColorectAlert™				Colorectal cancer

## Highlights

### NEAR-TERM VALUE DRIVERS

#### PCK3145 THERAPEUTIC PEPTIDE

- Release of positive interim results on the Phase IIa clinical study in the United Kingdom
- Completion of patient enrolment for the clinical study
- Publication of PSP<sup>®</sup> efficacy data in *Cancer Research*
- Peer-recognition through presentations at CapCure and at the American Association for Cancer Research (AACR)

#### FIBROSTAT<sup>®</sup>

- US FDA clearance and initiation of the Phase IIb trial in 12 centres across Canada and the US

#### PL-100 PROTEASE INHIBITOR

- Completion of study reporting favorable resistance profile for PL-100 against most of the currently-marketed protease inhibitors
- Issuance of six US patents for the anti-HIV protease inhibitors
- Presentation of Procyon's novel anti-HIV protease inhibitor at the XII<sup>th</sup> International HIV Drug Resistance Workshop in Mexico and at the Protease Targets & Drug Discovery Symposium in Philadelphia

### OTHER PROMISING EARLY/MID-STAGE CANDIDATES

#### AN<sub>s</sub>A PLATFORM

- Presentation of research findings on the induction of angiogenesis by nucleosomes at the AACR meeting in Washington
- Completion of independent scientific external due diligence, recommending the continuation of the program with further preclinical research on specificity and reactivity with tumors

#### PL-2500 INTEGRASE INHIBITOR

- Initiation of lead optimization studies
- Issuance of two US patents for the HIV anti-integrase program

#### PSP<sup>®</sup> SERUM-BASED IMMUNOASSAY

- Presentation of research findings on PSP<sup>®</sup> serum measurements in the clinical management of prostate cancer at the AACR meeting
- Completion of three validated assays
- Ongoing clinical proof-of-concept studies

#### COLOPATH<sup>®</sup>/COLORECTALERT<sup>™</sup>

- Completion by licensee partner of three studies totalling 1,787 subjects and presentation of positive results at the AACR meeting

### CORPORATE

- Initiation of growth strategy with the acquisition of Pharmacor and closing of a concurrent financing of \$3,250,000

### OBJECTIVES/MILESTONES

#### NEAR-TERM VALUE DRIVERS

- Completion of the PCK3145 Phase IIa trial and publication of final results during the first half
- Elucidation and publication of PCK3145's mode of action
- Designing of Phase IIb study for PCK3145 and subsequent IND filing by year-end
- Completion of Fibrostat<sup>®</sup> Phase IIb North American trial
- Filing of an IND for PL-100

#### PARTNERING DISCUSSIONS WITH PHARMACEUTICAL COMPANIES FOR THE FOLLOWING PRODUCTS:

- PCK3145 – Worldwide rights
- PL-100 – Worldwide rights
- Fibrostat<sup>®</sup> – European and Japanese rights

#### OTHER PROMISING EARLY/MID-STAGE CANDIDATES

- Completion of AN<sub>s</sub>A preclinical research program
- Optimization of lead compound PL-2500
- Initiation of low-risk population Colopath<sup>®</sup>/ColoRectAlert<sup>™</sup> study
- Completion of PSP<sup>®</sup> immunoassay trials and commencement of regulatory filings



## Message to shareholders

Once again, it gives me great pleasure to present this Annual Report, highlighting the Company's achievements and activities during Fiscal 2003. The year was marked by significant milestones in terms of clinical progress and corporate growth.

Early in the spring we completed the acquisition of Pharmacor, a very promising biotech company committed to the development of HIV/AIDS therapeutics. This important milestone in our growth strategy was followed by the initiation of the Phase IIb clinical trial for Fibrostat® in Canada and the US and later by the release of interim results with the Phase IIa trial for PCK3145, our therapeutic peptide for metastatic hormone-refractory prostate cancer.

As for any biotech of our size, prioritizing often becomes crucial. In 2003, we decided to devote most of our efforts to the development of three promising programs that we now refer to as Procyon's near-term value drivers.

Hence, PCK3145, our treatment for prostate cancer currently undergoing a Phase IIa trial; Fibrostat®, our topical cream for hypertrophic scars licensed out to Biovail Corporation for North America; and PL-100, a very unique HIV-protease inhibitor, have enjoyed extensive progress, as we devoted most of our efforts to their development. We feel these products have the potential to generate upfront and milestone revenues in the near term.



### PCK3145 THERAPEUTIC PEPTIDE – RESULTS BEYOND EXPECTATIONS

Without a doubt, PCK3145 was this year's revelation with the release of the interim results of the Phase IIa trial that was initiated in late-2002 in Manchester, UK. The encouraging results clearly suggest that PCK3145 has the potential to significantly reduce tumor metastasis in hormone-refractory prostate cancer patients without safety concerns or adverse effects. The most dramatic and unexpected results were shown in the levels of MMP-9 – Matrix Metalloproteinase-9 – an enzyme involved in angiogenesis, tumor invasion and metastasis. All five patients who had high plasma MMP-9 levels before treatment had reductions ranging from 34% to 90% after two cycles of treatment. In the remaining six patients who had normal levels of MMP-9 prior to treatment, they remained low.

New preclinical proof-of-concept studies conducted by Dr. Shafaat Rabbani of the McGill University Health Centre show that treatment of rat prostate cancer cells Mat Ly Lu with the drug resulted in a significant dose-dependent decrease in tumor volume, while bone histomorphometry showed that treatment with the drug at 100 ug/kg/day resulted in a marked decrease in tumor/bone volume ratio.

Since the announcement of these results, we have received a great deal of attention from potential pharmaceutical partners, validating the drug's value and potential. By year-end, we completed enrolment and final results are expected during the first half of 2004.

## FIBROSTAT® - PHASE IIb TRIAL UNDERWAY WITH A TIGHT PROTOCOL

In June, we initiated a North American clinical Phase IIb trial for Fibrostat® after receiving clearance from the US Food and Drug Administration and subsequently from Health Canada's Therapeutic Products Directorate. The enrolment of the 200 patients for the placebo-controlled, double-blind, randomized study began thereafter in 12 centers across Canada and the United States.

The Phase IIb trial is being conducted in collaboration with Biovail Corporation, our licensee partner for North America. Discussions with several potential partners for Europe and Japan are ongoing and the Company expects to out-license the product in these markets once data from the study is available.

## PL-100 PROTEASE INHIBITOR - UNPARALLELED RESISTANCE PROFILE

The last of Procyon's near-term value drivers is PL-100, a protease inhibitor for the treatment of drug-resistant HIV/AIDS. Even though this product is still undergoing preclinical studies, we have high hopes that it will be partnered in 2004. HIV/AIDS, unlike cancer, does not have a validated animal model for efficacy and developmental drugs usually behave in the same way in clinical settings as they do *in vitro*.

As resistance to currently-marketed drugs, and especially to protease inhibitors, is one of the main issues in the treatment of HIV/AIDS, the development of new drugs addressing resistance is an urgent need. In November, we reported the results of a resistance profile study conducted independently. The results indicated that Procyon's PL-100 has the potential for good activity against drug-resistant viruses in patients already under treatment as well as in newly-infected patients.

The study showed that the 14 viral strains tested were generally more susceptible to our proprietary drug, PL-100, than to the currently-marketed protease inhibitors, suggesting that PL-100 has a favorable and potentially distinct resistance profile. We have invested a lot in securing the intellectual property for this technology and we remain on track to file an Investigational New Drug (IND) dossier by September 2004 and to begin human clinical trials thereafter.

## OTHER PROMISING EARLY/MID-STAGE CANDIDATES

Assuring a constant flow of products in our pipeline is a hallmark at Procyon. We believe that our product portfolio is well-balanced, with four other products in development, namely Anti-Nucleosome Antibodies (ANsA), PL-2500 Integrase inhibitor, PSP<sup>94</sup> Serum-based immunoassay and Colopath®/ColorectAlert™. Although most of our efforts this year were devoted to our near-term value drivers, constant progress was assured with these other candidates. An overview of their development is provided in the next section of this report.

## CORPORATE GROWTH THROUGH ACQUISITION

In April 2003, we successfully completed the acquisition of Pharmacor, a Québec-based biopharmaceutical company committed to the discovery and development of innovative therapeutic agents for the treatment of HIV/AIDS, in exchange for seven million Procyon common shares. The Company also closed a concurrent \$3.25 million financing with the three main institutional investors in Pharmacor, namely Investissement Desjardins, Société Innovatech du Grand Montréal and the Fonds régional de solidarité FTQ Laval.

This acquisition is a first step in establishing Procyon as a leading biotechnology company aimed at drug development from discovery to human clinical trials. As four of our five products were already in the clinic this year, Pharmacor adds two new platforms of preclinical products and potential research compounds. Moreover, multiple synergies arise from this acquisition, both on the financial and scientific fronts. Not only does Procyon's clinical development team complement Pharmacor's basic research, but the combination of the two companies allows us to accelerate our development programs in a cost-effective manner.

In conclusion, I wish to welcome Mr. Jose Larrea, Vice-President, Life Sciences, Desjardins Venture Capital, who now sits on our Board of Directors. I would also like to thank all of our employees, who made the integration of Pharmacor seamless while accomplishing their ongoing responsibilities. I am very proud of the team that we have managed to put together and feel secure that we will be up to the challenge of delivering on the anticipated milestones for 2004.

Finally, I wish to thank all of our distinguished Directors, research collaborators and advisors, as well as all existing and new shareholders, for their support and confidence.

Signed: Hans J. Mäder

Hans J. Mäder  
Chairman, President and Chief Executive Officer

## PCK3145 Therapeutic peptide



INDICATION	Metastatic hormone-refractory prostate cancer
DEVELOPMENT STATUS	Clinical Phase IIa in Manchester, UK
PATENTS	World pending
2002 US PATIENT POPULATION*	Prevalence: 1,600,000 Incidence: 230,000 Deaths: 29,000
POTENTIAL WORLDWIDE REVENUES TO PARTNER	CAS\$ 1.6 billion annually <small>Procyon to receive a royalty on this figure</small>
PARTNER	Discussions underway

\*National Cancer Institute, SEER Database, 2003

### MODE-OF-ACTION

PCK3145 is a synthetic 15-mer peptide that is derived from the natural sequence of amino acids of the prostate secretory protein (PSP<sup>94</sup>). PSP<sup>94</sup> is one of three predominant proteins found in human seminal fluid along with prostate specific antigen (PSA) and prostatic acid phosphatase (PAP). Several studies have been conducted to evaluate the activity of PCK3145 as a tumor suppressive agent of prostatic adenocarcinoma. Interim results from the Phase IIa trial demonstrate that PCK3145 reduces levels of Matrix Metalloproteinase-9 (MMP-9), a Gelatinase B enzyme involved in angiogenesis, tumor invasion and metastasis, suggesting a potential role for PCK3145 in the inhibition and prevention of the metastatic process.

### CLINICAL PROGRESS

In late September, Procyon announced positive interim results from the Phase IIa clinical study being conducted at the Paterson Institute for Cancer Research, Christie CRC Research Centre, Manchester, UK. Procyon's multiple ascending dose open-label evaluation study includes 4 cohorts (5, 20, 40 and 80 mg/m<sup>2</sup>) of 4 patients for a total of 16 patients. The primary objective of this study is to evaluate the safety and the tolerability of PCK3145 administered intravenously at these therapeutic doses. The secondary objectives are to determine the pharmacokinetic profile of PCK3145 and to document any efficacy data, tumor responses using CT scans/MRI and PSA and other tumor markers.

The interim results from the twelve patients of the first three cohorts show no drug-related adverse effects and PSA reduction in 42% of the patients.

The most dramatic results presented last September and confirmed with new data, show a reduction in the levels of MMP-9 – Matrix Metalloproteinase-9 – a Gelatinase B enzyme involved in extracellular matrix degradation and tumor invasion (metastasis). All five patients who had plasma MMP-9 levels over 100 ug/L before treatment had reductions ranging from 34% to 90% after two cycles of treatment. In the remaining six patients who had low levels of MMP-9 prior to treatment (22 to 58 ug/L), the levels remained low and increased in only two cases, when cancer relapse was deemed to have occurred.

These clinical results clearly suggest the potential role of PCK3145 in the intervention of the metastatic process and were further validated with parallel animal studies showing that PCK3145 significantly reduced skeletal metastasis as well as hypercalcaemia in an experimental rat prostate cancer model. The latter preclinical work was conducted by Dr. Shafaat Rabbani of the McGill University Health Centre.

Procyon successfully completed the enrolment stage of its Phase IIa study in December 2003 and the Company expects to complete the second treatment cycle in all patients during the first quarter of 2004. It will then proceed with data analyses, followed by disclosure of the final clinical study report.



It is estimated that at least...

1 in 6

men developed prostate cancer in 2003\*

\*National Cancer Institute, SEER Database, 2003

## Fibrostat®



INDICATION	Hypertrophic scarring
DEVELOPMENT STATUS	Clinical Phase IIb in Canada and the US
PATENTS	Worldwide granted
WORLDWIDE PATIENT POPULATION*	39-68% following surgery/wounding 33-91% following thermal injury <small>Incidence is higher in darker-skinned and asian populations</small>
POTENTIAL WORLDWIDE REVENUES TO PARTNER	CA\$ 600 million annually <small>Procyon to receive a royalty on this figure</small>
PARTNER	Biovail Corporation for North America Discussions underway for Europe and Japan

\*CDC National Center for Health Statistics; Peled, Z.M. et al., 2000

### MODE-OF-ACTION

Fibrostat® is the only pharmaceutical cream designed to reduce hypertrophic scarring following dermal insult (surgery, trauma, burns, etc.). There are currently no commercialized topical preparations with an active pharmaceutical ingredient that prevents and/or treats hypertrophic scars and for which the mechanism of action is known. The active ingredient in Fibrostat®, 1,4 diaminobutane dihydrochloride, inhibits the activity of the enzyme tissue transglutaminase which is greatly increased in scar formation resulting in collagen cross-links. Procyon's Fibrostat® thus offers a unique and exciting approach with the regulation of collagen production.

### CLINICAL PROGRESS

In June 2003, the Company initiated the North American clinical phase IIb trial for Fibrostat®. The placebo-controlled, double-blind, randomized study immediately started the enrollment of 200 patients in 12 centers with extensive expertise in wound healing across Canada and the United States. The study is being conducted in collaboration with Biovail Corporation and both partners expect to release the final results during the second half of 2004.

In light of the available clinical data from the Canadian Phase IIa trial and the results observed in more than 200 patients treated under Health Canada's Special Access Programme, Procyon did not encounter any problems in receiving clearance from the US Food and Drug Administration (FDA) and subsequently from Health Canada's Therapeutic Products Directorate (TPD). The study design includes a four-week run-in period with the vehicle cream, followed by an eight-week treatment period. This design is intended to minimize the placebo effect that is often observed in vehicle cream-controlled trials due to occlusion and hydration.

Discussions with several potential partners for Europe and Japan are ongoing and the Company expects to license out the product in these markets once data from the Phase IIb study is available.



It is estimated that at least...  
**9,000,000**  
individuals developed a hypertrophic scar in 2003\*

## PL-100 Protease inhibitor



INDICATION	HIV/AIDS
DEVELOPMENT STATUS	Late-stage preclinical
PATENTS	US granted and World pending
2002 US PATIENT POPULATION*	Prevalence: 980,000 Incidence: 45,000 Deaths: 15,000
WORLDWIDE MARKET	CA\$ 3 billion
POTENTIAL WORLDWIDE REVENUES TO PARTNER	CA\$ 870 million annually <small>Procyon to receive a royalty on this figure</small>
PARTNER	Discussions underway

\*WHO, AIDS Epidemic Update, 2003

### MODE-OF-ACTION

Procyon's PL-100 is a protease inhibitor derived from the PL-1946 compound that demonstrates a unique resistance profile on drug- and multi-drug resistant strains of the HIV virus. Procyon's lead compound is promising for the development of new potent protease inhibitors based on the use of simple, original molecular scaffolds on which chemical groups are attached in a few easy steps to generate powerful protease inhibitors. Therefore, Procyon's competitive advantage is both medical in targeting the unmet medical need of viral resistance and economic in terms of cost-of-goods.

### CLINICAL PROGRESS

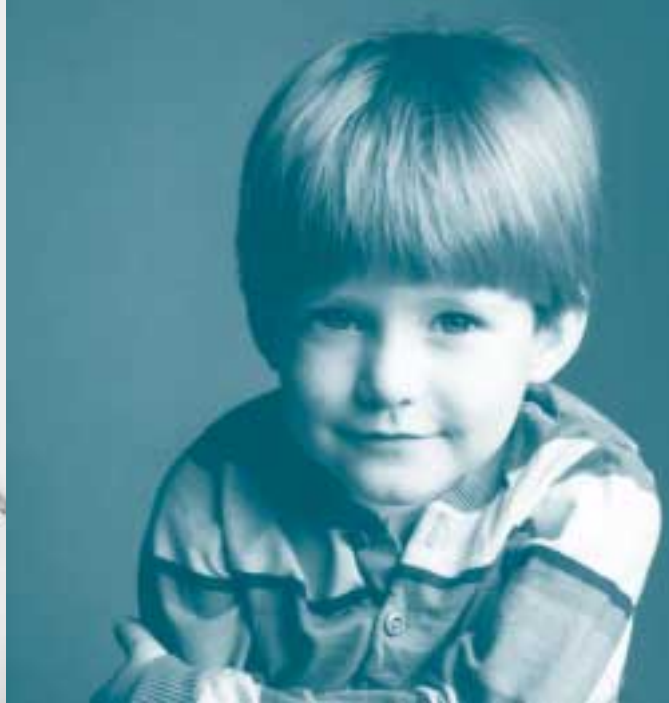
PL-100 preclinical studies, including pharmacokinetic, genotoxicity and other safety studies, are currently being conducted at Procyon. Chemistry and manufacturing studies are also being conducted in parallel to ensure availability of drug product for clinical testing. Preliminary results show PL-100 to be orally bioavailable with an acceptable half-life. The molecule has also shown to be *ritonavir-boostable*, as is the case with most of the currently-marketed protease inhibitors.

In November 2003, Procyon successfully completed a resistance profile study. The objective of the study was to gather information about the resistance profile of PL-100 using 14 clinical virus isolates, each with a different set of mutations. Strain selection was based on primary mutation diversity and cross-resistance profile and included mutated strains that are slightly, moderately or highly-resistant to most of the protease inhibitor products currently on the market. The selected viral strains were challenged with Procyon's lead compound PL-100 as well as with five currently-marketed drugs, namely: amprenavir (GlaxoSmithKline), indinavir (Merck), lopinavir (Abbott), nelfinavir (Agouron/Pfizer) and saquinavir (Hoffmann-La Roche).

On average, PL-100 showed better antiviral activity than the approved drugs tested. This indicates the potential for good activity against existing resistant viruses in treatment-experienced patients or in those patients newly-infected with similar resistant strains.

Also during the course of 2003, Procyon's scientists were invited to present a scientific poster reporting on the Company's breakthrough research at the XII<sup>th</sup> International HIV Drug Resistance Workshop, in Mexico. The Company was also invited to present the viral resistance profile of PL-100 at the Protease Targets & Drug Discovery Symposium in Philadelphia. Procyon was the only Canadian biotechnology company to be invited to present at this symposium.

The Company also secured its intellectual property in virology with the granting of six US patents covering its anti-HIV protease program. Procyon remains on track to file an IND to conduct human clinical trials by September 2004.



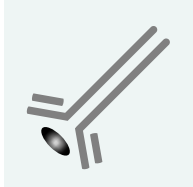
It is estimated that at least...

# 700,000

children were infected with HIV in 2003\*

### ANsA – Anti-Nucleosome Antibodies

Anti-nucleosome antibodies for the treatment of various cancers including lymphoma and renal carcinoma



**DEVELOPMENT STATUS** Preclinical

**PATENTS** Worldwide granted

#### UPDATE

Following large-scale production challenges with the lead candidate c2C5 derived from the ANsA technology, the Company completed a US external due diligence in collaboration with Dr. Howard Levine's group, Bioprocess Technology Consultants, Inc. The conclusion of the due diligence was a recommendation from Dr. Ronald Bukowski, Cleveland Clinic, and Dr. David E. Fisher, Dana Faber Cancer Institute, to pursue the program and to concurrently supplement it with more preclinical research confirming specificity and reactivity with tumors. In July, Procyon scientists and collaborators presented a scientific poster at the 94<sup>th</sup> Annual Meeting of the American Association for Cancer Research reporting on the potential anti-angiogenic function of the ANsA platform technology.

### PSP<sup>94</sup> Serum-based immunoassay

A reliable, quick-and-easy serum-based immunoassay to detect and monitor prostate cancer



**DEVELOPMENT STATUS** Clinical trials as a medical device

**PATENTS** US granted and World pending

#### UPDATE

In June 2003, Procyon completed three assay validation studies, namely free PSP, total PSP and PSP-binding protein. Results to date indicate that the PSP<sup>94</sup> Serum-based immunoassay could potentially be of value in the determination of the stage or the progression of the cancer. As reported in the October 27, 2003 issue of *Forbes Magazine*, prostatectomy is one of the most over-performed surgeries and such a diagnostic tool could significantly reduce the use of such invasive clinical procedures as prostate removals and biopsies. Procyon intends to conduct further proof-of-concept studies with academic collaborators in 2004.

### PL-2500 Integrase inhibitor

An integrase inhibitor that addresses a novel mechanism of action for the treatment of HIV/AIDS



**DEVELOPMENT STATUS** Preclinical

**PATENTS** US granted and World pending

#### UPDATE

In 2003, Procyon initiated the lead optimization studies with its anti-HIV integrase inhibitor. Procyon's virology scientists have spent over four years developing its proprietary compound library of small molecules targeting the HIV viral integrase. To date, there are no anti-integrase drugs available on the market and Procyon's novel family of anti-integrase compounds is one of very few known anti-integrase programs currently under exploration. During 2003, the Company also invested in its intellectual property portfolio and was granted two additional US patents for its integrase inhibitors. Procyon now has US patent protection over three families of compounds.

### Colopath®/ColorectAlert™

A simple screening and monitoring test for colorectal cancer



**DEVELOPMENT STATUS** Clinical trials as a medical device

**PATENTS** Worldwide granted

**PARTNER** IMI International Medical Innovations Inc.

#### UPDATE

In July, Procyon announced its shared enthusiasm with licensee partner, IMI International Medical Innovations Inc. on the ColorectAlert™ study results presented at the 94<sup>th</sup> Annual Meeting of the American Association for Cancer Research. Results from three studies totaling 1,787 subjects show that ColorectAlert™ detects 54% of early-stage colorectal cancers and 49% of all cancers. Subjects who had a positive ColorectAlert™ test were 3.5 times more likely to have cancer than subjects who had a negative test result. An additional finding in the study was the powerful effect of combining two screening tests - ColorectAlert™ and fecal occult blood test, which is widely available. In combination with FOBT, it found that over 99% of patients who are negative for both tests have no incidence of cancer. In 2001, Procyon licensed out to IMI the worldwide rights to its mucus-based colorectal test. The terms of the agreement include upfront and milestone payments as well as a royalty on sales of any rectal mucus-based screen test for colorectal cancer.

# Management's Discussion and Analysis of Operating Results and Financial Position

The following discussion and analysis should be read in conjunction with the Company's audited financial statements for the year ended December 31, 2003 and the related notes herein, which are prepared in accordance with Canadian generally accepted accounting principles. Some of the statements contained in this Management's Discussion and Analysis of Operating Results and Financial Position constitute forward-looking statements. These statements relate to future events or to Procyon's future financial performance and involve known and unknown risks, uncertainties and other factors that may cause the Company's actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements.

## OVERVIEW

Procyon Biopharma is a publicly-traded Canadian biotechnology company actively engaged in the discovery and development of innovative therapeutics and diagnostics in the fields of oncology and infectious diseases. The mission of the Company is to identify leading-edge technologies, bring them quickly to advanced human clinical trials and license them to pharmaceutical companies for further development and commercialization. Procyon receives from licensee partners upfront and milestone payments, as well as royalty revenues upon commercialization.

Procyon's products and technologies are steadily advancing from research through development, preclinical and clinical studies. As a result, today Procyon has three near-term value drivers, namely PCK3145, a treatment for prostate cancer currently undergoing a Phase IIa trial; Fibrostat<sup>®</sup>, a topical cream for hypertrophic scars licensed out to Biovail Corporation in North America; and PL-100, a very unique protease inhibitor. The Company is also developing two medical devices: Colopath<sup>®</sup>/ColorectAlert<sup>™</sup>, a simple screening and monitoring test for colorectal cancer; and PSP<sup>®</sup> Serum-based immunoassay, a reliable, quick-and-easy test to detect and monitor prostate cancer; as well as two other therapeutics: ANSA, a technology platform with potential therapeutic applications to various cancers; and PL-2500, an integrase inhibitor that addresses a novel mechanism of action for the treatment of HIV/AIDS.

In September, Procyon announced the interim results of the Phase IIa trial that was initiated in late-2002 in Manchester, England. The encouraging interim results clearly suggest that PCK3145 has the potential to significantly reduce tumor metastasis in hormone-refractory prostate cancer patients without safety concerns and adverse effects. This was shown with consistent reduction of the tumor metastasis marker, MMP-9, to normal levels. Study enrolment was completed during the fourth quarter of 2003 and final results are expected during the first half of 2004.

New preclinical proof-of-concept studies conducted by Dr. Shafaat Rabbani of the McGill University Health Centre show that treatment of rat prostate cancer cells Mat Ly Lu with the drug resulted in a significant dose-

dependent decrease in tumor volume, while bone histomorphometry showed that treatment with the drug at 100 ug/kg/day resulted in a marked decrease in tumor/bone volume ratio. In addition, histologic analysis of vertebra showed a marked absence of spinal cord compression which was consistently or significantly present in untreated control animals after 10 days of treatment.

In June 2003, Procyon initiated a North American clinical Phase IIb trial for Fibrostat<sup>®</sup> after receiving clearance from the US Food and Drug Administration and subsequently from Health Canada's Therapeutic Products Directorate. The enrolment of the 200 patients for the placebo-controlled, double-blind, randomized study began thereafter in twelve centers across Canada and the United States. The Phase IIb trial is being conducted in collaboration with Biovail Corporation which owns the marketing rights for North America. Discussions with several potential partners for Europe and Japan are ongoing and the Company expects to out-license the product in these markets once data from the study is available.

As resistance to currently-marketed drugs, and especially to protease inhibitors, is one of the main issues in the treatment of HIV/AIDS, the development of new drugs addressing resistance is an urgent need. In November, Procyon reported the results of a resistance profile study. The results indicated that PL-100, the Company's protease inhibitor, has the potential for good activity against drug-resistant viruses in patients already under treatment as well as in newly-infected patients. The study showed that the 14 viral strains tested were generally more susceptible to PL-100 than to the currently-marketed protease inhibitors, suggesting that PL-100 has a favorable and potentially distinct resistance profile. Procyon also secured its intellectual property in virology with the granting of six US patents covering its anti-HIV protease program. Procyon remains on track to file an IND to conduct human clinical trials by September 2004.

On the financial front, Procyon completed in April 2003 the acquisition of Pharmacor Inc., a Montréal-based biopharmaceutical company committed to the discovery and development of innovative therapeutic agents for the treatment of HIV/AIDS. This acquisition adds a strong pipeline of preclinical products and allows Procyon to accelerate its development programs with its new internal chemistry laboratories. The Company's new virology division was established from the Pharmacor operations. The Company also closed a concurrent \$3.25 million financing with the three main institutional investors in Pharmacor, namely Investissement Desjardins, Société Innovatech du Grand Montréal and the Fonds régional de solidarité FTQ Laval.

## RESULTS OF OPERATIONS

### Year ended December 31, 2003 compared with the year ended December 31, 2002

The net loss for the year ended December 31, 2003 amounted to \$10.7 million or \$0.17 per common share, compared with a net loss of \$6.9 million or \$0.14 per common share for the year ended December 31, 2002. The increase in the net loss was primarily the result of increased spending on research and development, due to the acquisition of Pharmacor Inc. on April 17, 2003 and the acceleration of the Company's Research and development programs, together with an increase in general and administrative expenses in 2003.

Revenues for 2003 were \$303,976, compared with \$403,914 in 2002. The reduced level of revenues in 2003 reflected the decrease in interest income generated in 2003 as a result of lower average levels of cash, together with a reduction in license revenue earned in 2003.

Gross research and development expenses for 2003 amounted to \$8,060,427, compared with \$4,951,461 in 2002. The increase of \$3,108,966 or 63% in 2003 reflected the high level of spending in the year, including \$1.1 million on HIV/AIDS research in the new Virology division formed following the acquisition of Pharmacor. The Phase IIa clinical trial for PCK3145 underway in the United Kingdom resulted in a significant increase over 2002, with the Phase IIb North American clinical trial for Fibrostat® accounting for most of the remaining increase over 2002. Spending on the ANSA technology declined slightly from the 2002 level. Research and development tax credits were also higher than in 2002, increasing to \$1,332,062 from the 2002 amount of \$1,232,981. A reduction in the rate of Québec tax credits effective June 12, 2003 partially offset the increase generated by higher expenditures in Québec compared to 2002. Research and development expenses represented 65% of total expenses before tax credits, compared with 58% in 2002.

General and administrative expenses for 2003 were \$3,364,702, an increase of \$284,810 or 9% over the total of \$3,079,892 in 2002. The increase resulted primarily from higher professional fees and the added costs associated with the Pharmacor acquisition.

Amortization expense amounted to \$895,721 in 2003, compared with \$493,207 in 2002. The increase reflected primarily the added amortization from the Pharmacor acquisition, together with the effect of an increase in the rate of amortization of laboratory and office equipment that was implemented effective January 1, 2003.

## LIQUIDITY AND CAPITAL RESOURCES

The Company has financed its operations and its acquisitions of technology and capital assets primarily through private placements and public issues of common shares, scientific research investment tax credits, interest income and amounts received under licensing agreements for certain of its products. A loan agreement entered into in December 2002 expanded the Company's financing base by providing it with a loan facility of \$10 million obtained under the Biolevier program of the Government of Québec. As at December 31, 2003, \$5 million has been drawn against this facility.

Cash and cash equivalents and short-term investments on hand at December 31, 2003 totaled \$9,917,167, compared with \$12,746,078 at December 31, 2002. The reduction of \$2,828,911 resulted primarily from the cash outflow of \$9,787,144 that was required to finance operating activities for the year 2003. This cash outflow included an increase of \$133,382 in non-cash working capital, resulting primarily from a decrease of \$1,104,505 in accounts payable and accrued liabilities and an increase of \$60,249 in prepaid expenses, partially offset by decreases of \$866,164 in investment tax credits recoverable and \$175,808 in accounts receivable. This cash outflow was for the most part funded by the drawdown of \$5,000,000, before cash expenses of \$102,856, on the Biolevier loan facility in November 2003, and the net proceeds of \$3,212,289 from the sale of units, each comprising one common share and 0.4153845 common share purchase warrant, arranged concurrent with the acquisition of Pharmacor Inc. in April 2003. In addition, \$40,163 was generated from the exercise of stock options.

The decrease of \$2,926,576 in short-term investments in 2003 reflected the additional cash required to support the year's activities in excess of the amounts injected from the debt and equity financing. An amount of \$188,364 was spent for intellectual property during the year, reflecting the costs incurred to obtain patents, and an additional \$163,304 for the purchase of property, plant and equipment, primarily for expanded laboratory facilities following the acquisition of Pharmacor. While the acquisition of Pharmacor was effected on a share-exchange basis, cash acquisition expenses of \$236,254 were incurred, but were partially offset by cash of Pharmacor at the time of the acquisition of \$159,832. Subsequent to the April 17, 2003 acquisition, a bank loan of Pharmacor of \$624,280 was repaid and long-term debt repayments of \$138,993 were made.

Investment tax credits recoverable at December 31, 2003 amounted to \$1,047,500, compared with \$895,000 at the end of 2002. The increase of \$152,500 resulted from the higher level of research and development expenses in 2003, partially offset by the effect of a reduction in the rate of Québec tax credits effective June 12, 2003. The Company had no material commitments for capital expenditures as at December 31, 2003.

Management believes that it has sufficient funds available, including another \$5 million tranche available under the loan facility, to support its ongoing activities for the next 15 to 18 months.

# Management's Discussion and Analysis of Operating Results and Financial Position

## RISKS AND UNCERTAINTIES

The Company's activities involve a number of risks and uncertainties that are generally experienced by the biotechnology industry. The future viability of Procyon depends upon its ability to successfully develop its technologies and products, to enter into licensing agreements and to obtain the regulatory approvals necessary to allow the products to be marketed.

The Company can make no assurance that its products will be developed successfully or receive regulatory approval. The new products of the Company are currently in the research and development stages. The Company can make no assurance that its research and development programs will result in commercially viable products. To achieve profitable operation, the Company, alone or with others, must successfully develop and market its products. To obtain regulatory approvals for the products being developed, clinical trials must demonstrate efficacy and that the products are safe for human use. Unsatisfactory results obtained from a particular study relating to a program may cause the Company or its collaborators to abandon its commitment to that program. The Company can make no assurance that any future animal or human test will yield favorable results.

The Company can make no assurance that products based on its technology, if approved for marketing, will achieve market acceptance. The degree of market acceptance will depend on the efficacy and safety of the product candidates, their potential advantage over alternative products and treatment method. The lack of such market acceptance would have a material adverse effect on the Company's business and financial condition.

To develop its technologies, the Company requires significant investment of financial resources. Consequently, the ability of the Company to obtain the cash needed to finance its operations is fundamental to its future success and therefore constitutes a business risk.

With regard to the concentration of credit risk, investment tax credits recoverable are due from the Québec government. The cash and cash equivalents are held with two Canadian chartered banks and the short-term investments are held in high quality commercial paper of major corporations and a banker's acceptance.

Certain matters discussed in this report are, by their nature, forward-looking and are subject to risks and other factors that are wholly or partially beyond the control of the Company's management. Consequently, actual results could differ materially.

## QUARTERLY INFORMATION

(Unaudited)

(Thousands of dollars, except per share amounts)

	2003				2002			
	Dec. 31	Sept. 30	June 30	March 31	Dec. 31	Sept. 30	June 30	March 31
Total revenues	64	62	87	91	116	127	90	71
Net loss	(3,192)	(2,773)	(3,102)	(1,652)	(2,163)	(1,480)	(1,621)	(1,613)
Per common share								
- Basic	(0.05)	(0.04)	(0.05)	(0.03)	(0.04)	(0.03)	(0.03)	(0.04)
- Diluted	(0.05)	(0.04)	(0.05)	(0.03)	(0.04)	(0.03)	(0.03)	(0.04)
Cash dividends declared	—	—	—	—	—	—	—	—

## Management's Report

Procyon Biopharma Inc.

Management is responsible for the integrity, objectivity and reliability of the accompanying consolidated financial statements and for ensuring that all information in the annual report is consistent with these financial statements. This responsibility includes selecting appropriate accounting policies and making estimates and other judgments consistent with Canadian generally accepted accounting principles.

Management has established and maintains control processes that provide reasonable assurance that the financial records are complete and accurate, that all financial transactions are properly authorized, that assets are safeguarded and that the Company and its subsidiaries comply with all reporting requirements.

The Company's Board of Directors is responsible for overseeing management's performance of its financial reporting responsibilities. The Board delegates this responsibility to the Audit Committee. The Audit Committee, whose members are not affiliated with the Company, is appointed by the Board to review the financial statements in detail with management and to report to the directors prior to their approval of the consolidated financial statements for publication.

Ernst & Young have been appointed as the Company's auditors to report to the shareholders regarding their audit of the consolidated financial statements.

Signed: Hans J. Mäder

Hans J. Mäder

CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER

Signed: Monique Létourneau

Monique Létourneau

EXECUTIVE VICE-PRESIDENT, FINANCE AND CHIEF FINANCIAL OFFICER

March 1, 2004

## Auditors' Report

To the Shareholders of Procyon Biopharma Inc.

We have audited the consolidated balance sheets of Procyon Biopharma Inc. as at December 31, 2003 and 2002 and the consolidated statements of operations and deficit and cash flows for the years ended December 31, 2003 and 2002. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated 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 consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2003 and 2002 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Signed: Ernst & Young LLP

Montréal, Canada

February 11, 2004

Chartered Accountants

# Consolidated Balance Sheets

As at December 31

	2003	2002
	\$	\$
<b>ASSETS</b> [NOTE 9]		
<b>Current assets</b>		
Cash and cash equivalents	476,673	379,008
Short-term investments [NOTE 5]	9,440,494	12,367,070
Accounts receivable	213,946	320,001
Investment tax credits recoverable [NOTE 16]	1,047,500	895,000
Prepaid expenses	155,093	52,806
	<b>11,333,706</b>	<b>14,013,885</b>
Property, plant and equipment [NOTE 6]	1,034,677	464,059
Intellectual property [NOTE 7]	7,305,837	4,721,827
Long-term investments [NOTE 8]	7,001	53,001
Deferred financing costs [NOTE 9]	663,686	176,174
	<b>20,344,907</b>	<b>19,428,946</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Current liabilities</b>		
Accounts payable and accrued liabilities	1,582,775	1,513,578
Deferred revenue	9,617	37,883
	<b>1,592,392</b>	<b>1,551,461</b>
Bioevier loan facility [NOTE 9]	5,043,223	—
Convertible debenture [NOTE 10]	50,000	50,000
Preferred shares [NOTE 12]	4,000,000	4,000,000
	<b>10,685,615</b>	<b>5,601,461</b>
<b>Shareholders' equity</b> [NOTE 12]		
Share capital	47,874,176	42,172,621
Warrants	751,292	952,214
Contributed surplus	2,550,164	1,499,988
Equity component of convertible debenture [NOTE 10]	675,000	675,000
Deficit	(42,191,340)	(31,472,338)
	<b>9,659,292</b>	<b>13,827,485</b>
	<b>20,344,907</b>	<b>19,428,946</b>

Commitments and guarantees [NOTE 13]

SEE ACCOMPANYING NOTES

On behalf of the Board:

Signed: Hans J. Mäder

Signed: Iain MacInnes

Hans J. Mäder  
Director

Iain MacInnes  
Director

## Consolidated Statements of Operations and Deficit

Years ended December 31

	2003	2002
	\$	\$
<b>REVENUES</b>		
Licence revenue	28,267	80,067
Interest and other income	275,709	323,847
	<b>303,976</b>	<b>403,914</b>
<b>EXPENSES</b>		
Research and development	8,060,427	4,951,461
Research and development tax credits (NOTE 16)	(1,332,062)	(1,232,981)
Net research and development	6,728,365	3,718,480
General and administrative	3,364,702	3,079,892
Amortization of property, plant and equipment	262,468	86,541
Amortization of intellectual property	624,957	406,666
Amortization of deferred financing fees	8,296	—
Financial charges	66,563	2,583
Foreign exchange gains	(32,373)	(12,864)
	<b>11,022,978</b>	<b>7,281,298</b>
<b>Net loss for the year</b>	<b>(10,719,002)</b>	<b>(6,877,384)</b>
Adjustment to terms of outstanding warrants (NOTE 12)	—	(350,000)
Deficit, beginning of year	(31,472,338)	(24,244,954)
<b>Deficit, end of year</b>	<b>(42,191,340)</b>	<b>(31,472,338)</b>
<b>Basic and diluted loss per share</b> (NOTE 12)	<b>(0.17)</b>	<b>(0.14)</b>
<b>Weighted average number of common shares outstanding</b>	<b>62,882,510</b>	<b>49,855,410</b>

SEE ACCOMPANYING NOTES

# Consolidated Statements of Cash Flows

Years ended December 31

	2003	2002
	\$	\$
<b>OPERATING ACTIVITIES</b>		
Net loss for the year	(10,719,002)	(6,877,384)
Items not affecting cash		
Amortization of property, plant and equipment	262,468	86,541
Amortization of intellectual property	624,957	406,666
Amortization of deferred financing fees	8,296	—
Loss on disposal of property, plant and equipment	—	2,161
Write-down of investment	46,000	—
Loan interest capitalized	43,223	—
Non-cash license revenues	(17,666)	(17,667)
Services paid by issuance of stock options	97,962	51,400
	(9,653,762)	(6,348,283)
Net change in non-cash balances relating to operations (NOTE 17)	(133,382)	353,467
<b>Cash flows related to operating activities</b>	<b>(9,787,144)</b>	<b>(5,994,816)</b>
<b>INVESTING ACTIVITIES</b>		
Acquisition of intellectual property	(188,364)	(282,575)
Acquisition of property, plant and equipment	(163,304)	(63,558)
Disposition of property, plant and equipment	—	4,900
Cash and cash equivalents obtained on acquisition of business	159,832	—
Business acquisition expenses	(236,254)	—
Maturities of short-term investments	18,316,970	13,266,305
Purchase of short-term investments	(15,390,394)	(20,608,157)
<b>Cash flows related to investing activities</b>	<b>2,498,486</b>	<b>(7,683,085)</b>
<b>FINANCING ACTIVITIES</b>		
Issuance of convertible debenture	—	62,500
Issue of preferred shares	—	4,000,000
Issue of units	3,530,000	10,001,520
Unit issue expenses	(317,711)	(1,082,731)
Issue of common shares	40,163	710,860
Issuance of long-term debt	5,000,000	—
Repayment of long-term debt assumed in an acquisition	(138,993)	—
Repayment of bank indebtedness assumed in an acquisition	(624,280)	—
Debt financing costs	(102,856)	(176,174)
<b>Cash flows related to financing activities</b>	<b>7,386,323</b>	<b>13,515,975</b>
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>97,665</b>	<b>(161,926)</b>
Cash and cash equivalents, beginning of year	379,008	540,934
<b>Cash and cash equivalents, end of year</b>	<b>476,673</b>	<b>379,008</b>
<b>Supplemental cash flow information</b>		
Cash paid during the year for:		
Interest	17,918	—

SEE ACCOMPANYING NOTES

# Notes to Consolidated Financial Statements (December 31, 2003)

## 1) Description of business

The Company is a biopharmaceutical company engaged in the development and commercialization of diagnostics and therapeutic drugs. It was incorporated under the laws of the Province of Ontario in 1986 and was continued under the *Canada Business Corporations Act* in 2001.

To date, the Company has financed its cash requirements primarily from equity issuances, investment tax credits, government grants and loans, license revenues and interest income. The success of the Company is dependent on bringing its technologies to market, obtaining the necessary regulatory approvals and achieving future profitable operations. It may be necessary for the Company to raise additional funds for the continuing development and marketing of its technologies.

## 2. Significant accounting policies

These consolidated financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles and have, in management's opinion, been properly prepared within reasonable limits of materiality and within the framework of the following accounting policies:

### Basis of consolidation

The consolidated financial statements include the accounts of the Company, those of its wholly-owned US subsidiary, Oncologic Biopharmaceuticals Corporation ["Oncologic"], which was purchased on September 30, 1997 and those of its wholly-owned Canadian subsidiary, Pharmacor Inc., since its acquisition on April 17, 2003. After the close of business on December 31, 2003, Pharmacor Inc.'s operations were wound up and all of its assets and liabilities were transferred into the Company, with a view to proceeding to its dissolution as soon as practicable. All significant intercompany transactions and balances have been eliminated upon consolidation.

### Use of estimates

The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and the disclosure of contingent assets and liabilities. The reported amounts and note disclosures are determined using management's best estimates based on assumptions that reflect the most probable set of economic conditions and planned courses of action. Actual results, however, may differ from the estimates used in these consolidated financial statements and such differences could be material.

### Cash and cash equivalents

Cash and cash equivalents consist of cash and highly liquid short-term investments with an original maturity of less than three months that are readily convertible to known amounts of cash and that are subject to an insignificant risk of change in value.

### Short-term and long-term investments

Short-term investments are recorded at the lower of cost and fair market value determined on a portfolio basis. Long-term investments are recorded at cost and are written down to their fair market value when a decline in value is other than temporary.

### Property, plant and equipment

Property, plant and equipment are recorded at cost, net of investment tax credits. Amortization is provided on a basis and at rates assigned to amortize the cost of the assets over their estimated useful lives. The annual rates of amortization are as follows:

Laboratory equipment	30% declining balance
Office equipment	20% declining balance
Computer equipment	30% declining balance
Leasehold improvements	20% straight-line basis

Effective January 1, 2003, following a review by management of the expected useful lives of laboratory and office equipment, the annual rates of amortization of laboratory equipment and office equipment were revised to 30% from 10% and 20% from 10% respectively, both on a declining balance basis.

### Intellectual property

Purchased patents and intellectual property consists of patents, licenses, and scientific knowledge relating to products under development purchased by the Company. Patent costs include legal fees to obtain patents and patent application fees.

Patent costs and purchased patents and intellectual property are amortized on a straight-line basis over 15 years.

## 2) Significant accounting policies (CONT'D)

On a periodic basis, management reviews the carrying value of intellectual property and considers whether there have been events or changes in circumstances that indicate that the carrying value may not be recoverable. The review is based on the assessment of technological changes, the Company's intended use and the projected estimated net undiscounted cash flows expected to be generated from the underlying intellectual property together with its residual value (net recoverable value). If such intellectual property is considered impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the intellectual property exceeds its fair value generally determined on a discounted expected cash flow basis. Any impairment results in a write-down of the intangible assets and a charge to income during the year.

### Revenue recognition

Sales revenue is recognized when the product is delivered to customers, title has passed and collection is reasonably assured. Contract research revenue is recognized as services are performed and collection is reasonably assured. License revenue is recognized over the term of the related license. Interest income is recognized when it is earned.

### Government assistance

Government assistance received in the form of grants and investment tax credits for qualifying research and development activities are applied as a reduction of the cost of the related property, plant and equipment or as a reduction of the applicable research and development expenses.

### Research and development

Research costs are charged against income as incurred. Development costs are charged against income in the period of expenditure unless a development project meets the criteria specified under generally accepted accounting principles for deferral and amortization. The Company has not deferred any such development costs to date.

### Income taxes

The Company follows the liability method of accounting for income taxes according to which future income tax assets and liabilities are determined based on the differences between the financial reporting and tax bases of assets and liabilities, measured using substantively enacted tax rates and laws that are expected to be in effect in the periods in which the future tax assets or liabilities are expected to be realized or settled. A valuation allowance is provided to the extent that it is more likely than not that future income tax assets will not be realized.

### Stock-based compensation

The Company has a stock-based compensation plan, which is described in note 12. Prior to January 1, 2003, no compensation expense was recognized for this plan when stock or stock options were issued to employees, officers and directors. Any consideration paid by employees, officers and directors on exercise of stock options or purchase of stock is credited to share capital. Options issued to consultants are recognized as an expense at the earlier of the vesting date or over the period over which the services are performed using the Black-Scholes option pricing model.

During the fourth quarter of 2003, the Company adopted the fair value method of accounting for stock-based compensation plans. The Company has selected the prospective method of adoption; accordingly, results from prior years have not been restated *[see note 3]*.

### Earnings per share

Basic earnings per share is calculated using the weighted average number of shares outstanding during the year. Diluted earnings per share is calculated using the treasury stock method, giving effect to the exercise of all dilutive securities. The treasury stock method assumes that proceeds from the exercise of options are used to purchase common shares at the average market price during the period. Shares issued in connection with share purchase loans are excluded from the calculation of basic earnings per share but are included for purposes of calculating diluted earnings per share when the effect is dilutive.

### Foreign currency translation

The consolidated financial statements are denominated in Canadian dollars. The operations of the US subsidiary are considered to be integrated with the Company and as such the temporal method is used whereby the monetary assets and liabilities recorded in a foreign currency are translated into Canadian dollars at year-end exchange rates and non-monetary assets and liabilities are translated at the exchange rates prevailing when the assets were acquired or liabilities were incurred. Revenue and expenses are translated at the average rate of exchange for the period. Gains and losses on translation of foreign currencies are included in the consolidated statement of operations in the current period.

### Financing costs

Financing costs related to the issuance of debt are deferred and amortized over the term of the related debt using the effective yield method.

### Financial instruments

Certain classes of preferred shares provide the holder with a retraction right, which may result in the Company being required to redeem the shares. Consequently, these preferred shares are presented as a liability in the balance sheet and carried at amortized value.

## Notes to Consolidated Financial Statements (December 31, 2003)

### 3) Changes in accounting policies

#### i) Impairment of long-lived assets

Effective January 1, 2003, the Company prospectively adopted the new CICA Section 3063 accounting recommendation on the impairment of long-lived assets. When the carrying value of a long-lived asset is less than its net recoverable value as determined on an undiscounted basis, an impairment loss is recognized. The impairment loss is recognized to the extent that the asset's fair value measured on a discounted expected cash flow basis over its life, is below its carrying value.

Prior to January 1, 2003, asset impairments were recorded to the extent that the amount of an asset's carrying value exceeded its net recoverable amount on an undiscounted cash flow basis.

The impact of the adoption of the new recommendations did not result in any change to the recognized intangible assets of the Company.

#### ii) Stock-based compensation

During 2003, the CICA amended their pronouncement relating to stock-based compensation, requiring companies to measure and expense all equity instruments awarded to employees. In the fourth quarter of 2003, the Company adopted this new recommendation prospectively. Consequently, the Company has applied a fair value based method to expense employee stock options awarded since January 1, 2003. Furthermore, for options awarded or modified during 2002, the Company will continue to present the pro forma net income information as if the fair value basis had been applied to those awards [NOTE 12].

### 4) Business acquisition

Effective April 17, 2003, the Company acquired 100% of the outstanding shares of Pharmacor Inc., a Montréal-based biopharmaceutical company committed to the discovery and development of innovative therapeutic agents for the treatment of HIV/AIDS, in exchange for 6,999,996 common shares of Procyon valued at \$2,800,000, based on the closing share price on April 17, 2003, plus acquisition costs of \$243,697. The acquisition has been accounted for using the purchase method at fair value. The results of operations of Pharmacor have been consolidated with the accounts of the Company since the date of acquisition.

The allocation of the purchase price is as follows:

	\$
Cash and cash equivalents	159,832
Accounts receivable	69,753
Investment tax credits recoverable	1,018,664
Prepaid expenses	42,038
Property, plant and equipment	669,782
Intellectual property	3,020,603
<b>Total assets acquired</b>	<b>4,980,672</b>
Bank indebtedness	624,280
Accounts payable and accrued liabilities	1,173,702
Long-term debt	138,993
<b>Total liabilities assumed</b>	<b>1,936,975</b>
<b>Net assets acquired</b>	<b>3,043,697</b>
Consideration represented by:	
Cash	236,254
Share capital [note 12]	2,800,000
Fair value of warrants issued [note 12]	7,443
	<b>3,043,697</b>

Of the assets acquired, \$3,020,603 was assigned to purchased patents and intellectual property. This intellectual property is being amortized over a fifteen-year period.

The bank indebtedness of \$624,280 above was collateralized by the investment tax credits recoverable. In July 2003, the investment tax credits were received and the bank indebtedness was repaid in full. The investment tax credits received are subject to audit by the taxation authorities. In addition, the long-term debt was repaid during the year.

One of the Company's directors represented a shareholder, Société en commandite T/C/Bio in both the Company (less than 5%) and Pharmacor (less than 10%). The acquisition by the Company of the shares of Pharmacor held by the shareholder represented less than 1% of the market capitalization of the Company. The director did not participate in and was not in attendance during any discussions or decisions relating to the acquisition of Pharmacor's shares.

### 5) Short-term investments

	2003	2002
	\$	\$
Commercial paper and a banker's acceptance, earning interest at rates ranging from 2.50% to 2.85% [2002 – 2.70% to 2.95%] and maturing on various dates from January to June 2004 [2002 – January to June 2003]	<b>9,440,494</b>	12,367,070
	<b>9,440,494</b>	12,367,070

## Notes to Consolidated Financial Statements (December 31, 2003)

### 6) Property, plant and equipment

	Cost \$	Accumulated amortization \$	Net carrying value \$
<b>As at December 31, 2003</b>			
Laboratory equipment	1,682,829	962,813	720,016
Office equipment	262,348	105,564	156,784
Computer equipment	438,718	300,529	138,189
Leasehold improvements	86,516	66,828	19,688
	<b>2,470,411</b>	<b>1,435,734</b>	<b>1,034,677</b>
<b>As at December 31, 2002</b>			
Laboratory equipment	386,064	167,693	218,371
Office equipment	170,962	49,719	121,243
Computer equipment	232,276	140,878	91,398
Leasehold improvements	82,930	49,883	33,047
	872,232	408,173	464,059

### 7) Intellectual property

	Cost \$	Accumulated amortization \$	Net carrying value \$
<b>As at December 31, 2003</b>			
Patent costs	1,923,025	525,273	1,397,752
Purchased patents and intellectual property	7,720,064	1,811,979	5,908,085
	<b>9,643,089</b>	<b>2,337,252</b>	<b>7,305,837</b>
<b>As at December 31, 2002</b>			
Patent costs	1,361,133	245,916	1,115,217
Purchased patents and intellectual property	4,943,914	1,337,304	3,606,610
	6,305,047	1,583,220	4,721,827

### 8) Long-term investments

Under the terms of a license agreement entered into in March 2001 with IMI International Medical Innovations Inc., a public company, the Company received cash and a warrant, expiring on March 19, 2004, to purchase 75,000 common shares of IMI exercisable at \$4.50 per share. Management estimated the fair value of this warrant at that time, using the Black-Scholes option pricing model, with a volatility factor of 45% and a risk-free interest rate of 5%, to be approximately \$53,000. The revenue is being recognized over a 36-month period, representing the term of the warrant. On June 30, 2003, the carrying value of the warrant was written down to \$7,000, management's estimate of its fair value at that date, determined using the Black-Scholes option pricing model with a volatility factor of 47% and a risk-free interest rate of 3%.

### 9) Biolevier loan facility

In December 2002, the Company signed a loan agreement with Investissement Québec (IQ) under the Biolevier program for a \$10,000,000 loan facility. As at December 31, 2003, the Company has drawn \$5,000,000 on this facility. Interest thereon to December 31, 2003 at 7.5% amounted to \$43,223 and has been accounted for as part of the loan facility.

The remainder of the facility is available for up to three years from the date of the first disbursement, November 19, 2003, to finance research and development programs, working capital and acquisitions of intellectual property or businesses. To draw down on the remainder of the facility the Company must have first disbursed funds towards qualified expenditures. To December 31, 2003, the Company has made qualified expenditures allowing them to draw down approximately \$3,000,000 of the remaining facility.

The terms and conditions of the loan agreement are as follows:

- i) The repayment term of the loan is ten years from the date of the first disbursement, November 19, 2003.
- ii) No capital or interest is repayable for the first three years after the initial disbursement. Interest is due on a monthly basis thereafter, with annual capital repayments equal to 25% of the Company's annual operating cash flows, if any.
- iii) Interest is at the average Canadian prime rate plus 3% [7.5% at December 31, 2003] and can be converted to a fixed rate after the final loan disbursement.
- iv) The loan is collateralized by a first ranking \$15,000,000 charge on all current and future assets including intellectual property of the Company and its subsidiaries. However, upon request by the Company, and subject to certain conditions, IQ will release the charge against any specific intellectual property for which the Company is in the process of entering into a licensing, marketing or operating agreement.

## Notes to Consolidated Financial Statements (December 31, 2003)

### 9) Biolevier loan facility (CONT'D)

In addition, the Company provided IQ with warrants to purchase 1,503,759 common shares at an exercise price of \$0.56 per share, expiring 5 years from the date of their issuance. The term of these warrants will automatically expire one year after loan repayment if repaid from operating cash flows, or two years after loan repayment in all other cases. Should the Toronto Stock Exchange permit the extension of the term of these warrants past 5 years, the life of the warrants could be extended. The number of warrants that may be exercised will be reduced in proportion to the amount loaned should the Company borrow less than \$7,500,000, to a minimum of 751,880 warrants. A total of 751,880 warrants vested on November 19, 2003, the date of the first disbursement of \$5,000,000. The fair value of these warrants on the vesting date, using the Black-Scholes option pricing model with a volatility factor of 62%, a risk-free interest rate of 4%, a dividend yield of nil and an expected life of 5 years amounted to \$392,952 [2002 - nil]. This amount is recorded as deferred financing costs, as are the costs associated with this facility in the amount of \$279,030, and both are being amortized to expense over the term of the loan using the effective yield method. The fair value of the remaining warrants will be recorded as deferred financing costs if and when they vest.

### 10) Convertible debenture

On February 1, 2000, the Company entered into a Canadian licensing agreement with a biopharmaceutical company [the "Holder"] whereby the Holder will advance funds to the Company upon the achievement of specific scientific and regulatory milestones related to Fibrostat®. The funds will be advanced up to a maximum of \$1,500,000, in the form of a non-interest bearing debenture, convertible into common shares, which matures on December 31, 2049. The Holder of the debenture has a right to convert the debenture into common shares at prices ranging from 125 % to 150% of the market price of the common shares at the date regulatory approval of Fibrostat® is obtained. As at December 31, 2003, the Company has received \$725,000. Of this amount, \$50,000 is included in liabilities and \$675,000 is recorded as the equity component of the convertible debenture. The liability component will be accreted over time by a charge to the statement of operations for interest accretion and at maturity will be equal to the face value of the debenture.

### 11) Income taxes

The income tax reported differs from the amount of the tax computed by applying statutory income tax rates to the loss before taxes. The reasons for the differences and the related tax effects are as follows:

	2003	2002
	%	%
Combined statutory federal and provincial rates	33.05	35.19
Increase (decrease) in taxes recoverable resulting from:		
Non-deductible expenses and other differences	(0.60)	(0.35)
Unrecognized tax benefits of operating losses	(33.77)	(36.46)
Tax credits not taxable in Québec	1.32	1.62
	—	—

The tax effects of temporary differences and net operating losses that give rise to future income tax assets and liabilities are as follows:

	2003	2002
	\$	\$
<b>Future income tax liability</b>		
Carrying values of intellectual property in excess of tax basis	1,331,000	624,000
Carrying values of property, plant and equipment in excess of tax basis	36,000	—
Others	60,000	87,000
<b>Total future income tax liability</b>	<b>1,427,000</b>	<b>711,000</b>
<b>Future income tax assets</b>		
Net operating losses carried forward – U.S.A.	647,000	720,000
Net operating losses carried forward – Canada	7,754,000	4,904,000
Research and development expenditures	6,996,000	4,345,000
Carrying values of property, plant and equipment below tax basis	—	132,000
Financing fees and share issue costs	420,000	544,000
Total future income tax assets	15,817,000	10,645,000
Valuation allowance	14,390,000	9,934,000
Net future income tax assets	1,427,000	711,000
<b>Net future income taxes</b>	<b>—</b>	<b>—</b>

## Notes to Consolidated Financial Statements (December 31, 2003)

### 11) Income taxes (CONT'D)

i) The Company has accumulated loss carry-forwards for Federal and Québec purposes, which are available to reduce future taxable income. The tax benefit of \$2,681,000 of these losses has been recognized in these financial statements as a future income tax asset. These loss carry-forwards expire as follows:

	Federal	Québec
	\$	\$
2004	980,000	980,000
2005	2,130,000	2,130,000
2006	3,134,000	3,134,000
2007	2,227,000	2,204,000
2008	6,276,000	6,104,000
2009	4,678,000	4,592,000
2010	5,698,000	5,521,000
	<u>25,123,000</u>	<u>24,665,000</u>

ii) The Company has accumulated net operating loss carry-forwards in the US of \$1,577,000. The tax benefit of \$1,389,000 of these losses has been recognized in these financial statements as a future income tax asset.

iii) The Company has approximately \$20,329,000 of research and development expenditures available for Federal tax purposes and \$28,079,000 for Québec tax purposes that are available to reduce taxable income in future years and have an unlimited carryforward period, the tax benefit of which has not been reflected in these financial statements.

### 12) Capital stock

#### Authorized

##### Common Shares

An unlimited number of common shares.

##### First Preferred Shares

An unlimited number of non-voting First Preferred Shares without par value, shall be issuable in series and the Board of Directors of the Company shall have the right, to fix the number of, and to determine the rights and conditions attaching to these shares.

##### Second Preferred Shares

An unlimited number of non-voting Second Preferred Shares without par value, shall in all respects be subject to and subordinate to the rights and conditions attaching to the First Preferred Shares.

#### Issued and outstanding

##### First Preferred Shares Series 1

On January 4, 2002, the Company issued 4,000,000 First Preferred Shares, Series 1 for a total consideration of \$4,000,000. From January 1, 2004 to December 31, 2006, the holder of these shares may elect (i) to convert them into common shares at two times the market price on the date of conversion, or (ii) to require the Company to redeem them for cash, in which case the Company must redeem the shares if it has received sufficient cash to do so, pursuant to a licensing agreement with the holder, and, if not, the Company may convert such shares at the market price at the date of conversion. If no election is made prior to December 31, 2006, the Company may redeem the shares on or prior to January 30, 2007 for cash or convert them into common shares at the market price on the date of conversion. Since these shares are retractable, they are presented as a long-term liability on the balance sheet. Determination of the fair value of these preferred shares is not practicable as, under the terms and conditions of these shares various alternatives are available to the holder.

##### Common shares

	Number of shares	Stated capital \$
<b>Balance as at December 31, 2001</b>	45,114,008	33,498,087
Issued on conversion of Units	6,897,600	9,173,808
Unit issuance costs – cash	—	(993,126)
Unit issuance costs – broker compensation warrants	—	(217,008)
Issued for cash on exercise of options	400,100	410,860
Repayment of shareholder loans	—	300,000
<b>Balance as at December 31, 2002</b>	52,411,708	42,172,621
Issued on conversion of Units	7,844,445	3,137,778
Issued in exchange for shares of Pharmacor Inc.	6,999,996	2,800,000
Unit issuance costs – cash	—	(276,386)
Issued for cash on exercise of options	79,750	40,163
<b>Balance as at December 31, 2003</b>	<u>67,335,899</u>	<u>47,874,176</u>

## Notes to Consolidated Financial Statements (December 31, 2003)

### 12) Capital stock (CONT'D)

On April 17, 2003, the Company issued 6,999,996 common shares in exchange for 100% of the outstanding common shares of Pharmacor Inc. In addition, the Company completed a concurrent \$3,250,000 financing by way of a private placement of 7,222,223 Units at \$0.45 each before cash expenses. Each Unit consists of one Procyon common share and 0.4153845 common share purchase warrant, with each whole common share purchase warrant entitling the holder to purchase one additional common share for a period of two years from the date of filing of an IND ["Investigational New Drug"] of Pharmacor's lead compound, at a price per common share equal to the greater of \$0.45 and the market price of the Company's common shares immediately prior to the IND filing. Also on April 17, 2003, a creditor of Pharmacor purchased an additional 622,222 Units on the same terms and conditions, for proceeds of \$280,000.

On May 10, 2002, the Company issued 6,897,600 Units at \$1.45 each for total cash proceeds of \$10,001,520, before issue expenses. Each Unit consisted of one common share and one-half common share purchase warrant for a total of 3,448,800 common share purchase warrants. Each whole common share purchase warrant entitles the holder to purchase one additional common share for \$1.75 up to November 10, 2003. These warrants expired unexercised. In addition to the cash commission paid and other issue costs totaling \$1,082,731, the Company has granted to the underwriters broker compensation warrants to purchase up to 482,832 Units which may be exercised at an exercise price of \$1.45 per Unit, if exercised at any time before May 10, 2003, and at \$1.595 per Unit if exercised at any time on or after May 10, 2003 but before May 10, 2004. An estimated fair value of \$236,588, determined using the Black-Scholes option pricing model with a volatility of 62%, a risk-free interest rate of 5%, a dividend yield of nil and an expected life of 2 years, was attributed to these broker compensation warrants and was recorded as an increase in contributed surplus, with reductions of \$217,008 and \$19,580 to the Common shares and the Warrants respectively.

#### Employee share purchase loan program

In 2000, the Company implemented an employee share purchase loan program. Key employees were permitted to participate in the 2000 Special Warrant Offering through share purchase loans. Loans were limited to a maximum of \$100,000 to any one individual and related, for each loan, to the purchase of 38,168 special warrants at \$2.62 each. These loans are non-interest bearing and are collateralized by the underlying common shares. As at December 31, 2003, the shares had a market value of approximately \$56,500 and two of these loans totaling \$200,000 were outstanding to officers and directors. The loans are due on April 11, 2013 and can be repaid at any time and must be repaid in full when the market price of the common shares reaches \$2.65 for ten consecutive trading days, or upon termination of the borrowers' employment with the Company, subject to certain conditions.

#### Stock option plan

The Company has a stock option plan for employees, directors, officers, consultants and members of the advisory board of the Company. As of December 31, 2003, the maximum number of common shares to be issued pursuant to the stock option plan is 6,645,865. Options granted to employees and officers vest over two years and expire three years [five years prior to 2001] from the grant date. Generally, options granted to directors vest immediately.

	2003		2002	
	Number	Weighted average exercise price \$	Number	Weighted average exercise price \$
Options outstanding, beginning of year	3,765,300	1.29	3,958,932	1.34
Granted	506,500	0.41	587,500	0.81
Forfeited	(264,900)	0.70	(180,000)	1.33
Expired	(288,650)	1.00	(201,032)	1.46
Exercised	(79,750)	0.50	(400,100)	1.03
Options outstanding, end of year	3,638,500	1.25	3,765,300	1.29
<b>Exercisable</b>	<b>3,050,167</b>	<b>1.37</b>	<b>2,771,134</b>	<b>1.48</b>

Effective January 1, 2003, the Company began prospectively recording compensation expense for awards granted to employees.

An amount of \$35,517 was recorded as an expense and credited to contributed surplus on April 1, 2003, representing the fair value of stock options granted to an officer of the Company in lieu of a cash bonus payment, determined using the Black-Scholes option pricing model with a volatility of 61%, a risk-free interest rate of 3% a dividend yield of nil and an expected life of the option of 3 years. An additional amount of \$17,445 was recorded as an expense and was credited to contributed surplus in 2003 for the fair value of stock options granted to other employees, also determined using the Black-Scholes option pricing model, with a volatility of approximately 60%, a risk-free interest rate of 3% to 4%, a dividend yield of nil and an expected life of the option of 3 years.

Had compensation cost for 2002 been determined based on the fair value of options as of the date of grant using the Black-Scholes option pricing model, using a volatility factor of 63%, a risk-free interest rate of 4%, a dividend yield of nil and a weighted-average expected life of the options of 3 years and had the fair value been amortized over the vesting period of the options, the Company's net loss and basic and diluted loss per common share for each of the past two years would have been as follows:

## Notes to Consolidated Financial Statements (December 31, 2003)

### 12) Capital stock (CONT'D)

	2003	2002
	\$	\$
Net loss – as reported	(10,719,002)	(6,877,384)
Pro forma stock-based compensation	(60,070)	(26,111)
Net loss – pro forma	(10,779,072)	(6,903,495)
Loss per share – basic and diluted – as reported	(0.17)	(0.14)
Loss per share – basic and diluted – pro forma	(0.17)	(0.14)

The weighted-average grant-date fair value of options granted in 2003 was \$0.17 (2002 - \$0.37).

Additional information concerning stock options outstanding as at December 31, 2003 is as follows:

Price range \$	Options outstanding			Options exercisable	
	Number of outstanding options	Weighted average months remaining	Weighted average exercise price \$	Number of exercisable options	Weighted average exercise price \$
0.30 to 0.44	505,000	15	0.34	225,000	0.35
0.45 to 0.57	724,000	18	0.50	605,667	0.50
0.75 to 1.00	488,000	19	0.93	388,000	0.91
1.05 to 1.30	289,000	19	1.09	199,000	1.11
1.85 to 2.15	1,632,500	9	1.98	1,632,500	1.98
0.30 to 2.15	3,638,500	14	1.25	3,050,167	1.37

#### Warrants

	Number of common shares reserved for issuance	
		\$
<b>Balance as at December 31, 2001</b>	5,470,625	233,687
Issued on conversion of Units	3,448,800	827,712
Unit issuance costs	—	(109,185)
Broker warrants for Units	482,832	—
Warrants from Broker Units	241,416	—
<b>Balance as at December 31, 2002</b>	9,643,673	952,214
Issued on conversion of Units	3,258,461	392,222
Unit issuance costs - cash	—	(41,325)
Issued in connection with Pharmacor acquisition	150,000	7,443
Issued to Investissement Québec [NOTE 9]	1,503,759	392,952
Expired warrants	(7,584,996)	(952,214)
<b>Balance as at December 31, 2003</b>	6,970,897	751,292

	Expiry date	Common share equivalent
Oncologic warrants i)	September 30, 2007	1,575,845
Broker warrants for Units issued May 10, 2002 ii)	May 10, 2004	482,832
Private placement April 17, 2003 iii)	See note below	3,258,461
Warrants relating to Pharmacor acquisition iv)	April 17, 2006	150,000
Investissement Québec warrants [NOTE 9]	February 6, 2008	1,503,759
		6,970,897

- i) In September 1997, warrants were issued to the former shareholders of Oncologic to purchase 1,575,845 common shares upon the achievement of certain milestones. The warrants expire on September 30, 2007 and are exercisable, subject to prior vesting, at \$0.01 per share 60 days after the acceptance of an Investigational New Drug application for the ANSA technology by the United States Food & Drug Administration.
- ii) On May 10, 2002, the Company granted to the underwriters broker compensation warrants to purchase up to 482,832 Units at \$1.595 per unit [\$1.45 prior to May 10, 2003], also as discussed under "Common shares". The value of these compensation warrants was recorded in contributed surplus.
- iii) On April 17, 2003, warrants were issued to purchase 3,258,461 common shares for a period of two years from the date of filing of an IND of Pharmacor's lead compound at a price per common share equal to the greater of \$0.45 and the market price of the Company's common shares immediately prior to the IND filing. These warrants will expire on April 17, 2005, if an IND has not been filed by that date.
- iv) Also on April 17, 2003, the Company issued warrants to purchase an additional 150,000 common shares at an exercise price of \$1.35 per common share. These warrants, which were issued in connection with the acquisition of Pharmacor, expire on April 17, 2006 and are recorded at \$7,443, based on their fair value at the date of issue using the Black-Scholes option pricing model with a volatility factor of 61%, a risk-free interest rate of 3%, a dividend yield of nil and an expected life of 3 years.

## Notes to Consolidated Financial Statements (December 31, 2003)

### 12) Capital stock (CONT'D)

#### Contributed surplus

	\$
<b>Balance as at December 31, 2001</b>	862,000
Options issued to consultants i)	51,400
Compensation warrants issued to underwriters [see "Common shares"]	236,588
Amendment to terms of common share purchase warrants ii)	350,000
<b>Balance as at December 31, 2002</b>	1,499,988
Options issued to consultants i)	45,000
Options granted to employees	52,962
Warrants expired in 2003 [see "Warrants"]	952,214
<b>Balance as at December 31, 2003</b>	2,550,164

- i) During 2002, the Company issued options, expiring in 2005, to consultants to purchase 200,000 common shares at a price of \$1.00 and 25,000 common shares at a price of \$0.57 in consideration for services rendered. These options are included in the table under the stock option plan above. Management has estimated the fair value of these options using the Black-Scholes option pricing model, with a volatility factor of 63% and a risk free interest rate of 4%, a dividend yield of nil and an estimated life of 3 years to be approximately \$96,400. This amount has been recorded as an expense over the vesting period with an amount of \$51,400 reported in 2002 and \$45,000 in 2003.
- ii) On April 5, 2002, the Company amended the terms of the common share purchase warrants issued on July 31, 2000, resulting in an increase of \$350,000 in contributed surplus, based on the fair value of the warrants using the Black-Scholes option pricing model with a volatility of 59% a dividend yield of nil and a risk-free interest rate of 5% for the additional one year life.

#### Diluted earnings per share

No options or warrants outstanding at December 31, 2003 and 2002 were included in the calculation of diluted earnings per share, as all such securities would be anti-dilutive. Common shares granted subject to share purchase loans were also excluded since they would also have been anti-dilutive.

### 13) Commitments and guarantees

The Company is committed under operating leases for premises and equipment in the following amounts:

	\$
2004	266,332
2005	169,969
2006	67,662
2007	65,006
2008	67,650
2009 and thereafter	112,750
	749,369

The Company periodically enters into research agreements or strategic alliances with third parties that include indemnification provisions that are customary in the industry. These guarantees generally require the Company to compensate the other party for certain damages and costs incurred as a result of third party intellectual property claims or damages arising from these transactions. In some cases, the maximum potential amount of future payments that could be required under these indemnification provisions is not limited. These indemnification provisions generally survive termination of the underlying agreement. The nature of the intellectual property indemnification obligations prevents the Company from making a reasonable estimate of the maximum potential amount it could be required to pay. Historically, the Company has not made any indemnification payments under such agreements and no amount has been accrued in these consolidated financial statements with respect to these indemnification obligations.

### 14) Segmented information

The Company operates in only one segment, which is the sector related to the development and commercialization of diagnostic and therapeutic drugs. All revenues were earned in Canada, substantially all operations are carried out in Canada and all assets, with the exception of certain intellectual property, are located in Canada.

Information by geographic segment is as follows:

	2003	2002
	\$	\$
<b>Intellectual property</b>		
Canada	5,622,947	2,816,587
United States	1,682,890	1,905,240
	7,305,837	4,721,827

## Notes to Consolidated Financial Statements (December 31, 2003)

### 15) Financial instruments

#### i) Fair Values

##### Short-term financial assets and liabilities

The carrying amounts of cash and cash equivalents, short-term investments, accounts receivable, investment tax credits recoverable and accounts payable are a reasonable estimate of their fair values because of the short maturity of these instruments. The effective rate of return on cash equivalents and short-term investments is approximately 2.9% [December 2002 – 2.6%].

##### Long-term financial liabilities

The fair value of the BioLevier loan facility approximates its carrying value due to the variable nature of the interest rate.

The fair value of the convertible debenture using a 9.5% discount rate is estimated at \$11,000 [\$10,000 in 2002].

#### ii) Concentration of credit risk

Investment tax credits recoverable are due from the Québec government. The cash and cash equivalents are held with two Canadian chartered banks. The short-term investments are held in commercial paper of seven major corporations and one banker's acceptance [2002 – seven investments in commercial paper] and therefore do not represent a concentration of credit risk.

### 16) Government assistance

The Company incurred research and development expenditures that are eligible for investment tax credits. The investment tax credits recorded are based on management's estimates of amounts that are expected to be recovered and that are subject to audit by taxation authorities. The Company has also earned other non-repayable government assistance related to various research and development projects. These amounts have been recorded as a reduction of research and development expenses, and are as follows:

	Year ended December 31,	
	2003	2002
	\$	\$
Investment tax credits	1,332,062	1,232,981
Other government assistance	77,383	9,730

Investment tax credits earned in connection with certain research and development expenditures incurred in Québec are fully refundable. The non-refundable portion of the Federal investment tax credits earned can be applied against taxes payable in future years, and the Company has accumulated investment tax credits of approximately \$3,998,000. The benefit of these tax credits has not been reflected in these financial statements. These investment tax credits expire as follows:

	\$
2006	4,000
2007	56,000
2008	366,000
2009	305,000
2010	297,000
2011	998,000
2012	624,000
2013	1,348,000
	3,998,000

### 17) Net change in non-cash balances relating to operations

The net change in non-cash working capital balances relating to operations represents the following:

	2003	2002
	\$	\$
<b>Decrease (increase) in:</b>		
Accounts receivable	175,808	4,921
Investment tax credits recoverable	866,164	911,064
Prepaid expenses	(60,249)	(19,543)
	981,723	896,442
<b>Increase (decrease) in:</b>		
Accounts payable and accrued liabilities	(1,104,505)	(480,575)
Deferred revenue	(10,600)	(62,400)
	(133,382)	353,467

### 18) Comparative figures

Certain comparative figures have been reclassified to conform to the presentation adopted in the current year.

## BOARD OF DIRECTORS

### Hans J. Mäder

Chairman of the Board, President and  
Chief Executive Officer  
Procyon Biopharma Inc.

### Chandra J. Panchal, M.Sc., Ph.D.

Senior Executive Vice-President,  
New Technologies and Preclinical Research, Procyon Biopharma Inc.

### Bernard Coupal, Ph.D.

President, Gestion T<sup>2</sup>C<sup>2</sup> / Bio Inc.

### Hans C. Fluehler

Chief Executive Officer, The Canfhel Group

### Phil Gold, C.C., O.Q, M.D., Ph.D.

Executive Director, Clinical Research Centre  
The Montreal General Hospital –  
McGill University Health Centre

### Jose Larrea

Vice-President, Life Sciences, Desjardins Venture Capital

### Max Link, Ph.D.

Former Pharmaceutical Executive,  
Professional Director

### Iain MacInnes

Vice-President, Branch Manager and Senior Investment Advisor,  
TD Waterhouse Investment Advice

## GENERAL INFORMATION

### AUDITORS

Ernst & Young LLP  
Montréal, Québec

### TRANSFER AGENTS

Computershare Trust Company of Canada  
Montréal, Québec

### LEGAL COUNSEL

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Montréal, Québec

### INVESTOR RELATIONS

Christian Marcoux, M.Sc.  
Director, Communications  
ir@procyonbiopharma.com

### ANNUAL GENERAL AND SPECIAL MEETING

Thursday, June 17th, 2004 at 10:30 A.M.  
Centre Mont-Royal, International Room  
2200 Mansfield Street, Montréal, Québec

### STOCK LISTING

Toronto Stock Exchange (TSX)  
Ticker symbol: PBP

A copy of the Company's Annual Information Form and Annual Report may be obtained by writing to the head office of the Company located at 1650 Trans-Canada Highway, Suite 200, Dorval, Québec, H9P 1H7 or by faxing requests to (514) 685-5138.

Ce rapport annuel est également disponible en français.

## MANAGEMENT TEAM



**HANS J. MÄDER**  
Chairman,  
President and  
Chief Executive Officer



**CHANDRA J. PANCHAL, M.Sc., Ph.D.**  
Senior Executive  
Vice-President,  
New Technologies and  
Preclinical Research



**JAMES W. SUTTON, M.D.**  
Vice-President, Clinical  
Research and  
Regulatory Affairs



**MONIQUE LÉTOURNEAU, M.Sc., CFA**  
Executive  
Vice-President, Finance  
and Chief Financial  
Officer



**DANIEL C. BÖCK, Ph.D.**  
Vice-President,  
Business Development  
and Licensing



**RICHARD LA RUE, LL.L., D.D.N.**  
Vice-President,  
Legal Affairs,  
Human Resources and  
Corporate Secretary



**BRIAN L. DAVIES, CA**  
Director, Finance  
and Controller

