



**2007**  
Annual Report  
May 31, 2007

Nexia Biotechnologies Ltd.

September 27, 2007

Dear Shareholders:

On behalf of the Management and Directors of Nexia, I am pleased to report our financial results for the year ending May 31, 2007 and provide a current update on operations.

During the year, Nexia completed a corporate reorganization with Enseco Energy Services Corp. ("Enseco") resulting in 2,125,000 shares of Enseco and 24,032,539 shares of Nexia being distributed pro-rata to shareholders. Nexia's present asset base consists of the BioSteel® program, 1,715,975 shares of PharmAthene (AMEX: PIP), and working capital derived from our recent loan transaction. Nexia's management is focused on three primary objectives: (1) The outsourcing of BioSteel® research, development and manufacturing activities, thereby preserving cash resources. (2) Diversifying our investment asset portfolio away from current 100% exposure to PharmAthene, and (3) deployment of our working capital in a manner which best takes advantage of managements' expertise in biotech corporate reorganization.

On August 28, 2007, we entered into an agreement with the University of Wyoming ("UOW"). In addition to covering the cost of BioSteel manufacturing, UOW will conduct research into biomedical devices, sports equipment and protective equipment. We will share equally in any licensing or royalty revenue derived from this initiative. A second transgenic goat herd will be established at UOW and UOW will contribute towards the maintenance of the Canadian herd until the second herd is in place. To date no commercial application has been identified for BioSteel. We continue to pursue the BioSteel® opportunity and our outsourcing initiatives will keep the program alive and yet allow us to reduce the amount of financial resources allocated to BioSteel®.

Also on August 28, 2007 PharmAthene announced that the Delaware Chancery Court had determined that its merger with Healthcare Acquisition Corp. was valid. Nexia now holds 1,715,945 shares of PharmAthene which are subject to escrow and share sale restrictions. 50% of our shares will become free trading in February 2008 and another 50% six months later. Approximately 165,000 shares are also held in escrow and are subject to certain closing conditions expiring in August 2008.

The Board of Directors has determined to diversify the investment portfolio, in order not to be exposed to one, illiquid, share position. To this extent, we entered into a US\$5 million dollar loan agreement, which provides Nexia with liquidity in which to broaden its investments. The loan is secured against all of our assets and bears interest at 7.5% annually. We will use the loan proceeds to diversify our investments and to provide Nexia with additional revenue and value opportunities. On September 24, 2007 the Biomerger Industries Ltd. share acquisition has deployed \$4.4 million of the loan proceeds. Management is confident that this investment will result in positive returns to Nexia in fiscal 2008.

On behalf of the Board of Directors I would like to thank our management team, consultants, corporate advisors and shareholders for their support over the past year. We look forward to an eventful and profitable year ahead.

Sincerely,



David L. Tonken  
President, CEO & Chairman of the Board

## SELECTED FINANCIAL INFORMATION\*

<i>(in Canadian dollars)</i> <b>Statement of operations data</b>	2007	2006	2005
	May 31		
	12-months	12-months	9-months
<b>Revenues</b>			
Contract revenues .....	—	—	414,578
Interest income.....	51,393	56,142	116,528
BioSteel sales.....	8,288	—	13,237
	<u>59,621</u>	<u>56,142</u>	<u>544,343</u>
<b>Expenses</b>			
Research and development.....	157,854	74,677	2,228,489
Investment tax credits .....	(285,355)	—	(438,606)
<b>Net research and development.....</b>	<b>(127,501)</b>	<b>74,677</b>	<b>1,789,883</b>
Business development.....	182,097	79,186	1,441,034
Administrative .....	478,097	504,651	1,033,070
Amortization .....	5,694	12,832	389,840
Write-down of property plant and equipment .....	—	—	63,912
Financing costs .....	51,523	—	—
Foreign exchange loss (gain) .....	(163,923)	—	6,553
Loss (Gain) on sale of assets.....	—	—	(15,959,353)
Accretion of interest term loan.....	93,258	—	—
Interest on term loan .....	31,497	—	9,251
Total expenses	<u>550,742</u>	<u>671,346</u>	<u>(11,225,810)</u>
<b>Net income (loss) .....</b>	<b>(491,121)</b>	<b>(615,204)</b>	<b>11,770,153</b>
Weighted average number of shares outstanding during the period .....	<u>24,032,639</u>	<u>24,032,639</u>	<u>23,383,763</u>
<b>Basic and diluted net earnings (loss) per share.....</b>	<b>(0.02)</b>	<b>\$ (0.03)</b>	<b>\$ 0.50</b>

As at May 31	2007	2006	2005
<b>Balance sheet data*</b>			
Cash and cash equivalents.....	\$ 5,487,979	\$ 1,576,551	\$ 967,674
Short-term investments .....	—	—	1,705,077
Current assets .....	5,588,950	1,670,685	3,167,456
Total assets.....	14,617,414	10,102,520	11,663,983
Total long term liabilities .....	5,439,103	—	—
Total liabilities .....	5,560,698	445,179	554,082
<b>Shareholders' equity</b>			
Capital stock .....	1	1	47,543,638
Contributed surplus.....	47,296,337	47,296,337	502,700
Deficit .....	(38,239,622)	(37,638,997)	(36,936,437)
<b>Total shareholders' equity.....</b>	<b>\$ 9,056,716</b>	<b>\$ 9,657,341</b>	<b>\$ 11,109,901</b>

\*Above information should be read in conjunction with the financial statements, related financial statement notes and ensuing Management's Discussion and Analysis of Financial Condition and Results of Operations.

### **Basis of Presentation [see Note 1 of the financial statements]**

Under the Emerging Issues Committee - EIC 89 - *Exchanges of Ownership Interests Between Enterprises Under Common Control-Wholly and Partially-Owned Subsidiaries*, Nexia is required to prepare its financial statements using the continuity of interests method of accounting. Accordingly, the financial statements of Nexia reflect the assets and liabilities of the transferred business, the biotech operations, at their book value as reported in the financial statements of Nexia Biotechnologies Inc. ("Old Nexia"). This method of accounting also requires that the results of operations presented in the financial statements of Nexia include the operations of Old Nexia and Nexia pertaining to the biotech operations for the entire fiscal period in which the transfer took place. In addition, the financial statements of Nexia presented for the prior year were restated to reflect the financial position and the results of operations as if Nexia and Old Nexia, with respect to the biotech related operations, had been combined since their inception. In accordance with the continuity of interests method, the new shares of the Company were valued at a nominal amount and the net carrying value of the net assets of the biotech operations, excluding the accumulated deficit, was presented as contributed surplus amounting to \$47,296,337 as at May 31, 2006. In 2005, Nexia changed its year end from August 31 to May 31 and the corresponding period has 9 months presented.

## MANAGEMENT'S DISCUSSION & ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

*(in Canadian dollars except if otherwise indicated)*

The following analysis explains the variations in results of operations, financial position and cash flows for *Nexia Biotechnologies Ltd.* ("Nexia" or the "Company") for the year ended May 31, 2007. The information is current as at September 27, 2007. Additional information relating to Nexia can be found on SEDAR at [www.sedar.com](http://www.sedar.com).

### Forward-Looking Statements

Some of the statements contained in this Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") constitute forward-looking statements. These statements relate to future events or to Nexia's future financial performance and involve known and unknown risks, uncertainties and other factors that may cause Nexia's actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements.

### Description of Business

Nexia Biotechnologies Ltd., formerly 6539718 Canada Inc. ["Nexia" or the "Company"], was incorporated under the Canada Business Corporations Act on March 06, 2006, as a wholly owned subsidiary of Nexia Biotechnologies Inc. ["Old Nexia"] which invested \$1 for 100% of the common shares of the Company, for the purpose of participating in a Plan of Arrangement [the "Arrangement"] among Nexia, Old Nexia, Enseco Energy Services Corp. ["Enseco"], Enseco Management Corp., Old Nexia shareholders and Enseco shareholders. Pursuant to the Arrangement, Nexia issued 24,032,539 new common shares to the Old Nexia shareholders in exchange for all of the preferred shares of Old Nexia. Concurrently, in satisfaction of the redemption of its preferred shares owned by Nexia, Old Nexia transferred to Nexia its net assets. On October 23, 2006, as a result of the Arrangement, the following net assets were transferred from Old Nexia to Nexia, at net carrying value:

	\$
Cash and cash equivalents	981,214
Accounts receivable	302,500
Prepaid expenses and other	281,426
Capital assets	2,937
Investment in PharmAthene	8,182,000
Accounts payable and accrued liabilities	(82,581)
	<u>9,667,496</u>

Nexia did not carry on any active business from the date of its incorporation to October 23, 2006, the date of the completion of the Arrangement. On October 24, 2006, Nexia changed its name from 6539718 Canada Inc. to Nexia Biotechnologies Ltd. Nexia became a reporting issuer in October 2006 and obtained a listing on the CNQ stock exchange in January 2007.

Following the completion of the Arrangement, Nexia carries on substantially the same business carried on by Old Nexia prior to the completion of the Arrangement and is a biotechnology company engaged in the business of developing recombinant proteins in the form of Bio Steel ® biomaterial. The former officers and directors of Old Nexia became the management team of Nexia.

Detailed information concerning the Arrangement may be obtained by reviewing the materials filed by Nexia Biotechnologies Ltd., Nexia Biotechnologies Inc. and Enseco Energy Services Corp. at [www.sedar.com](http://www.sedar.com).

Nexia also currently holds approximately 7.2% of the shares of PharmAthene Inc. (“PharmAthene”), a US based pharmaceutical company and approximately 80% of the equity shares of Biomerger Industries Ltd., a corporation that trades on NEX under the symbol BIL.H.

### **Basis of Presentation**

Under the Emerging Issues Committee - EIC 89 - Exchanges of Ownership Interests Between Enterprises Under Common Control-Wholly and Partially-Owned Subsidiaries, Nexia is required to prepare its financial statements using the continuity of interests method of accounting. Accordingly, the financial statements of Nexia reflect the assets and liabilities of the transferred business, the biotech operations, at their book value as reported in the financial statements of Old Nexia. This method of accounting also requires that the results of operations presented in the financial statements of Nexia include the operations of Old Nexia and Nexia pertaining to the biotech operations for the entire fiscal period in which the transfer took place. In addition, the financial statements of Nexia presented for the prior year were restated to reflect the financial position and the results of operations as if Nexia and Old Nexia, with respect to the biotech related operations, had been combined since their inception.

In accordance with the continuity of interests method, the new shares of the Company were valued at a nominal amount and the net carrying value of the net assets of the biotech operations, excluding the accumulated deficit, was presented as contributed surplus amounting to \$47,296,337 as at May 31, 2006. The following information should be read in conjunction with Nexia’s audited annual financial statements and notes included therewith, which are prepared in accordance with Canadian generally accepted accounting principles for interim financial statements.

### **Developments in the Current Year**

In January 2007, Nexia’s shares began trading on the CNQ, under the symbol NXBL. For information on CNQ, shareholders may wish to visit the CNQ website at [www.cnq.ca](http://www.cnq.ca).

Also in January 2007, PharmAthene announced a merger proposal with Health Care Acquisition Corp. [“HAQ”], a U.S. Special Purpose Acquisition Corporation with over \$65 million in cash assets. In August 2007, PharmAthene announced that the stockholders of HAQ had approved the proposed merger of HAQ and PharmAthene. PharmAthene has further announced that a certificate of merger has been filed, that the name of the merged company is PharmAthene Inc. and that the common shares of PharmAthene are presently trading on the AMEX Exchange under the symbol “PIP”. Further information with respect to this merger is available in the Proxy Statement and related materials filed by HAQ and PharmAthene. These materials may be found at [www.sec.gov](http://www.sec.gov). Nexia presently holds 1,715,945 shares of PharmAthene. The Proxy Statement also provides details of the lock-up agreement which restricts the sale of 50% of PharmAthene shares held by Nexia for six months, after closing and the remaining 50% for twelve months after the closing, and the potential of a US\$1.3 million milestone payment to be paid to Nexia under certain conditions if an award, procurement or contract for Valortim™ occurs prior to December 31, 2007.

In May 2007, the Board of Directors determined to diversify Nexia’s investment portfolio such that Nexia would not be exposed to one, illiquid, share position in PharmAthene. To this extent, Nexia entered into a US\$5 million dollar term loan agreement, which provides Nexia with the ability to spread its investment risk.

Subsequent to the year end, Nexia announced on September 13, 2007 that it had entered into an agreement (the “Agreement”) to acquire all of the issued and outstanding shares of Cavalon Capital Partners Ltd. [“Cavalon”]. Cavalon’s primary asset was an investment agreement (the “Investment Agreement”) with Xillix Technologies Corp. [“Xillix”] [TSX: XLX] whereby Cavalon had the exclusive right to invest the sum of \$4.4 million in Xillix in consideration for voting and non-voting shares. Upon the closing of the Agreement, Nexia became Cavalon’s successor in interest to the Investment Agreement. The investment in Xillix was completed on September 24, 2007, and subsequently Xillix was renamed Biomerger Industries Ltd. (“Biomerger”). Biomerger trades on the NEX under the symbol BIL.H.

The head office of Nexia is located at 70 St. George's Crescent, Edmonton, Alberta T5N 3M7 and its registered office is located at 1000, 400 – 3rd Avenue S.W., Calgary, Alberta T2P 4H2.

## **Financial Review** *(see basis of presentation)*

### **Year ended May 31, 2007**

The loss for the year ended May 31, 2007 was \$491,000 (\$0.02 per share) compared to \$615,000 (\$0.03 per share) for the previous year. The fourth quarter loss was \$183,000 (\$0.01 per share) compared to \$182,000 for the previous year. Overall higher expenditures related to R&D operations, business development of \$182,000 and higher interest expenses of \$125,000, including \$93,000 of which were non-cash, were offset by the realization of prior year investment tax credits of \$285,000 and a net foreign exchange gain on term loan of \$164,000 related primarily to the US dollar denominated term loan.

### **Revenues**

Nexia had \$51,000 in interest revenues for the year ended May 31, 2007 compared to \$56,000 for the prior year. The fourth quarter interest revenues were \$23,000 compared to \$12,000 in the prior year as a result of higher cash balances. In addition, sales of BioSteel® samples generated \$8,000 in the last quarter of 2007, resulting in the total revenues of \$60,000 for the year.

### **Research and Development Expenses**

Research and development expenses for the year ended May 31, 2007 were \$158,000 compared to \$75,000 in the prior year. For the fourth quarter, the expenses were \$28,000 compared to \$52,000 in the prior year. Research and development expenditures relate to the maintenance of the BioSteel® goat herd and development consulting expenses. Consulting expense as well as goat maintenance costs increased in 2007.

### **Business Development Expenses**

Business development expenses for the year ended May 31, 2007 were \$182,000 compared to \$79,000 in the prior year. This reflects higher activity, consulting fees and bonuses paid in the current year. Expenses for the fourth quarter were \$35,000 compared to \$26,000 in the prior year.

### **Administrative Expenses**

Administrative expenses for the year ended May 31, 2007 were \$478,000 and in line with the \$505,000 expended in the prior year. For the fourth quarter, the expenses were \$133,000 compared to \$111,000 in the prior year. The administrative expenditures relate primarily to costs related to maintaining public company requirements, overseeing Nexia's investment in PharmAthene, CEO, CFO and Board of Directors salaries and fees as well as costs associated with maintaining Nexia's intellectual property.

### **Amortization Expense**

Amortization expense for the year ended May 31, 2007 was \$6,000 compared to \$13,000 in the prior year as a result of a depleted cost base. Quarterly expense was minimal.

### **Interest on Term Loan**

In May 2007, Nexia obtained a term loan from a US based investment fund. The loan bears interest at 6% per annum and Nexia is also responsible for the payment of 25% withholding taxes and, as a result, effectively the loan bears interest at 7.5%. On a quarterly basis, this will result in a payment of US\$93,750 of interest and withholdings. Interest and withholdings of US\$600,000 were deposited with the lender's trustee to cover these costs for the term of the loan.

### **Interest Accretion on Term Loan**

The term repayment options as described in Note 5 of the financial statements were concluded to be an embedded derivative and were recorded as such on the balance sheet at their fair value of US\$2,238,000 as at May 3, 2007. The embedded derivative was valued using a risk free interest rate of 4.18%, volatility factor at 78.4% and included all the repayment options in the valuation model. Going forward, the

embedded derivative will be revalued to fair value with any change in value included in the statement of operations. As at May 31, 2007, no change in value was identified, however, this monetary liability was translated to CDN\$2,393,000 as at May 31, 2007, using the year-end exchange rate.

The balance of US\$2,762,000 presented as long-term debt was derived by subtracting the value of the embedded derivative from the US\$5,000,000 balance and later adjusted for any accretion and foreign exchange fluctuation. As at May 31, 2007, CDN\$93,258 was accreted to long-term debt.

### ***Financing Costs***

Financing expenses of \$52,000, comprised of legal fees, were expensed during the last quarter.

### **Liquidity and Capital Resources**

Nexia had cash and cash equivalents and short-term investments of \$5.49 million at May 31, 2007 [see subsequent events]. In addition, Nexia had \$34,000 in other receivables.

During the last quarter, net \$4.9 million in term loan proceeds were invested in short-term government backed securities bearing interest currently at 4% per annum. The proceeds were net of US\$600,000 [CDN\$666,000] which was deposited with the lender's trustee to cover interest and withholding costs for the term of the loan.

The major uses of funds during the year ended May 31, 2007 related to cash used in operations of \$953,000 compared to \$1.09 million in 2006.

Nexia's surplus short-term liquidities are invested only in liquid, high-grade investment securities of the Canadian and US government, reputable corporations and banks, with varying terms to maturity, taking into account operating, investment, capital and cash-flow requirements. The Board of Directors of Nexia monitors compliance with the above described investment policy on a quarterly basis. Nexia does not have any asset backed commercial paper in its short-term investments.

Taking into consideration the nature of Nexia's operations, management believes that Nexia's existing working capital should be sufficient to finance operations and capital needs for approximately 18 months.

### **Off Balance Sheet Arrangements**

Nexia does not have any off balance sheet arrangements at May 31, 2007.

### **Related Party Transactions**

Nexia's related transactions are disclosed in Notes 8 and 10 of the financial statements.

### **Contractual Obligations**

Nexia's only significant contractual obligations consist of the term loan described in Note 5 of the financial statements and the investment transaction completed subsequent to the year end, described elsewhere in this MD&A and Note 10 of the financial statements.

### **Financial Instruments**

Nexia does not use currency or other hedging instruments.

### **Controls and Procedures**

#### ***Disclosure Controls and Procedures***

Nexia's Chief Executive Officer and Chief Financial Officer are responsible for establishing and maintaining Nexia's disclosure controls and procedures in order to provide reasonable assurance that all relevant information is recorded, processed, summarized and reported to them on a timely basis so that the appropriate decisions can be made regarding public disclosures.

The Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of Nexia's disclosure controls and procedures as at May 31, 2007 and have concluded that Nexia's disclosure controls and procedures were not fully effective due to a material weakness in Nexia's internal control over financial reporting described below under the heading "*Internal Controls Over Financial Reporting*".

### ***Internal Controls Over Financial Reporting***

The Chief Executive Officer and Chief Financial Officer have assessed the design of Nexia's internal controls over financial reporting as at May 31, 2007. Management has concluded that a material weakness existed in the design of internal controls over financial reporting during the year ended May 31, 2007. A material weakness is defined as a significant deficiency, or combination of significant deficiencies, in internal controls over financial reporting such that there is a reasonable possibility that a material misstatement of Nexia's annual or interim financial statements will not be prevented or detected on a timely basis. This weakness has resulted in a material misstatement in Nexia's interim financial statements.

In particular, management of Nexia has determined that Nexia's interim financial statements for the quarterly periods ended November 30, 2006 and February 28, 2007 should have been presented using the continuity of interests method of accounting under EIC 89 EIC 89 - Exchanges of Ownership Interests Between Enterprises Under Common Control-wholly and Partially-Owned Subsidiaries. This method of accounting requires that the results of operations presented in the financial statements of Nexia include the operations of Old Nexia and Nexia pertaining to the biotech operations for the entire fiscal period in which the transfer took place. In addition, the comparative financial statements of Nexia were restated to reflect the financial position and the results of operations as if Nexia and Old Nexia, with respect to the biotech related operations, had been combined since their inception.

Management of Nexia believes that the identified weakness was primarily a result of the complexity of the Plan of Arrangement transaction to which Nexia was a party. Management of Nexia is satisfied that any internal weaknesses regarding internal controls over financial reporting have now been remediated.

## **Critical Accounting Policies**

### **Use of Estimates**

The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires management to make estimates and assumptions particularly as they relate to the value of the investment in PharmAthene, the value of the derivative instrument and the investment tax credits. These estimates and assumptions affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and such differences could be significant.

### **Investments**

Equity investments where Nexia does not exercise significant influence, as is the case for the investment in PharmAthene, are accounted for by the cost method whereby earnings are recognized only to the extent that dividends are declared. Annually, or whenever events or changes in circumstances indicate, Nexia performs a review of its investment in PharmAthene to determine if there has been other than temporary impairment in value. Any impairment in the value of the investment results in a write-down, which is charged to income during the year.

### **Foreign Operations and Foreign Currency Transactions**

The underlying stock price of our PharmAthene investment of \$8.182 million is denominated in US dollars and as such is subject to fluctuation. Our term loan of US\$5 million will also be affected by the fluctuation in the US dollar. Since May 31, 2007, the US dollar has depreciated by approximately 5% resulting in an

additional unrealized gain of approximately \$250,000. The continued weakness of the US dollar will have a negative effect on our assets, offset somewhat by the positive effect on our liabilities.

## **New Accounting Pronouncements**

### **Accounting Changes**

Effective June 1, 2007, Nexia will adopt the new recommendations of the CICA Handbook Section 1506, Accounting Changes. Under these new recommendations, voluntary changes in accounting policy are permitted only when they result in the financial statements providing reliable and or relevant information, These recommendations also require changes in accounting policy to be applied retrospectively unless doing so is impracticable, require prior period errors to be corrected retrospectively, require enhanced disclosures about the effects of changes in accounting policies, estimates and errors on the financial statements, and require the disclosure of new primary sources of generally accepted accounting principles that have been issued but not yet effective. The impact that the adoption of this section will have on Nexia's financial statements will depend on the nature of future accounting changes and the required additional disclosure on Recent Accounting Pronouncements.

### **Capital Disclosures**

CICA Handbook Section 1535, Capital Disclosures, requires disclosure of an entity's objectives, policies and processes for managing capital, quantitative data about what the entity regards as capital and whether the entity has complied with any capital requirements and, if it has not complied, the consequences of such noncompliance. This standard is effective for interim and annual financial statements relating to fiscal years beginning on or after October 1, 2007, specifically June 1, 2008 for Nexia. Nexia has not yet determined the impact of the adoption of this change on the disclosure in its financial statements.

### **Financial Instruments Disclosures**

CICA Handbook Section 3862, Financial Instruments – Disclosures, increases the disclosures currently required that will enable users to evaluate the significance of financial instruments for an entity's financial position and performance, including disclosures about fair value. In addition, disclosure is required of qualitative and quantitative information about exposure to risks arising from financial instruments, including specified minimum disclosures about liquidity risk and market risk. The quantitative disclosures must also include a sensitivity analysis for each type of market risk to which an entity is exposed, showing how net income and other comprehensive income would have been affected by reasonably possible changes in the relevant risk variable. This standard is effective for interim and annual financial statements relating to fiscal years beginning on or after October 1, 2007, specifically July 1, 2008 for Nexia. Nexia has not yet determined the impact of the adoption of this change on the disclosure in its financial statements.

### **Financial Instruments Presentation**

CICA Handbook Section 3863, Financial Instruments – Presentation, replaces the existing requirements on presentation of financial instruments which have been carried forward unchanged to this new section. This standard is effective for interim and annual financial statements relating to fiscal years beginning on or after October 1, 2007, specifically June 1, 2008 for Nexia. Nexia has not yet determined the impact of the adoption of this change on the disclosure in its financial statements.

### **General Standards on Financial Statement Presentation**

CICA Handbook Section 1400, General Standards on Financial Statement Presentation, has been amended to include requirements to assess and disclose an entity's ability to continue as a going concern. The changes are effective for Nexia for interim and annual financial statements beginning on or after January 1, 2008. Nexia has not yet determined the impact of the adoption of this change on the disclosure in its financial statements.

## Subsequent Events

### Investment in PharmAthene

In August 2007, PharmAthene announced that the stockholders of Healthcare Acquisition Corp. [“HAQ”] approved the proposed merger of HAQ and PharmAthene. PharmAthene has further announced that a certificate of merger has been filed, that the name of the merged company is PharmAthene Inc. and that the common shares of PharmAthene are presently trading on the AMEX Exchange under the symbol “PIP”.

Nexia holds 1,715,975 shares representing approximately 7.2% of the merged entity. A lock-up agreement restricts the sale of 50% of PharmAthene shares for six months after closing and 50% for 12 months after closing. There exists the potential of a US\$1.3 million milestone payment to be paid to Nexia under certain conditions if an award, procurement or contract for Valortim™ occurs prior to December 31, 2007.

Further information with respect to this merger is available in the Proxy Statement and related materials filed by HAQ and PharmAthene. These materials may be found at [www.sec.gov](http://www.sec.gov).

### Investment in Cavalon and Xillix

On September 13, 2007, Nexia announced that it had entered into an agreement (the “Agreement”) to acquire all of the issued and outstanding shares of Cavalon Capital Partners Ltd. (“Cavalon”). The purchase price was \$333,390 and was satisfied by the issuance of 1,666,950 common shares of Nexia issued at a price of \$0.20 per share. Cavalon’s primary asset was an investment agreement (the “Agreement”) with Xillix Technologies Corp. (“Xillix”) {TSX: XLX} whereby Cavalon has the exclusive right to invest the sum of \$4,400,000 in Xillix in consideration for voting and non-voting shares. Upon the closing of the Agreement, Nexia became Cavalon’s successor in interest to the Investment Agreement and Nexia proceeded with the investment in Xillix. The investment in Xillix was completed on September 24, 2007 and as a result, the following has occurred.

- (a) Nexia has made a non-interest loan of \$4,400,000 to Xillix (the “Loan”); and
- (b) 94.5% of the Loan has been converted into 112,023,510 common shares of Xillix and 435,647,055 non-voting shares of Xillix, such that Nexia now holds 45% of the voting common shares of Xillix and 100% of the non-voting shares of Xillix, providing Nexia with the ownership of 80% of the total equity interests in Xillix.

Subsequently, Xillix changed its name to Biomerger Industries Ltd.

Pursuant to the Agreement, each of Mr. Matthews and Ms. Tonken acquired ownership of 833,475 Nexia Shares. As a result of this transaction, Mr. Matthews owns or controls 2,512,767 Nexia Shares representing 9.8% of the outstanding Nexia Shares and Ms. Tonken, who acts jointly or in concert with Mr. Matthews, owns or controls 1,833,475 Nexia Shares representing 7.1% of the outstanding Nexia Shares. The Nexia Shares issued to Mr. Matthews and Ms. Tonken will be held in escrow pending the completion of a future transaction between Xillix and a third party. If no such transaction is completed within 18 months from the closing of the Agreement, the Nexia Shares issued pursuant to the Agreement will be cancelled.

The Agreement was a related party transaction. The shareholders of Cavalon and the recipients of the shares are Greg Matthews a director of Nexia and the spouse of David Tonken, a director and officer of Nexia. The Agreement was approved by Nexia’s directors [excluding Mr. Tonken and Mr. Matthews] on the basis that it will provide Nexia with an opportunity to deploy its capital in a manner that may produce returns greater than those currently realized.

### Risks and Uncertainties

**Prospects for companies in the biotechnology industry generally may be regarded as uncertain given the nature of the industry and, accordingly, investments in biotechnology companies should be regarded as speculative. Nexia’s realization of its long-term potential will be dependent upon the**

successful development and commercialization of products currently under development. Nexia can make no assurance that these products will be developed successfully or receive regulatory approval. Nexia's product is currently in the research and development stages the riskiest stage for a company in the biotechnology industry. Nexia can make no assurance that its research and development programs will result in commercially viable products. To achieve profitable operations, Nexia, alone or with others, must successfully develop, introduce and market its products. To obtain regulatory approvals for the products being developed and to achieve commercial success, clinical trials must demonstrate that the products are safe for human use and that they demonstrate efficacy. Unsatisfactory results obtained from a particular study relating to a program may cause Nexia or its collaborators to abandon its commitment to that program. Nexia can make no assurance that any future animal or human test, if undertaken, will yield favorable results.

Nexia can make no assurance that any products based on its technology, if approved for marketing, will ever achieve market acceptance. These products, if successfully developed, will compete with a number of products manufactured and marketed by major companies, as well as new products currently under development by such companies and others. The degree of market acceptance of any of these products will depend on the efficacy and safety of the product candidates, their potential advantage over alternative products and treatment methods. Nexia can make no assurance that consumers in general will accept and utilize any of these products, and the lack of such market acceptance would have a material adverse effect on Nexia's business, financial condition and result of operations.

To date, Nexia has not recorded any revenues from the sale of products, other than samples sales, and there can be no assurance that significant additional losses will not occur in the near future or that Nexia will be profitable in the future.

A significant portion of Nexia's assets are invested in PharmAthene and Nexia can give no assurance that PharmAthene products can be successfully developed. The shares held in PharmAthene have sale restrictions which negatively impact their value. Any decline in the value of PharmAthene shares will have a significant negative impact on Nexia. In 2007, Nexia obtained a US\$5 million dollar loan which is secured by all of Nexia's assets. Nexia's ability to repay the loan is subject to the value of PharmAthene and the value of the investments made with the loan proceeds. Substantial decline in the value of these investments will impair Nexia's ability to repay the loan when it comes due.

## Selected Quarterly Information

(in thousands of Canadian dollars except per share amounts)

	2007				
	<i>Q1</i>	<i>Q2</i>	<i>Q3</i>	<i>Q4</i>	<i>YTD</i>
Revenues	6	9	11	31	56
Research & Development	52	52	26	28	158
Investment tax credits	-	(285)	-	-	(285)
Business Development	62	62	23	35	182
Administrative	74	131	140	133	478
Interest on long term debt		-	-	32	32
Interest accretion on term loan		-	-	93	93
Foreign exchange (gain) loss		-	-	(164)	(164)
Net (loss) income	(180)	47	(175)	(183)	(491)
Loss per share, Basic and diluted	(0.01)	0.001	(0.01)	0.011	(0.03)
	2006				
	<i>Q1</i>	<i>Q2</i>	<i>Q3</i>	<i>Q4</i>	<i>YTD</i>
Revenues	15	14	15	12	56
Research & Development	6	10	7	52	75
Investment tax credits	-	-	-	-	-
Business Development	17	10	26	26	79
Administrative	113	181	100	111	505
Interest on long term debt	-	-	-	-	-
Interest accretion on term loan	-	-	-	-	-
Foreign exchange (gain) loss	-	-	-	-	-
Net (loss) income	(125)	(190)	(118)	(182)	(615)
Loss per share, Basic and diluted	(0.006)	(0.008)	(0.007)	(0.009)	(0.03)

## Other MD&A Requirements

As at September 27, 2007, Nexia had 25,699,589 common shares and no stock options outstanding. Additional information about Nexia can be found on SEDAR at [www.sedar.com](http://www.sedar.com) and at Nexia's website at [www.nexiabiotech.com](http://www.nexiabiotech.com).

*Financial Statements*

**Nexia Biotechnologies Ltd.**

**[formerly 6539718 Canada Inc.]**

May 31, 2007 and 2006

## MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING

The accompanying consolidated financial statements of Nexia Biotechnologies Ltd. and all information presented in this annual report are the responsibility of management and have been approved by the Board of Directors of Nexia Biotechnologies Ltd.

These consolidated financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles. They include some amounts that are based on estimates and judgments. Management has determined such amounts on a reasonable basis to ensure that the financial statements are presented fairly in all material aspects. The financial information presented elsewhere in the annual report is consistent with that in the consolidated financial statements.

In order to ensure the accuracy and the objectivity of the information included in the consolidated financial statements, the Company's management maintains systems of internal accounting and administrative controls. Management is of the opinion that these controls provide reasonable assurance that the financial information is relevant, reliable and accurate and that the Company's assets are appropriately accounted for and adequately safeguarded.

The Board of Directors exercises its responsibility over the consolidated financial statements included in the annual report and over financial reporting and internal controls through the Company's Audit Committee. The Committee reports its findings to the Board for consideration when approving the consolidated financial statements for issuance to the shareholders. The Committee also considers, for review by the Board and approval by the shareholders, the appointment of the external auditors. Ernst & Young LLP, independent external auditors meet regularly with the Audit Committee to discuss audit activities, financial reporting issues and other related matters.

The consolidated financial statements have been audited on behalf of the shareholders by Ernst & Young LLP, in accordance with Canadian generally accepted auditing standards. Ernst & Young LLP has full and free access to the Audit Committee with respect to their findings concerning the fairness of the financial reporting and the adequacy of internal controls.



David L. Tonken  
President, CEO &  
Chairman of the Board



Dejan Ristic  
Chief Financial Officer

## AUDITORS' REPORT

To the Shareholders of  
**Nexia Biotechnologies Ltd.**

We have audited the balance sheets of **Nexia Biotechnologies Ltd.** (the "Company") as at May 31, 2007 and 2006 and the statements of operations, deficit and comprehensive loss and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at May 31, 2007 and 2006 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

*Ernst & Young LLP*

Montreal, Canada  
September 7, 2007  
Chartered Accountants  
[Except for note 10 [ii], which is as of September 24, 2007]

# Nexia Biotechnologies Ltd.

## BALANCE SHEETS

As at May 31

	2007	2006
	\$	\$
<b>ASSETS [note 5]</b>		
<b>Current</b>		
Cash and cash equivalents [note 5]	5,487,979	1,576,551
Accounts receivable	34,420	25,662
Prepaid expenses	66,551	68,472
<b>Total current assets</b>	<b>5,588,950</b>	<b>1,670,685</b>
Prepaid expenses and other assets	202,215	249,835
Restricted cash [note 5]	644,249	-
Investment in PharmAthene [notes 4 and 10]	8,182,000	8,182,000
	<b>14,617,414</b>	<b>10,102,520</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Current</b>		
Accounts payable and accrued liabilities	121,595	445,179
<b>Total current liabilities</b>	<b>121,595</b>	<b>445,179</b>
Derivative [note 5]	2,393,367	-
Term loan [note 5]	3,045,736	-
<b>Total liabilities</b>	<b>5,560,698</b>	<b>445,179</b>
<b>Shareholders' equity</b>		
Capital Stock [note 6]	1	1
Contributed surplus [note 1]	47,296,337	47,296,337
Deficit	(38,239,622)	(37,638,997)
<b>Total shareholders' equity</b>	<b>9,056,716</b>	<b>9,657,341</b>
	<b>14,617,414</b>	<b>10,102,520</b>

Subsequent events [note 10]

See accompanying notes

On behalf of the Board:



David L. Tonken  
Director



Gregory B. Matthews  
Director

**Nexia Biotechnologies Ltd.****STATEMENTS OF OPERATIONS, DEFICIT AND  
COMPREHENSIVE LOSS**

Year ended May 31

	2007	2006
	\$	\$
<b>REVENUES</b>		
Interest Income	51,393	56,142
Bio Steel® sales	8,228	-
	<u>59,621</u>	<u>56,142</u>
<b>EXPENSES</b>		
Total research and development	157,854	74,677
Investment tax credits <i>[note 7]</i>	(285,355)	-
Net research and development	(127,501)	74,677
Business development	182,097	79,186
Administrative	478,097	504,651
Amortization of capital assets	5,694	12,832
Financing costs <i>[note 5]</i>	51,523	-
Foreign exchange gain	(163,923)	-
Interest accretion on term loan <i>[note 5]</i>	93,258	-
Interest on term loan	31,497	-
	<u>550,742</u>	<u>671,346</u>
<b>Net loss and comprehensive loss</b>	<u>(491,121)</u>	<u>(615,204)</u>
<b>Deficit, beginning of year</b>	(37,638,997)	(36,936,437)
Adjustment to the carrying value of net assets transferred	(109,504)	(87,356)
<b>Deficit, end of year</b>	<u>(38,239,622)</u>	<u>(37,638,997)</u>
<b>Basis and diluted loss per share <i>[note 6]</i></b>	<u>(0.02)</u>	<u>(0.03)</u>
<b>Weighted average number of shares outstanding during the year</b>	<u>24,032,639</u>	<u>24,032,639</u>

*See accompanying notes*

**Nexia Biotechnologies Ltd.**

**STATEMENTS OF CASH FLOWS**

Year ended May 31

	2007 \$	2006 \$
<b>OPERATING ACTIVITIES</b>		
Net loss for the year	(491,121)	(615,204)
Add (deduct) items not involving cash:		
Amortization of capital assets	5,694	12,832
Interest accretion on term loan <i>[note 5]</i>	93,258	-
Unrealized foreign exchange gain	(163,195)	-
	<u>(555,364)</u>	<u>(602,372)</u>
Net change in non-cash working capital balances		
Related to operations	(379,999)	(492,003)
<b>Cash flows relating to operating activities</b>	<u>(953,363)</u>	<u>(1,094,375)</u>
<b>INVESTING ACTIVITIES</b>		
Acquisition of capital assets	-	(1,826)
Purchase of short-term restricted investments <i>[note 5]</i>	(666,209)	-
Redemption of short term investment	-	1,705,077
<b>Cash relating to investing activities</b>	<u>(666,209)</u>	<u>1,703,251</u>
<b>FINANCING ACTIVITIES</b>		
Term loan <i>[note 5]</i>	5,531,000	-
Issuance of common shares	-	1
<b>Cash flows relating to financing activities</b>	<u>5,531,000</u>	<u>1</u>
<b>Net change in cash and cash equivalents during the year</b>	<b>3,911,428</b>	<b>608,877</b>
Cash and cash equivalents, beginning of year	<u>1,576,551</u>	<u>967,674</u>
<b>Cash and cash equivalents, end of year</b>	<b><u>5,487,979</u></b>	<b><u>1,576,551</u></b>
<b>Supplemental cash flows information</b>		
Cash paid during the year for interest	-	-

*See accompanying notes*

**Nexia Biotechnologies Ltd.**  
**Annual Audited Financial Statements for the Year Ended May 31, 2007**  
**Notes to the Financial Statements**

**1. DESCRIPTION OF BUSINESS, PLAN OF ARRANGEMENT, ASSET TRANSFER AND BASIS OF PRESENTATION**

Nexia Biotechnologies Ltd., formerly 6539718 Canada Inc. [“Nexia” or the “Company”], was incorporated under the Canada Business Corporations Act on March 06, 2006, as a wholly owned subsidiary of Nexia Biotechnologies Inc. [“Old Nexia”] which invested 1\$ for 100% of the common shares of the Company, for the purpose of participating in a Plan of Arrangement [the “Arrangement”] among Nexia, Old Nexia, Enseco Energy Services Corp. [“Enseco”], Enseco Management Corp., Old Nexia shareholders and Enseco shareholders.

Pursuant to the Arrangement, Nexia issued 24,032,539 new common shares to the Old Nexia shareholders in exchange for all the preferred shares of Old Nexia. Concurrently, in satisfaction of the redemption of its preferred shares owned by Nexia, Old Nexia transferred to the Company its net assets in the biotech operations.

On October 23, 2006, as a result of the above Arrangement, the following net assets were transferred from Old Nexia to Nexia, at net carrying value:

	\$
Cash and cash equivalents	981,214
Accounts receivable	302,500
Prepaid expenses and other assets	281,426
Capital assets	2,937
Investment in PharmAthene	8,182,000
Accounts payable and accrued liabilities	(82,581)
	<u>9,667,496</u>

Nexia did not carry on any active business from the date of its incorporation to October 23, 2006, the date of the completion of the Arrangement. On October 24, 2006, Nexia changed its name from 6539718 Canada Inc. to Nexia Biotechnologies Ltd. Nexia became a reporting issuer in October 2006 and obtained a listing on the CNQ stock exchange in January 2007.

Following the completion of the Arrangement, Nexia carries on substantially the same business carried on by Old Nexia prior to the completion of the Arrangement and is a biotechnology company engaged in the business of developing recombinant proteins in the form of Bio Steel ® biomaterial. The former officers and directors of Old Nexia became the management team of Nexia.

Under the Emerging Issues Committee - EIC 89 - *Exchanges of Ownership interests between enterprises under common control-wholly and partially-owned subsidiaries*, Nexia is required to prepare its financial statements using the continuity of interests method of accounting.

Accordingly, the financial statements of Nexia reflect the assets and liabilities of the transferred business, the biotech operations, at their book value as reported in the financial statements of Old Nexia. This method of accounting also requires that the results of operations presented in the financial statements of Nexia include the operations of Old Nexia and Nexia pertaining to the biotech operations for the entire fiscal period in which the transfer took place.

In addition, the comparative financial statements of Nexia were restated to reflect the financial position and the results of operations as if Nexia and Old Nexia, with respect to the biotech related operations, had been combined since their inception.

In accordance with the continuity of interests method, the new shares of the Company were valued at a nominal amount and the net carrying value of the net assets of the biotech operations, excluding the accumulated deficit, was presented as contributed surplus amounting to \$47,296,337 as at May 31, 2006.

## **2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

These financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles, the most significant of which are summarized below.

### **Use of estimates**

The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires management to make estimates and assumptions particularly as they relate to the value of the investment in PharmAthene, the value of the derivative instrument and the investment tax credits. These estimates and assumptions affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and such differences could be significant.

### **Cash and cash equivalents**

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

### **Restricted cash**

Cash and short-term investments that are subject to restrictions that prevent its use for current purposes are presented as restricted cash within the long-term assets section.

### **Investment**

Equity investments where Nexia does not exercise significant influence, as it is the case for the investment in PharmAthene Inc. ["PharmAthene"], are accounted for by the cost method whereby earnings are recognized only to the extent that dividends are declared. Annually, or whenever events or changes in circumstances indicate, Nexia performs a review of its investment in PharmAthene to determine if there has been other than temporary impairment in value. Any impairment in the value of the investment results in a write-down, which is charged to income during the year.

### **Revenue recognition**

Interest revenue is recognized on a time proportion basis.

Bio Steel revenues are recognized when recombinant proteins are shipped and collection is reasonably assured.

### **Research and development**

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

### **Income taxes**

Nexia follows the liability method of accounting for income taxes. Under this method, future income tax assets and liabilities are determined based on the differences between the financial reporting and tax bases of assets and liabilities and are 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.

### **Financing costs**

Costs incurred to issue debt are expensed as incurred.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

### Foreign currency translation

Monetary assets and liabilities denominated in foreign currencies are translated into Canadian dollars at rates of exchange prevailing at the balance sheet date. Revenues and expenses are translated into Canadian dollars at rates of exchange in effect at the related transaction dates. Exchange gains and losses arising from the translation of foreign currency items are included in the determination of net income.

### Stock-based compensation and other stock-based payments

Nexia has a stock option incentive plan, which is described in *note 6*. Direct awards of stock to employees and non-employees and stock option awards granted to non-employees are accounted for in accordance with the fair value method of accounting for stock-based compensation. The fair value of direct awards of stock is determined based on the quoted market price of Nexia's stock while the fair value of stock options is estimated at the date of grant using the Black-Scholes option pricing model. Options issued to employees, officers and directors are recognized as an expense over the vesting period with a corresponding increase to contributed surplus. 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 with a corresponding increase to contributed surplus. Any consideration paid by employees, officers and directors on exercise of stock options or purchase of stock is credited to share capital.

### Loss per share

Loss per share is calculated using the weighted average number of shares outstanding during the year. Dilutive 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 year.

## 3. CHANGES TO ACCOUNTING POLICIES

Effective June 1, 2006, Nexia adopted the new recommendations of the Canadian Institute of Chartered Accountants (CICA) Handbook Section 3855, Financial Instruments – Recognition and Measurement, Section 3865, Hedges and Section 1530, Comprehensive Income. The adoption of the new standards was applied prospectively without restatement.

### Section 3855 – Financial Instruments – Recognition and Measurement

Under the new standards, while financial assets and financial liabilities are initially recognized at fair value, they are subsequently re-measured based on their assigned classification. The classification of the financial assets and liabilities depends on the purpose for which the financial instruments were acquired and their characteristic.

The following summarizes the possible assigned classifications and their subsequent method of measurement and the treatment of their respective gains and losses.

#### Held-for-trading

Financial assets and financial liabilities in this classification are acquired with the intention of generating profits. Nexia may also designate as held-for-trading upon initial recognition, any financial instrument whose fair value can be reliably measured. These instruments are accounted for at fair value with the change in the fair value recognized immediately in net income.

#### Held-to-maturity

Financial instruments included in this category have fixed maturity or determinable payments and management intends and has the ability to hold these instruments to maturity. The financial assets and financial liabilities classified as held-to-maturity are measured at amortized cost using the effective interest method and the gain and loss is recognized immediately in net income.

### 3. CHANGES TO ACCOUNTING POLICIES (CONTINUED)

#### Loans, Receivables and Other Liabilities

This category includes all loans and receivables, except debt securities, and other liabilities that are not classified as held-for-trading. They are measured at amortized cost using the effective interest method and the gain and loss is recognized immediately in net income.

#### Available-for-sale

Financial assets classified as available-for-sale are carried at fair value which represents the bid price when financial assets are quoted in active markets. For financial assets for which there is no quote in active markets, they are measured at cost. The gain or loss originating from subsequent measurement is recognized in Other Comprehensive Income and is transferred to net income when the asset is derecognized. Any unrealized gain or loss of foreign exchange related to available-for-sale financial instruments is also recognized in Other Comprehensive Income and transferred to net income when the asset is derecognized. Impairment write-downs relating to available-for-sale financial instruments are immediately recognized in net income.

As at June 1, 2006, Nexia has elected the following classifications for its financial assets and liabilities:

	Classification	Measurement
<b>Financial assets</b>		
Cash and cash equivalents	Held for trading	Fair value
Accounts receivable	Loans and receivables	Amortized cost
Investment in PharmAthene	Available for sale	Cost
<b>Financial liabilities</b>		
Accounts payable and accrued liabilities	Other liabilities	Amortized cost
Long term debt	Loans payables	Amortized cost

Nexia has one outstanding contract with an embedded derivative [note 5].

The investment in PharmAthene is an equity instrument that does not have a quoted market price in an active market. Consequently, it is measured at cost.

#### Section 3865 – Hedges

Under the new standard, hedges may be designated as either fair value hedges, cash flow hedges or hedges of net investments in self-sustaining foreign operations. Nexia does not currently use hedging instruments; therefore, the adoption of this section does not have any impact on Nexia's financial statements.

#### Section 1530 – Comprehensive Income

The comprehensive income section requires the presentation of comprehensive income and its components in the financial statements. Comprehensive income is the change in the net assets of a company arising from transactions, events and circumstances from non-owners sources. The adoption of this section did not have any impact on Nexia's financial statements.

### 4. INVESTMENT IN PHARMATHENE

The investment in PharmAthene inc. ["PharmAthene"] consists of 7,465,501 Series C Convertible Preferred Shares of PharmAthene, 2,239,650 Warrants to acquire Series C Convertible Preferred Shares exercisable at US\$0.9122978 per share, expiring in March 2008 [the "US\$0.91 warrants"]; and 1,343,790 Warrants acquire Common Shares of PharmAthene exercisable at US\$0.01 per share, expiring in October 2014 [the "US\$0.01 Warrants"].

#### 4. INVESTMENT IN PHARMATHENE (CONTINUED)

The value of the investment was allocated to its separate components as follows:

	\$
Series C Convertible Preferred Shares	7,905,800
US\$0.91 Warrants	260,600
US\$0.01 Warrants	15,600
	8,182,000

The US\$0.91 Warrants were valued using a minimum value option pricing model using a risk-free interest rate of 2.90%, a dividend yield of nil and a weighted average expected life of 3 years. The US\$0.01 Warrants' fair value was estimated to be equivalent to their face value of US\$0.01 due to their contingent nature.

#### 5. LONG-TERM DEBT

On May 3, 2007, Nexia entered into an agreement with a US based biotechnology Investment Fund [the "Fund"] for a US dollar denominated term loan. The term loan for US\$5,000,000 bears interest at 6%. In addition, Nexia is responsible for paying the withholding taxes on interest payments amounting to 25% of the interest payable. Upon maturity, on November 3, 2008, the Fund can select any of the following repayment terms:

[i] payment in cash of US\$5,000,000 plus accrued interest; or

[ii] payment in cash of US\$2,500,000 plus accrued interest on the outstanding balance of US\$5,000,000 and the transfer by Nexia to the Fund of 33.85% of its PharmAthene investment or any securities or other consideration for which the PharmAthene have been exchanged, or

[iii] delivery by Nexia to the Fund of:

(A) that number of PharmAthene securities having a value of US\$6,800,000 [determined via an independent valuation report] plus accrued interest payable in cash, if the PharmAthene investment or any securities into which they are convertible in accordance with their terms have not been listed and posted for trading on a recognized stock exchange, or

(B) if the PharmAthene Investment have been redeemed by PharmAthene prior to completion of a contemplated merger [see note 10], an amount in cash equal to US\$6,800,000, plus accrued interest.

The repayment options as described above were concluded to be an embedded derivative and were recorded as such on the balance sheet at their fair value of US\$2,238,000 as at May 3, 2007. The embedded derivative was valued using a risk free interest rate of 4.18%, volatility factor at 78.4% and included all the repayment options in the valuation model. Going forward, the embedded derivative will be revalued to fair value with any change in value included in the statement of operations. As at May 31, 2007, no change in value was identified, however, this monetary liability was translated to CDN\$2,393,367 as at May 31, 2007 using the year-end exchange rate.

The balance of US\$2,762,000 presented as long-term debt was derived by subtracting the value of the embedded derivative from the US\$5,000,000 balance and later adjusted for any accretion and foreign exchange fluctuation. As at May 31, 2007, \$93,258 was accreted to long-term debt.

The term loan is secured by a first priority lien on all of the existing and after acquired assets of Nexia.

## 5. LONG-TERM DEBT (CONTINUED)

Nexia was required to deposit in escrow with the Fund's trustee the sum of US\$600,000 [CDN\$641,760 as at May 31, 2007,] representing the amount of interest and withholding taxes to be paid on the term loan from the date of the advance of the term loan to the maturity date. The related investment, including interest earned amounting to \$2,489 as at May 31, 2007, is shown as restricted cash on the balance sheet.

No more than US\$1,000,000 of the term loan proceeds can be used for general working capital purposes. The balance of the loan proceeds shall be used to make acquisitions of businesses, property or assets that would constitute mortgaged property. Such loan covenant was met as at May 31, 2007.

Financing costs, related to the loan of \$51,523 comprised of legal fees are included in the statement of operations.

## 6. CAPITAL STOCK

### Authorized

An unlimited number of voting common shares without par value.  
An unlimited number of preferred shares issuable in series.

### [i] Issued and outstanding

	#	\$
<b>Common shares</b>		
Balance as at May 31, 2007	<u>24,032,639</u>	<u>1</u>

As described in *note 1*, Nexia issued 24,032,539 common shares in connection with the Plan of Arrangement. The remaining 100 shares were issued on original formation of Nexia.

### [ii] Stock Option Incentive Plan

Nexia has adopted an incentive stock option plan [the "Option Plan"] which provides that the board of directors of Nexia may from time to time, in its discretion, grant to directors, officers and employees and consultants of Nexia, non-transferable options to purchase common shares, provided that the number of common shares reserved for issuance will not exceed 10% of the issued and outstanding common shares. Such options will be exercisable for a period of up to 5 years from the date of grant. In connection with the foregoing, the number of common shares reserved for issuance to any individual director or officer will not exceed five percent [5%] of the issued and outstanding common shares. Nexia currently does not have any options to purchase common shares issued and outstanding.

### Loss per share

Nexia's diluted loss per share is equivalent to its basic loss per share, since Nexia does not have any potentially issuable shares and that these would have an anti-dilutive effect.

## 7. INCOME TAXES

The income tax expense (recovery) reported differs from the amount of the tax expense (recovery) computed by applying the statutory rates to the net loss. The reasons for the differences and the related tax effects are as follows:

	<b>2007</b>
	%
Canadian tax recovery at statutory rate	(32.52)
Increase in taxes recoverable resulting from:	
Income tax recovery	0.86
Non-deductible expenses	0.86
Unrecognized tax benefits of operating losses and other available deductions	31.66
	<u>—</u>

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

	<b>2007</b>
	\$
<b>Future income tax liability</b>	
Unrealized foreign exchange gain	(24,000)
<b>Future income tax assets</b>	
Tax basis of intangibles in excess of carrying bases	7,000
Financing fees	12,000
Net operating losses carried forward	185,000
<b>Total future income tax assets</b>	204,000
Valuation allowance	(180,000)
<b>Net future income tax assets</b>	—
<b>Net future income tax liability</b>	<u>—</u>

Nexia has accumulated non-capital losses which are available to reduce future taxable income. These losses, if not utilized, will expire as follows:

	<b>Federal</b>	<b>Alberta</b>	<b>Ontario</b>
	\$	\$	\$
<b>Available to</b>			
2027	630,000	630,000	630,000

## **7. INCOME TAXES [CONTINUED]**

The Company incurred research and development expenditures which are eligible for investment tax credits. The investment tax credits recorded are based on management's estimates of amounts expected to be recovered and are subject to audit by taxation authorities. The amounts recorded in 2007 relate to amounts received in excess of prior year amounts recorded. No amounts were recorded as receivable relating to the current year. The amounts recorded as a reduction of research and development expenses were \$285,355 [nil in 2006].

Even though the continuity of interests method requires to present the comparative figures as if Old Nexia and Nexia had been combined since their inception, the comparative tax figures were not disclosed in the present note as available accumulated tax losses and research and development expenditures of Old Nexia were not transferred to Nexia. As such, the comparative information would not be meaningful.

## **8. RELATED PARTY TRANSACTION**

Since November 11, 2005, Nexia has entered into a corporate development consulting agreement with a director and a significant shareholder of Nexia, for an amount of \$10,000 (\$5,000 prior to November 2006) per month. In 2007, this director has been paid \$95,000 [2006- \$33,225] for his consulting services. Nexia's President and CEO, is also a director and a significant shareholder. The President and CEO receives \$10,000 per month compensation (\$5,000 prior to November 2006), on a one-year term basis and has received \$95,000 for these services in 2007 [2006- \$33,225]. In addition, these two directors received \$60,000 bonus each in 2007 and nil in 2006. These directors were also paid director retainer and meeting fees of \$3,500 per quarter, \$750 per teleconference and \$1,500 for a formal meeting (\$2500, \$600 and \$1,250, respectively prior to November 2006). These related party transactions are recorded at their exchange values, agreed between the parties and Nexia.

## **9. FINANCIAL INSTRUMENTS**

The carrying values of the cash and cash equivalent, accounts receivable and accounts payable and accrued liabilities, approximate fair values due to the short-term maturity of these instruments. The long term debt is recorded at amortized cost and it approximates the fair value.

## **10. SUBSEQUENT EVENTS**

### **[i] Investment in PharmAthene**

In August 2007, PharmAthene announced that the stockholders of Healthcare Acquisition Corp. ["HAQ"] approved the proposed merger of HAQ and PharmAthene. PharmAthene has further announced that a certificate of merger has been filed, that the name of the merged company is PharmAthene Inc. and that the common shares of PharmAthene are presently trading on the AMEX Exchange under the symbol "PIP".

Nexia holds 1,715,975 shares representing approximately 7.2% of the merged entity. The lock-up agreement restricts the sale of 50% of PharmAthene shares for six months after closing and the remaining 50% for twelve months after the closing, and the potential of a US\$1.3 million milestone payment to be paid to Nexia under certain conditions if an award, procurement or contract for Valortim™ occurs prior to December 31, 2007.

Given the merger transaction was completed in August 2007 and that PharmAthene became public, the repayment option [iii] of the term loan, as described in note 5, is no longer applicable.

### **[ii] Investment in Cavalon and Xillix**

On September 13, 2007, Nexia announced that it has entered into an agreement [the "Agreement"] to acquire all of the issued and outstanding shares of Cavalon Capital Partners Ltd. ["Cavalon"]. The purchase price is \$333,390 and will be satisfied by the issuance of 1,666,950 common shares of Nexia issued at a price of \$0.20 per share. Cavalon's primary asset is an investment agreement [the

## 10. SUBSEQUENT EVENTS (CONTINUED)

“Investment Agreement”] with Xillix Technologies Corp. [“Xillix”] [TSX: XLX] whereby Cavalon has the exclusive right to invest the sum of \$4,400,000 in Xillix in consideration for voting and non-voting shares. Upon the closing of the Agreement, Nexia will become Cavalon’s successor in interest to the Investment Agreement and Nexia will proceed with the investment in Xillix. The investment in Xillix was completed on September 24, 2007 and as such, the following has occurred:

- Nexia has made a non-interest bearing loan of \$4,400,000 to Xillix (the “Loan”);
- 94.5% of the Loan has been converted into 112,023,510 common shares of Xillix and 435,647,055 non voting shares of Xillix, such that Nexia now holds 45% of the voting common shares of Xillix and 100% of the non-voting shares of Xillix, providing Nexia with the ownership of 80% of the total equity interests in Xillix.

Subsequently, Xillix has changed its name to Biomerger Technologies Inc.

Pursuant to the Agreement, each of Mr. Matthews and Ms. Tonken acquired ownership of 833,475 Nexia Shares. As a result of this transaction, Mr. Matthews owns or control 2,512,767 Nexia Shares representing 9.8% of the outstanding Nexia Shares and Ms. Tonken, who acts jointly or in concert with Mr. Matthews, owns or control 1,833,475 Nexia Shares representing 7.1% of the outstanding Nexia Shares. The Nexia Shares issued to Mr. Matthews and Ms. Tonken will be held in escrow pending the completion of a future transaction between Xillix and a third party. If no such transaction is completed within 18 months from the closing of the Agreement, the Nexia Shares issued pursuant to the Agreement will be cancelled.

The Agreement is a related party transaction. The shareholders of Cavalon and the recipients of the shares are Greg Matthews a director of Nexia, and the spouse of David Tonken, a director and officer of Nexia. The Agreement has been approved by Nexia’s directors [excluding Mr. Tonken and Mr. Matthews] on the basis that it will provide Nexia with an opportunity to deploy its capital in a manner that may produce returns greater than those currently realized.

## **CORPORATE INFORMATION**

### **MANAGEMENT**

*David L. Tonken - President, CEO and Chairman of the Board  
Dejan Ristic - Chief Financial Officer*

### **DIRECTORS**

*David L. Tonken  
Gregory B. Matthews  
Dr. Ian Forrester*

### **CONTACT INFORMATION**

***Nexia Biotechnologies Ltd.***  
*P.O. Box 187, Jean-Talon Branch, Montreal, Quebec, Canada, H1S 2Z2*  
*Tel: 780.486.2317 Fax: 514.371.7880*  
[www.nexiabiotech.com](http://www.nexiabiotech.com)

## **SHAREHOLDER SERVICES**

### ***Transfer Agent & Registrars***

***Olympia Trust***  
*2300, 125 – 9th Ave SE Calgary, AB T2G 0P6*  
*Tel: (403) 261-0900 Fax (403) 265-1455*

### ***Auditors***

***Ernst & Young LLP***  
*1 Place Ville-Marie, Suite 2400, Montreal, Quebec, Canada, H3B 3M9*  
*Tel: 514.875.6060 Fax: 514.871.8713*

### ***Legal Counsel***

***Borden Ladner Gervais LLP***  
*1000 Canterra Tower, 400 Third Avenue S.W., Calgary, Alberta, Canada*  
*T2P 4H2*  
*Tel.: 403.232.9500 Fax: 403.266.1395*