



# 2008 ANNUAL REPORT

*MethylGene*

DISCOVER, DEVELOP, DELIVER<sup>®</sup>

## FORWARD-LOOKING INFORMATION

Certain statements contained in this annual report, other than statements of fact that are independently verifiable at the date hereof, may constitute forward-looking statements. Such statements, based as they are on the current expectations of management of MethylGene Inc., inherently involve numerous risks and uncertainties, known and unknown, many of which are beyond MethylGene's control that could cause future results, performance or achievements to differ significantly from the results, performance or achievements expressed or implied by such forward-looking statements. Such risks include, but are not limited to, the impact of general economic conditions; economic conditions in the pharmaceutical industry; changes in the regulatory environment in the jurisdictions in which MethylGene does business; stock market volatility; fluctuations in costs; expectation with respect to our intellectual property position and our ability to protect our intellectual property and operate our business without infringing upon the intellectual property rights of others; changes to the competitive environment due to consolidation; changes in the standard of care; timing and effects of regulatory action; the continuation of collaborations; the unilateral decisions and/or strategies of collaborators; the results of clinical trials; the ability to demonstrate acceptable or adequate pharmacokinetic/bioequivalency of any compound; the timing of enrollment or completion of clinical trials; the success, efficacy or safety of our compounds; the ability to scale-up, formulate and manufacture sufficient GMP quantities of any compounds; as well as other risks included in MethylGene's Annual Information Form (AIF) under the heading "Item 10 – Risk Factors" which you are urged to read. Consequently, actual future results may differ materially from the anticipated results expressed in the forward-looking statements. The reader should not place undue reliance on the forward-looking statements including those in this annual report. These statements speak only as an update on the date they are made and MethylGene is under no obligation to revise such statements as a result of any event, circumstance or otherwise except in accordance with the law. Our AIF may be found at [www.sedar.com](http://www.sedar.com).

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## TABLE OF CONTENTS

01 *Corporate Profile*

01 *Drug Development Pipeline*

02 *Message to Shareholders*

04 *MGCD265, MGCD290, MGCD0103*

05 *Financial Section*

48 *Shareholder Information*

# CORPORATE PROFILE

## METHYLGENE INC.

MethylGene Inc. (TSX: MYG) is a publicly-traded, clinical stage, biopharmaceutical company focused on the discovery, development and commercialization of novel therapeutics for cancer. The Company's product candidates include: MGCD265, an oral, multi-targeted kinase inhibitor targeting the c-Met, VEGF, Tie-2 and Ron receptor tyrosine kinases that is in two Phase I clinical trials for solid tumor cancers; MGCD290, a fungal Hos2 (HDAC) inhibitor being developed in combination with fluconazole for fungal infections that is also in Phase I clinical studies; and MGCD0103, an oral, isoform-selective HDAC inhibitor which has been in multiple clinical trials for solid tumors and hematological malignancies and is licensed to Taiho Pharmaceutical Co. Ltd. A fourth compound discovered using MethylGene's HDAC platform, EVP-0334 – a potential cognition enhancing agent, is in a Phase I study sponsored by EnVivo Pharmaceuticals Inc. MethylGene also has a funded collaboration with Otsuka Pharmaceutical Co. Ltd. for application in ocular diseases using the Company's proprietary kinase inhibitor chemistry. Please visit our website at [www.methylgene.com](http://www.methylgene.com).

## DRUG DEVELOPMENT PIPELINE

### AS OF MARCH 2009

MethylGene has developed expertise to design inhibitors for enzymes involved in disease resulting in a diverse pipeline.

	INDICATION	RESEARCH	PRECLINICAL	CLINICAL		
				PHASE I	PHASE II <sup>1</sup>	PHASE III
<b>PROPRIETARY PROGRAMS</b>						
MGCD265 (kinase inhibitor)	Cancer	-----				
MGCD290 (Hos2/HDAC inhibitor)	Fungal infections	-----				
MGCD0103 (HDAC inhibitor) <sup>2</sup>	Cancer	-----			TAIHO <sup>4</sup>	
<b>PARTNERED PROGRAMS</b>						
EVP-0334 (HDAC inhibitor) <sup>3</sup>	Alzheimer's	-----		ENVIVO		
Kinase inhibitors	Ocular diseases	-----	OTSUKA			

<sup>1</sup> Includes Phase I/II Trials.

<sup>2</sup> MGCD0103 is currently on partial clinical hold for new patient enrollment.

<sup>3</sup> A cognition enhancing agent (source: EnVivo website, March 2009).

<sup>4</sup> Licensed to Taiho for certain Asian countries.

# DEAR FELLOW SHAREHOLDERS,

The past year was challenging for many biotechnology companies and MethylGene was no exception. The market capitalization for many biotechnology companies has been significantly affected and the accompanying financing environment continues to be extremely difficult. Furthermore, there remains uncertainty regarding the length and depth of the current global recession.

Accordingly, we made the strategic decision to focus our efforts on advancing the clinical development of our most near-term value generating compounds and began the process of winding down our research activities. This and other actions we have taken are expected to extend our cash into approximately the third quarter of 2010.

In 2008, we also faced a timing setback with our clinical oncology compound, MGCD0103. Based on the recommendation of a standing safety committee, we voluntarily suspended new enrollment in our clinical trials for this compound due to observations of pericarditis reported as serious adverse events (SAE) in a relatively small percentage of our cancer patient population. The U.S. Food and Drug Administration (FDA) concurred with this action and MGCD0103 is currently on partial clinical hold. Under the partial clinical hold, patients previously enrolled in MGCD0103 clinical trials who were confirmed to have no signs of pericarditis or pericardial effusion continued in their respective studies.

In January 2009, we reacquired the rights to MGCD0103 (outside of territories licensed to Taiho) from Celgene Corporation. With the Investigational New Drug application back in our hands, we, along with regulatory and safety consultants, are working toward the goal of lifting the partial clinical hold. Once this hold is lifted, we can evaluate the status, funding requirements and potential partnering opportunities for this compound. MGCD0103 has demonstrated activity in a number of tumor types as both a single agent and in combination with currently marketed drugs. We have presented data at the American Society of Clinical Oncology (ASCO) annual meetings and at the American Society of Hematology (ASH) annual meetings in 2007 and 2008 describing these results.

Over the course of 2008 we made significant progress with two additional compounds from our pipeline: MGCD265 an oral, multi-targeted (c-Met) kinase inhibitor for oncology and MGCD290, a Hos2 inhibitor for fungal infections.

We initiated two clinical trials for MGCD265 in patients with advanced solid cancer tumors that are refractory to current standard treatments. The purpose of these dose-escalating trials is to evaluate the safety, pharmacokinetics, pharmacodynamics and the maximum tolerated dose of the compound. We continue to enroll patients and

we expect to report preliminary Phase I data, as well as commence a Phase I/II or a Phase II clinical trial during 2009.

MGCD290 enhances the activity and efficacy of current azole treatments against key fungal pathogens when co-administered with azoles. Azoles are a commonly-used class of drugs for the treatment of fungal infections. However, resistance to azoles is an increasing problem and some infections are especially difficult to manage medically. MGCD290 represents a unique compound that may increase the sensitivity of fungi to azoles. In the fourth quarter of 2008, we received approval from Health Canada to begin Phase I clinical studies in healthy volunteers. We expect to complete our Phase I studies, including studies in combination with fluconazole, in 2009. We plan to evaluate potential partnering opportunities and funding requirements for the compound in order to determine the potential next steps for its development.

We also entered into a world-wide research collaboration and license agreement with Otsuka Pharmaceutical Co. Ltd., a global pharmaceutical company, for the development of novel, small molecule kinase inhibitors for the treatment of ocular diseases, excluding cancer. This partnership is another example of our ability to leverage our technology into disease indications beyond our cancer focus.

Our principal objectives for 2009 include: obtaining the lift of the partial clinical hold for MGCD0103, initiating a Phase I/II or Phase II clinical trial with MGCD265 and completing Phase I studies for MGCD290. We will also seek and evaluate potential new partnerships and funding opportunities with the goal of moving our Company forward in these challenging times as well as enhancing shareholder value.

Sincerely,

(signed)  
DONALD F. CORCORAN  
President and Chief Executive Officer  
MethylGene Inc.  
Montréal, March 26, 2009

## MGCD265

AN ORAL, SMALL MOLECULE, MULTI-TARGETED (c-Met) KINASE INHIBITOR FOR CANCER

MGCD265 is in two dose-escalating Phase I clinical trials (Trials 101 and 102) in patients with advanced metastatic or unresectable solid tumors that are refractory to standard therapy. Examples of tumor types in these trials include colon, renal, gastric, lung, pancreatic and bladder. The Company expects to report preliminary Phase I data, as well as commence a Phase I/II or Phase II clinical trial in 2009.

MGCD265 inhibits a novel set of receptor tyrosine kinases: c-Met, the three vascular endothelial growth factor receptors (VEGFRs), Tie-2 and Ron. These kinases are involved in tumor development, metastasis and the formation of blood vessels (angiogenesis) that feed the tumor.

## MGCD290

AN ORAL, Hos2 (HDAC) INHIBITOR FOR FUNGAL INFECTIONS

MGCD290 is in multiple Phase I clinical studies in healthy volunteers as a single agent and in combination with fluconazole. These Phase I studies are expected to be completed during 2009.

MGCD290 targets the fungal Hos2 enzyme which is implicated in fungal resistance to commonly used antifungal agents called azoles. Fungal infections are a growing concern due to resistance to treatment in immunocompromised patients, including cancer patients. MGCD290, when administered in combination with azoles, affects fungi in two ways: it sensitizes azole-resistant fungi to treatment with azoles and it broadens the spectrum of azole activity.

## MGCD0103

AN ORAL, SMALL MOLECULE, ISOFORM-SELECTIVE, HISTONE DEACETYLASE (HDAC) INHIBITOR FOR CANCER

MGCD0103 has been in multiple Phase I and Phase II clinical trials in solid tumors and hematological malignancies. The compound is on partial clinical hold due to some observations of pericarditis and pericardial effusion. The Company expects to file its complete response to the U.S. Food & Drug Administration (FDA) with the goal of lifting this hold. Once the hold is lifted, the Company can evaluate the status, funding requirements and potential partnering opportunities for MGCD0103.

Histone deacetylases are a family of 11 enzymes (or isoforms) that may act as a master regulator of gene expression and when misregulated appear to affect diseases including cancer. MGCD0103 inhibits a subset of these enzymes that we believe play a key role in cancer progression.

# FINANCIAL SECTION

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

MANAGEMENT'S DISCUSSION AND ANALYSIS PROVIDES A REVIEW OF OUR PERFORMANCE AND SHOULD BE READ IN CONJUNCTION WITH OUR AUDITED FINANCIAL STATEMENTS AND NOTES INCLUDED HERewith WHICH HAVE BEEN PREPARED IN ACCORDANCE WITH CANADIAN GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP). THIS REVIEW WAS PREPARED BY MANAGEMENT FROM INFORMATION AVAILABLE AS AT MARCH 25, 2009 AND COMPARES THE YEAR ENDED DECEMBER 31, 2008 WITH THE YEAR ENDED DECEMBER 31, 2007 AND THE QUARTER ENDED DECEMBER 31, 2008 WITH THE QUARTER ENDED DECEMBER 31, 2007. OTHER INFORMATION ABOUT THE COMPANY MAY BE FOUND IN OUR ANNUAL INFORMATION FORM (AIF), THE MANAGEMENT PROXY CIRCULAR, ON [WWW.SEDAR.COM](http://WWW.SEDAR.COM), AND ON OUR WEBSITE [WWW.METHYLGENE.COM](http://WWW.METHYLGENE.COM).

### FORWARD-LOOKING STATEMENTS

To the extent any statements made in this document contain information that is not historical, these statements are essentially forward-looking and are subject to risks and uncertainties which are fully described in our AIF. Actual results, levels of activity, performance, or achievements could differ materially from those projected herein and depend on a number of factors, including the successful and timely completion of research and clinical trials, the ability to scale-up and formulate adequate good manufacturing practices (GMP) quantities of our compounds, the uncertainties related to the regulatory process, and the commercialization of our drug products thereafter.

Where we say “we”, “us”, “our” or the “Company”, we mean MethylGene Inc., unless otherwise indicated. All amounts are presented in Canadian dollars and are rounded to the nearest thousand unless otherwise indicated. All percentages reflected herein are calculated on whole amounts as contained in our financial records and financial statements and not on the rounded amounts as disclosed herein unless otherwise indicated.

## OVERVIEW

We are a publicly-traded biopharmaceutical company focused on the discovery, development and commercialization of novel therapeutics with a focus on cancer.

The current world-wide economic climate/environment has impacted the biotechnology industry, including MethylGene, with a market in which it is relatively difficult to raise capital. We have implemented several steps to extend our cash by focusing our resources on our most promising clinical programs and have restructured the Company through a phased discontinuance of discovery research, as described below. We have not invested in any asset-backed securities and we believe our choice of investments in marketable securities are secure and can be redeemed at our stated market values subject to minor costs associated with early redemption. We believe that our current cash and investments, plus expected tax credits, interest income and projected revenues from our current collaborations will be sufficient to carry out our currently planned research and development activities into the third quarter of 2010.

We are currently running two Phase I trials for MGCD265, our multi-targeted (c-Met) kinase inhibitor and Phase I clinical trials in healthy volunteers for MGCD290, our fungal HDAC inhibitor. In addition, we are working on obtaining the release of the partial clinical hold placed by the U.S. Food and Drug Administration (FDA) on MGCD0103 which has been in multiple clinical trials.

During the quarter ended December 31, 2008, we realigned our operations to focus resources on the development of our clinical pipeline and as a result began the process to discontinue discovery research. The reduction, of approximately 50% of our workforce, will be done in three phases to ensure we meet our commitments to the funded research programs including sirtuin inhibitors with Celgene Corporation (“Celgene”) and kinase inhibitors for ocular diseases with Otsuka Pharmaceutical Co. Ltd. (“Otsuka”). The first phase of the reduction occurred in the fourth quarter of 2008, the second phase occurred in January 2009 with the conclusion of the sirtuin program and the third phase is expected at the conclusion of the Otsuka research program in September 2009 unless extended by Otsuka. Total charges recorded in the fourth quarter and year ended December 31, 2008 relating to this realignment was \$403 including both termination costs and impairment charges related to property, plant and equipment.

On October 24, 2008, Celgene informed us that they were terminating our license and collaboration agreement, subject to a ninety-day transition period. As a result, we have reacquired exclusive rights as of January 23, 2009, for our oncology histone deacetylase (HDAC) inhibitors including MGCD0103 and oncology-focused sirtuin inhibitors in the ter-

ritories licensed to Celgene. Previously, on September 17, 2008, we informed Celgene that we would exercise our right to convert our license and collaboration agreement with them subject to a ninety-day notice period. We would no longer, as a result of our conversion, have the right to co-promote and profit-share on commercialization in North America, but instead would receive royalty and milestone payments.

As a result of our conversion, Celgene was responsible for 100% of development costs for MGCD0103 for the period from December 17, 2008 to January 22, 2009, inclusive and we are responsible for any future development costs thereafter. Celgene was also responsible to continue funding the sirtuin research program up to January 22, 2009 inclusively. As a result of converting the agreement, we no longer have any continuing obligations towards Celgene for this program and recorded to income \$2.1 million and \$12.1 million of license and up-front fees from unearned revenues in the third and fourth quarters of 2008, respectively.

Previously, on July 22, 2008, we along with our partner Celgene, announced that based on the recommendation of a standing internal safety committee, the companies were voluntarily suspending on a temporary basis, enrollment of new patients into clinical trials evaluating MGCD0103. On August 15, 2008, the FDA concurred with this position and contemporarily placed a partial clinical hold on enrollment of new patients for MGCD0103 and requested the companies' submission of data and an action plan to mitigate risk for patients.

On March 25, 2008, we entered into a world-wide research collaboration with Otsuka for the development of novel, small molecule, kinase inhibitors for the local delivery and treatment of ocular diseases, excluding cancer. The financial terms include an up-front amount of US\$2.0 million; research support of approximately US\$1.9 million over the next 18 months which can be extended; an equity amount of US\$3.0 million in MethylGene's common stock should we complete a concurrent financing of at least US\$10.0 million and are listed on a U.S. stock exchange; or alternatively, a US\$1.5 million equity investment at a 20% premium if MethylGene is solely listed on the Toronto Stock Exchange (TSX) after such 18-month period.

On February 6, 2008, we exercised our right to opt-out of further funding in our collaboration with EnVivo Pharmaceuticals ("EnVivo") for HDAC inhibitors for neurodegenerative diseases such as Huntington's, Parkinson's and Alzheimer's. We would receive royalties on net sales of any approved compounds and receive a share of any sublicense income from future partnerships that EnVivo may enter with other companies for specific neurodegenerative diseases.

## **LIQUIDITY**

We have sustained operating losses since our inception as we have continually invested in research and development activities including running clinical trials. We have financed our research and development activities, technology acquisition and capital expenditures primarily through private and public placements of equity, proceeds from our research collaborations and partnerships, government assistance by way of investment tax credits (ITCs) on qualified Scientific Research and Experimental Development (SR&ED) expenditures, a Technology

Partnerships Canada (TPC) grant, and interest income on our investments of excess cash. These will continue to be our main source of funds until we generate product sales and/or royalties. We expect to continue to incur losses over the next several years as we continue to develop our clinical programs.

## **REVENUES**

We have not generated any revenues from product sales to date and do not expect to do so for a number of years. Revenues to date have been generated substantially from our research collaborations and license agreements.

## **RESEARCH AND DEVELOPMENT EXPENSES**

Our research and development expenses consist primarily of salaries and related personnel costs, fees paid to external service providers such as contract research organizations (CROs) and contract manufacturing organizations (CMOs) related to clinical trials, contractual obligations for clinical development, clinical sites, laboratory, manufacturing and scale-up, formulation of clinical drug supplies, and costs for facilities and amortization of equipment. As a result of the risks and uncertainties, we are unable to estimate the specific timing and future costs of our research and development programs.

## **SIGNIFICANT PROJECTS**

Our product candidates, including MGCD265, our multi-targeted (c-Met) kinase inhibitor; MGCD290, our fungal Hos2 (HDAC) inhibitor; and MGCD0103, our HDAC oncology inhibitor, will have to complete various phases of clinical trials and obtain regulatory approval before they can generate product revenues. The costs to complete these clinical trials and to attain regulatory approval are significant, and we expect to incur significant research and development expenses over the next few years.

## **SEGMENTED INFORMATION**

We operate in a single business segment focused on the discovery, development and commercialization of novel therapeutics. We operate out of leased facilities in Canada and all of our assets are located in Canada. During 2008, we derived revenues from research collaboration and license agreements with partners from the United States and Japan.

## **CREDIT RISK**

The Company earns interest income from investments of excess cash and has an investment policy that monitors the safety and preservation of these investments, which limits the amount invested in any one company or fund and requires the investments to be made in highly rated companies or funds, R1 low or higher. Management reviews each investment as it arises. The Company has determined that for the foreseeable future investments will only be made in Government or selected Canadian bank instruments. All investments are reviewed by the Audit Committee each quarter. We do not have any investments in asset-backed commercial paper as at December 31, 2008.

## **CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

In preparing our financial statements, we are required to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. We have identified the following accounting policies that we believe require application of management's most subjective judgments, often requiring the need to make estimates about the effect of matters that are inherently uncertain and may change in subsequent periods. Our actual results could differ from these estimates and such differences could be material.

### **REVENUE RECOGNITION**

We recognize revenues from various research collaboration and license agreements, which may include multiple elements, as the contracted services are performed or when milestones are achieved, in accordance with the terms of the specific agreements. Up-front payments for the use of technology where further services are to be provided or fees received on the signing of research agreements are recognized over the period of performance of the related activities, and as such, require estimates. Up-front licensing revenue is deferred and recognized over the term during which we maintain substantive contractual obligations, which may also involve estimates from management. In the event the period of the substantive obligations changes then the appropriate adjustment will be made to the amortization of unearned revenue. Amounts received in advance of revenue recognition are included in unearned revenue. Milestone payments are recognized as they are earned. Revenue that is recognized but has not been invoiced to partners is recorded as unbilled revenue.

### **IMPAIRMENT OF LONG-LIVED ASSETS**

Long-lived assets which include property, plant and equipment and intangible assets are regularly reviewed for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. Impairment is assessed by comparing the carrying amount of an asset with its expected future net undiscounted cash flows from use together with its residual value (net recoverable value). If such assets are considered impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds their fair value, generally determined on a discounted cash flow basis. Any impairment results in a write-down of the asset and a charge to income during the year, if required. The preparation of future cash flows and determination of the fair value require management to make a number of estimates.

## **GOVERNMENT ASSISTANCE**

We incur research and development expenditures which are eligible for refundable ITCs. The ITCs recorded are based on our estimates of amounts expected to be recovered and are subject to an audit by the taxation authorities which may result in material differences. We claimed refundable ITCs from Québec in 2008 and 2007. As we are a public company, federal ITCs are not refundable. Further reductions in the rate of our refundable ITCs may occur in the future should our status as a Canadian controlled company change.

## **VALUATION ALLOWANCE FOR FUTURE TAX ASSETS**

We have determined a valuation allowance for future tax assets which are primarily related to our deferred contract revenue and research and development expense carryforwards. The implementation of tax planning strategies or the generation of future taxable income could result in the recognition of some portion or all of these carryforwards, which could result in a material increase in our earnings per share through the recovery of future income taxes.

## **STOCK-BASED COMPENSATION**

We have applied the fair value based method to measure and expense all equity instruments awarded to employees, directors and consultants. Management must make estimates about the expected life of the options, the volatility factor, the weighted-average risk-free interest rate, and the dividend yield to determine the fair value of the options granted.

## **NEW ACCOUNTING STANDARDS**

### **NEW ACCOUNTING STANDARDS ISSUED AND ADOPTED IN 2008**

The following *Handbook* Sections, released by the Canadian Institute of Chartered Accountants (CICA), were adopted by the Company on January 1, 2008 and applied prospectively without restatement:

Section 1535, "Capital Disclosures", establishes standards for disclosing information about an entity's capital and how it is managed. It describes the disclosure of the entity's objectives, policies and processes for managing capital, the quantitative data about what the entity regards as capital, whether the entity has complied with any capital requirements, and, if it has not complied, the consequences of such non-compliance.

Section 3862, "Financial Instruments – Disclosures", describes the required disclosure for the assessment of the significance of financial instruments for an entity's financial position and performance and of the nature and extent of risks arising from financial instruments to which the entity is exposed and how the entity manages those risks.

Section 3863, "Financial Instruments – Presentation", establishes standards for presentation of the financial instruments and non-financial derivatives. It carries forward the presentation related requirements of Section 3861 "Financial Instruments - Disclosure and Presentation".

Section 1400, "General Standards of Financial Statement Presentation" has been amended to include requirements to assess and disclose an entity's ability to continue as a going concern. The adoption of this section had no impact on the Company's annual financial statements.

#### **RECENT ACCOUNTING PRONOUNCEMENTS**

##### **Section 3064, "Goodwill and Intangible Assets"**

In February 2008, the CICA issued Section 3064, "Goodwill and Intangible Assets". Section 3064, which replaces Section 3062, "Goodwill and Other Intangible Assets" and Section 3450, "Research and Development Costs", establishes standards for the recognition, measurement, presentation and disclosure of goodwill and intangible assets. This standard is effective for our interim and annual financial statements beginning on January 1, 2009. We expect that this change will result in the write-off against deficit as a retrospective adjustment of \$1.9 million of intangible assets related to previously capitalized patent expenses as none of the programs which relate to these patents have received regulatory approval for commercialization.

#### **INTERNATIONAL FINANCIAL REPORTING STANDARDS CONVERSION PLAN**

The CICA will converge Canadian GAAP with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB) over a transition period to end in 2011.

The IASB currently has projects underway that are expected to result in new pronouncements that continue to evolve IFRS, and, as a result, IFRS as at the transition date is expected to differ from its current form.

As per our IFRS conversion plan, we have identified the differences between IFRS and our current accounting policies and during 2009 we plan to assess the impact of these differences as well as the various accounting alternatives offered pursuant to IFRS. We have invested and expect to continue to invest in training and resources throughout the transition period to facilitate a timely conversion. We expect our plan will identify and evaluate the impact of the conversion to IFRS on operational elements such as information technology, internal controls over financial reporting (ICFR), disclosure controls and procedures (DC&P), and our current business policies. The impact on our financial reporting cannot be reasonably estimated at this time.

## SELECTED ANNUAL INFORMATION

The following selected annual information should be read in conjunction with our audited financial statements and related notes thereto included in this report. The selected financial information is derived from our audited financial statements for each of the three most recently completed financial years.

### STATEMENT OF OPERATIONS DATA

For the years ended December 31, (in thousands of dollars, except for per share data)	2008 \$	2007 \$	2006 \$
Research collaboration and contract revenues	12,188	11,381	12,217
License and up-front fees	17,307	4,120	3,809
<b>Total revenues</b>	<b>29,495</b>	<b>15,501</b>	<b>16,026</b>
Research and development – net of refundable tax credits	35,696	32,806	20,709
Government assistance recovery of non-refundable tax credits	—	—	(5,975)
General and administrative	5,536	4,908	4,977
Interest income	(1,653)	(3,104)	(2,439)
Foreign exchange (gain) loss	(1,952)	1,840	(338)
Corporate and other transaction costs	725	—	—
Other expenses	261	1,073	456
<b>Total expenses</b>	<b>38,613</b>	<b>37,523</b>	<b>17,390</b>
Income tax (recovery) expense	(139)	—	6,148
<b>Net loss for the year</b>	<b>(8,979)</b>	<b>(22,022)</b>	<b>(7,512)</b>
Basic and diluted loss per share	(0.24)	(0.62)	(0.26)

### SUMMARIZED BALANCE SHEET DATA

As at December 31, (in thousands of dollars)	2008 \$	2007 \$
Cash and cash equivalents and marketable securities	38,606	60,733
Unbilled revenue and other assets	7,593	7,311
Property, plant and equipment and intangible assets – net	4,078	5,096
<b>Total assets</b>	<b>50,277</b>	<b>73,140</b>
Current liabilities	9,933	12,810
Long-term liabilities	3,258	15,082
<b>Total liabilities</b>	<b>13,191</b>	<b>27,892</b>
Shareholders' equity	37,086	45,248
<b>Total liabilities &amp; shareholders' equity</b>	<b>50,277</b>	<b>73,140</b>

No dividends were declared or paid on our common shares since our inception. We do not expect to pay any dividends in the foreseeable future.

## **FISCAL YEAR ENDED DECEMBER 31, 2008 COMPARED TO FISCAL YEAR ENDED DECEMBER 31, 2007 – RESULTS OF OPERATIONS**

### **REVENUES**

#### **Research Collaborations and Contract Revenues**

Research collaborations and contract revenues for 2008 of \$12.2 million increased by \$807 from 2007. The increase relates primarily to the research revenues from the Otsuka agreement entered into, in the first quarter of 2008.

#### **License and Up-front Fees**

License and up-front fees of \$17.3 million increased by \$13.2 million primarily due to the impact of converting the license and collaboration agreement with Celgene. We transferred these amounts from both current and long-term unearned revenues as we no longer have substantive obligations to Celgene.

### **RESEARCH AND DEVELOPMENT EXPENSES**

Gross research and development expenses in 2008 of \$37.2 million increased by \$2.7 million or 7.8% over 2007. This increase relates primarily to increased expenditures in clinical development on MGCD265 and on MGCD290, partially offset by lower expenditures on MGCD0103 and lower expenditures on discovery research.

Government assistance from current operations of \$1.5 million in 2008, primarily in the form of ITCs, was \$196 lower than in 2007. This reduction is primarily due to the fact that 2007 benefitted from the release of a provision as a result of a favourable tax audit.

### **GENERAL AND ADMINISTRATIVE EXPENSES**

General and administrative expenses of \$5.5 million in 2008 increased by \$628 or 12.8% versus 2007 due primarily to higher legal and professional fees in relation to completing the Otsuka agreement and converting the EnVivo and Celgene agreements.

### **INTEREST INCOME AND FOREIGN EXCHANGE (GAIN) LOSS**

Interest income of \$1.7 million decreased by \$1.5 million in 2008 versus 2007 relating to lower average interest rate earned of 3.19% in 2008 versus 4.44% in 2007 and the impact of having lower average cash equivalents and marketable securities of \$49.1 million in 2008 versus \$69.6 million in 2007.

We incurred a realized foreign exchange gain of \$2.0 million in 2008 versus a loss of \$1.8 million in 2007 as the Canadian dollar decreased significantly in value versus the U.S. dollar, primarily in the fourth quarter of 2008. During 2008, the Canadian dollar traded in a range of \$0.77 to \$1.03 with most of the decrease coming in the last four months of the year while in 2007 it traded in the range of \$0.85 to \$1.10 resulting in an exchange loss in 2007. The Company held US\$8.6 million and US\$9.3 million of net U.S. dollar denominated assets at the end of 2008 and 2007, respectively.

#### **CORPORATE AND OTHER TRANSACTION COSTS**

Corporate and other transaction costs of \$725 relate to the write-off of previously capitalized costs of \$280 due to preparation and consultation for a financing opportunity which did not occur and to business and strategic consulting costs of \$445 incurred during 2008 with no such costs in 2007.

#### **OTHER EXPENSES**

Other expenses include amortization of property, plant and equipment, lease abandonment costs, write-off of patents and property, plant and equipment, and bank charges. Total other expenses of \$261 were \$812 lower than in 2007. The Company revised its estimate and recorded an additional lease abandonment cost of \$80 in 2008 [\$345 in 2007] taking into account current market information. The Company determined that certain of its property, plant and equipment were impaired as a consequence of the business realignment undertaken in the fourth quarter of 2008 and consequently recorded a write-off of \$51 [\$36 in 2007] net of accumulated depreciation of \$1.3 million [\$135 in 2007]. In addition, the Company recorded a patent write-off of \$97 [\$642 in 2007] net of amortization of \$13 in 2008 [\$295 in 2007] as certain of the patents were no longer required or no longer part of our core business.

#### **INCOME TAXES**

The Company recognized an amount of \$407 of unrealized gains on cash and cash equivalents and marketable securities in the statement of comprehensive loss net of a future income tax expense of \$139 for the year ended December 31, 2008. Pursuant to EIC-172, this future income tax liability was offset by an income tax benefit relating to previously unrecognized tax loss carryforwards which resulted in the \$139 future income tax recovery in the statement of operations for the year ended December 31, 2008.

#### **COMPREHENSIVE LOSS**

We recorded an unrealized gain of \$699 in 2008 [unrealized loss of \$945 in 2007], net of income tax expense of \$312 [nil in 2007] on cash and cash equivalents and marketable securities through the comprehensive loss and a reversal of \$292 in 2008 relating to the reclassification into income of realized gains [reversal of realized loss of \$921 in 2007], net of income tax recovery of \$173 [nil in 2007] on cash and cash equivalents and marketable securities resulting in an overall increase of other comprehensive income in 2008 of \$407 [decrease of \$24 in 2007]. This relates primarily to the strengthening of the U.S. dollar versus the Canadian dollar on cash and available-for-sale cash equivalents and marketable securities denominated in U.S. dollars.

## SELECTED QUARTERLY FINANCIAL INFORMATION

The following selected quarterly financial information provides a summary of the key financial results over the previous eight quarters. This selected information is derived from our unaudited quarterly financial statements.

(in thousands of dollars, except per share data)	YEAR ENDED 2008				YEAR ENDED 2007			
	Q1 \$	Q2 \$	Q3 \$	Q4 \$	Q1 \$	Q2 \$	Q3 \$	Q4 \$
Research collaboration and contract revenues	3,199	3,192	2,994	2,803	2,525	2,635	2,640	3,581
License and up-front fees	1,029	1,088	2,838	12,352	1,017	1,018	1,016	1,069
<b>Total revenue</b>	<b>4,228</b>	<b>4,280</b>	<b>5,832</b>	<b>15,155</b>	<b>3,542</b>	<b>3,653</b>	<b>3,656</b>	<b>4,650</b>
Research and development – gross expenditures	8,890	10,469	8,761	9,079	6,735	8,803	9,197	9,770
Government assistance	(363)	(419)	(346)	(375)	(365)	(313)	(695)	(326)
Research and development – net	8,527	10,050	8,415	8,704	6,370	8,490	8,502	9,444
General and administrative	1,681	1,378	1,250	1,227	1,184	1,244	1,185	1,295
Corporate and other transaction costs	—	503	222	—	—	—	—	—
Interest income	(594)	(419)	(331)	(309)	(756)	(833)	(773)	(742)
Other expenses	14	13	54	180	18	39	52	964
Foreign exchange (gain) loss	(169)	126	(437)	(1,472)	(20)	919	248	693
<b>Total expenses</b>	<b>9,459</b>	<b>11,651</b>	<b>9,173</b>	<b>8,330</b>	<b>6,796</b>	<b>9,859</b>	<b>9,214</b>	<b>11,654</b>
Income tax (recovery) expense	—	—	—	(139)	—	—	—	—
<b>Net (loss) income</b>	<b>(5,231)</b>	<b>(7,371)</b>	<b>(3,341)</b>	<b>6,964</b>	<b>(3,254)</b>	<b>(6,206)</b>	<b>(5,558)</b>	<b>(7,004)</b>
Basic and diluted (loss) income per share	(0.14)	(0.20)	(0.09)	0.19	(0.10)	(0.17)	(0.15)	(0.20)
Other Comprehensive (loss) income (net of income taxes)	195	(10)	30	192	(161)	(69)	(484)	690
<b>Comprehensive (loss) income</b>	<b>(5,036)</b>	<b>(7,381)</b>	<b>(3,311)</b>	<b>7,156</b>	<b>(3,415)</b>	<b>(6,275)</b>	<b>(6,042)</b>	<b>(6,314)</b>

## **THREE-MONTH PERIOD ENDED DECEMBER 31, 2008 COMPARED TO THREE-MONTH PERIOD ENDED DECEMBER 31, 2007 – RESULTS OF OPERATIONS**

### **REVENUES**

#### **Research Collaborations and Contract Revenues**

Research collaborations and contract revenues in Q4, 2008 of \$2.8 million decreased by \$778 from Q4, 2007 due to lower clinical development related revenues from Celgene partially offset by higher revenues from Otsuka.

#### **License and Up-front Fees**

License and up-front fees of \$12.4 million in Q4, 2008 were \$11.3 million higher than in Q4, 2007 due to converting the license and collaboration agreement with Celgene. We transferred these amounts from current unearned revenues as we no longer have substantive obligations to Celgene.

### **RESEARCH AND DEVELOPMENT EXPENSES**

Gross research and development expenses in Q4, 2008 of \$9.1 million decreased by \$691 or 7.1% as compared to Q4, 2007. This decrease relates primarily to decreased expenditures in clinical development on MGCD0103 and lower expenditures on discovery research partially offset by higher expenditures on MGCD290 and MGCD265.

Government assistance of \$375 in Q4, 2008, primarily in the form of ITCs was \$49 higher than in Q4, 2007.

### **GENERAL AND ADMINISTRATIVE EXPENSES**

General and administrative expenses of \$1.2 million in Q4, 2008 was lower by \$68 or 5.2% as compared to Q4, 2007 primarily due to lower compensation costs due to the realignment and lower office expenses.

### **INTEREST INCOME AND FOREIGN EXCHANGE**

Interest income in Q4, 2008 of \$309 was \$433 lower than Q4, 2007 due to lower average cash balances and lower average interest rates of \$41.3 million and 2.58% in Q4 2008, versus \$64.8 million and 4.51% in Q4, 2007, respectively.

We recorded a realized foreign exchange gain in Q4, 2008 of \$1.5 million versus a loss of \$693 in Q4, 2007. The average exchange rates for the Canadian dollar versus the U.S. dollar for Q4, 2008 and Q4, 2007 were \$0.83 and \$1.02, respectively, on approximately US\$9 million of U.S. dollar denominated assets in both Q4, 2008 and Q4,2007.

## **OTHER EXPENSES**

Other expenses include amortization of property, plant and equipment, lease abandonment costs, write-off of patents and property, plant and equipment, and bank charges. Total other expenses of \$180 were \$784 lower than in 2007. The Company revised its estimate and recorded an additional lease abandonment cost of \$80 in Q4, 2008 [\$345 in Q4, 2007] taking into account current market information. The Company determined that certain of its property, plant and equipment were impaired as a consequence of the business realignment and consequently recorded a write-off of \$51 [nil in Q4, 2007] net of accumulated depreciation. In addition, the Company recorded a patent write-off of \$54 in Q4, 2008 [\$606 in Q4, 2007] net of accumulated depreciation.

## **INCOME TAXES**

In Q4, 2008, the Company recognized an amount of \$407 of unrealized gains on available-for-sale cash and cash equivalents and marketable securities in the statement of comprehensive loss net of a future income tax expense of \$139 for the year ended December 31, 2008. Pursuant to EIC-172, this future income tax liability was offset by an income tax benefit relating to previously unrecognized tax loss carryforwards which resulted in a \$139 future income tax recovery in the statement of operations for the quarter and year ended December 31, 2008.

## **COMPREHENSIVE LOSS**

We recorded an unrealized gain of \$525 in Q4, 2008 [unrealized gain of \$79 in Q4, 2007] on cash and cash equivalents and marketable securities through the comprehensive loss and a reversal of \$194 in Q4, 2008 relating to the reclassification into income of realized gains [reversal of \$609 in Q4, 2007 relating to the reclassification into income of realized losses] on cash and cash equivalents and marketable securities resulting in an overall increase of other comprehensive income in Q4, 2008 of \$331 [increase of \$690 in Q4, 2007] before income tax expense of \$139 [nil in Q4, 2007]. This relates primarily to the strengthening of the U.S. dollar versus the Canadian dollar on cash and available-for-sale cash equivalents and marketable securities denominated in U.S. dollars.

## **SUMMARY OF USE OF CASH**

Cash used in operations in the year ended December 31, 2008 was \$22.2 million which was essentially unchanged from the prior year. We acquired \$428 of property, plant and equipment and intangible assets during 2008 [\$1.5 million in 2007]. The reduction related primarily to lower spending on laboratory equipment and patents.

There was no cash generated from financing activities during 2008 [2007 – net \$18.8 million related to the issue of 5.5 million shares in respect of our financing which closed on March 2, 2007].

## **OTHER CAPITAL RESOURCES**

Research and development tax credits receivable as at December 31, 2008 of \$1,473 are \$181 higher than as at December 31, 2007 due to higher eligible expenditures in 2008. Unbilled revenues as at December 31, 2008 of \$4.4 million are marginally higher than as at December 31, 2007 due to lower clinical related revenues from Celgene offset by higher research related revenues from Otsuka. Other assets as at December 31, 2008 of \$1.7 million have decreased by \$138 from December 31, 2007 due primarily to lower interest receivable.

Accounts payable and accrued liabilities as at December 31, 2008 of \$9.2 million, are \$685 higher than as at December 31, 2007 due primarily to higher payables due to Celgene. The current portion of unearned revenue as at December 31, 2008 of \$549 is \$3.6 million lower than as at December 31, 2007 and long-term unearned revenue of \$2.9 million has decreased by \$11.7 million relating to the impact of converting the agreement with Celgene.

## **OFF-BALANCE SHEET ARRANGEMENTS**

Our off-balance sheet arrangements consist of operating leases, royalty and milestone commitments and guarantees. Other than these commitments, which are considered to be in the ordinary course of business, we do not have any other off-balance sheet arrangements and do not expect to enter into any other such arrangements outside of the ordinary course of our business in the near future.

## **TRANSACTIONS WITH RELATED PARTIES**

Taiho Pharmaceutical Co. Ltd. ("Taiho") and Celgene are related parties as they are shareholders of the Company. We have recorded \$27.5 million of contract revenues and license fees from these related collaborators during 2008 [\$14.3 million in 2007]. This significant increase relates to transferring the current and long-term unearned revenues to contract and license fees as we no longer have any substantive obligations to Celgene since we converted our agreement with them.

In addition, unbilled revenues amounted to \$3.8 million as at December 31, 2008 [\$4.1 million in 2007] the current and long-term portions of unearned revenues amounted to \$1.2 million as at December 31, 2008 [\$18.3 million in 2007] and accounts payable and accrued liabilities were \$2.2 million as at December 31, 2008 [\$1.1 million in 2007].

## **PROPOSED TRANSACTIONS**

At the Company's stage of development we pursue collaborations, licensing opportunities and potential M&A opportunities as well as various financing alternatives on an ongoing basis.

## **FINANCIAL INSTRUMENTS**

Although we carry significant U.S. dollar based investments and do have U.S. dollar expenditures and payments, we do not use currency or other hedging instruments as a policy.

## FINANCIAL COMMITMENTS

We are committed to two leases which expire in December 2010, two leases which expire in February 2011 and one lease, which we are seeking to sub-lease, which expires in December 2012. The lease abandonment costs recorded in the statement of operations and deficit are also included in the operating lease commitments shown in the table below. In addition, we have entered into several contracts with certain CROs, CMOs and other suppliers for clinical development that have incurred commitments beyond December 31, 2008 and which are reflected in the table below.

### OPERATIONAL LEASES – CONTRACTUAL OBLIGATIONS

(in millions of dollars)	Total \$	Less than 1 year (2009) \$	2-3 years (2010-2012) \$
Operating leases	3.3	1.4	1.9
Operating contract commitments	1.8	1.7	0.1
<b>Total</b>	<b>5.1</b>	<b>3.1</b>	<b>2.0</b>

### COMMITMENTS UNDER ROYALTY, LICENSE AND GOVERNMENT GRANT AGREEMENTS

There is a royalty payable between 0.75% to 1.75% of net sales relating to the beta-lactamase program if a product is commercialized.

We have also indemnified third parties under various research and license agreements (and clinical trial contracts) for certain damages and costs as a result of intellectual property claims or damages arising from the use of the intellectual property. In addition, we have agreed to indemnify corporate partners, CROs, CMOs and clinical trial sites. To date, we have not had any claims under these indemnification provisions and we do not anticipate that any amounts will be due under these agreements in the future.

### OUTSTANDING SHARE DATA

The number of common shares and stock options outstanding as of March 25, 2009 was 36,682,398 and 2,845,548, respectively. Total authorized number of stock options is 4,200,000 of which 115,146 have been previously exercised. This excludes 192,500 founder options which were issued outside the Plan and have also been exercised.

The decrease in loss to (\$0.24) per share in 2008 from (\$0.62) per share in 2007 is primarily the result of the increase in non-cash revenue due to converting the Celgene agreement.

## **DIVIDEND POLICY**

Our current intention is to reinvest future earnings in order to finance the growth of our business. As a result, we do not intend to pay dividends in the foreseeable future. Any future determination to pay cash dividends is at the discretion of our Board of Directors and will depend on our financial condition, results of operations, capital requirements and such other factors our Board of Directors deems relevant.

## **OTHER**

### **DISCLOSURE CONTROLS AND INTERNAL CONTROLS OVER FINANCIAL REPORTING**

In accordance with the Canadian Securities Administrators Multilateral Instrument 52-109, we have filed certificates signed by the President and Chief Executive Officer and the Vice-President Finance and Chief Financial Officer that, among other things, report on the design and effectiveness of disclosure controls and procedures (DC&P), and the design and effectiveness of internal controls over financial reporting (ICFR).

### **DISCLOSURE CONTROLS AND PROCEDURES**

The Company has designed disclosure controls and procedures, and has evaluated their effectiveness. Based on the evaluation of our DC&P, management has concluded that they are sufficiently effective as of December 31, 2008 to provide reasonable assurance that material information relating to the Company is made known to management particularly during the period in which the annual filings are being prepared.

### **INTERNAL CONTROLS OVER FINANCIAL REPORTING**

The Company has designed ICFR and evaluated their effectiveness as of December 31, 2008. Based on the evaluation of our ICFR, management has concluded that they were effective in providing reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with Canadian GAAP.

All control systems, no matter how well designed, have inherent limitations, including the possibility of human error and the circumvention or overriding of the controls or procedures. As a result, there is no certainty that our DC&P or ICFR will prevent all errors or all fraud.

There were no changes in our ICFR that occurred during the year ended December 31, 2008 that would materially affect, or is reasonably likely to materially affect our ICFR.

## MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING

The accompanying financial statements of MethylGene Inc. and other financial information included in this annual report are the responsibility of the management and have been approved by our Board of Directors.

These financial statements were prepared by management in accordance with Canadian generally accepted accounting principles and necessarily include some amounts that are based on management's best estimates and judgments where appropriate. Financial information included elsewhere in this annual report is consistent with that in the financial statements.

To ensure the accuracy and objectivity of the information contained in the financial statements, MethylGene Inc.'s management maintains a system of internal accounting and administrative controls.

Management believes this system gives reasonable assurance that the financial information is reliable and provides an adequate basis for the financial statements, and that the Company's assets are properly accounted for and safeguarded.

The Board of Directors carries out its responsibility for the financial statements in this annual report primarily through its Audit Committee. The Audit Committee is formed of independent directors who review the Company's annual financial statements as well as management's analysis and the operating results and recommend their approval to the Board.

These financial statements have been audited by our external auditors, Ernst & Young LLP, Chartered Accountants. They periodically meet with the Audit Committee to discuss auditing, the reporting of financial information and other related subjects.

(signed)  
Donald F. Corcoran  
President & CEO  
March 26, 2009

(signed)  
Klaus B. Kepper  
Vice President, Finance & CFO  
March 26, 2009

# AUDITORS' REPORT

To the Shareholders of  
**MethylGene Inc.**

We have audited the balance sheets of **MethylGene Inc.** as at December 31, 2008 and 2007 and the statements of operations and deficit, 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 December 31, 2008 and 2007 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<sup>1</sup>  
Chartered Accountants

Montréal, Canada  
February 23, 2009

<sup>1</sup> CA Auditor permit no. 16652

# BALANCE SHEETS

As at December 31 ,	2008	2007
[In thousands of Canadian dollars]	\$	\$
<b>ASSETS</b>		
<b>Current</b>		
Cash and cash equivalents	5,947	3,208
Marketable securities [notes 5 and 10]	32,659	57,525
Research and development tax credits receivable [note 15]	1,473	1,292
Unbilled revenue [note 12]	4,435	4,196
Interest receivable [note 7]	326	612
Other current assets [note 6]	1,034	886
<b>Total current assets</b>	<b>45,874</b>	<b>67,719</b>
Security deposits [note 7]	325	325
Property, plant and equipment [note 8]	2,131	3,089
Intangible assets [note 9]	1,947	2,007
	<b>50,277</b>	<b>73,140</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Current</b>		
Accounts payable and accrued liabilities [note 12]	9,192	8,507
Current portion of unearned revenue [note 12]	549	4,117
Current portion of lease abandonment cost [note 4]	192	186
<b>Total current liabilities</b>	<b>9,933</b>	<b>12,810</b>
Unearned revenue [note 12]	2,859	14,558
Lease abandonment cost [note 4]	399	524
<b>Total liabilities</b>	<b>13,191</b>	<b>27,892</b>
<b>Shareholders' equity</b>		
Capital stock [note 11]	118,095	118,095
Contributed surplus [note 11]	8,855	8,445
Deficit	(90,175)	(81,196)
Accumulated other comprehensive income (loss) [note 21]	311	(96)
<b>Total shareholders' equity</b>	<b>37,086</b>	<b>45,248</b>
	<b>50,277</b>	<b>73,140</b>

Commitments and guarantees [note 16]  
See accompanying notes

On behalf of the Board:

(signed)  
Colin R. Mallet  
Director

(signed)  
Louis Lacasse  
Director

## STATEMENTS OF OPERATIONS AND DEFICIT

For the years ended December 31, [In thousands of Canadian dollars, except for share and per share amounts]	2008 \$	2007 \$
<b>REVENUES</b> [notes 12 and 13]		
Research collaborations and contract revenues	12,188	11,381
License and up-front fees	17,307	4,120
	<b>29,495</b>	<b>15,501</b>
<b>EXPENSES</b>		
Research and development [notes 1, 8 and 9]	37,199	34,505
Government assistance [note 15]	(1,503)	(1,699)
Net current research and development	35,696	32,806
General and administrative	5,536	4,908
Interest income	(1,653)	(3,104)
Amortization of property, plant and equipment	17	17
Write-off of property, plant and equipment [note 1]	51	36
Write-off of intangible assets	97	642
Lease abandonment cost [note 4]	80	345
Corporate and other transaction costs [note 19]	725	—
Bank charges and interest	16	33
Foreign exchange (gain) loss	(1,952)	1,840
	<b>38,613</b>	<b>37,523</b>
Loss before income tax	(9,118)	(22,022)
Future income tax recovery [note 14]	139	—
<b>Net loss for the year</b>	<b>(8,979)</b>	<b>(22,022)</b>
Deficit, beginning of year	(81,196)	(59,174)
<b>Deficit, end of year</b>	<b>(90,175)</b>	<b>(81,196)</b>
Basic and diluted loss per share [note 11]	(0.24)	(0.62)
Weighted average number of common shares	36,682,398	35,740,880

## STATEMENTS OF COMPREHENSIVE LOSS

For the years ended December 31, [In thousands of Canadian dollars]	2008 \$	2007 \$
<b>Net loss for the year</b>	<b>(8,979)</b>	<b>(22,022)</b>
<b>Other comprehensive income (loss)</b> [note 21]		
Change in unrealized gains (losses) on cash equivalents and marketable securities, net of income tax expense of \$312 [2007 – nil]	699	(945)
Reclassification adjustment to net loss of realized (gains) losses on cash equivalents and marketable securities, net of income tax recovery of \$173 [2007 – nil]	(292)	921
	<b>407</b>	<b>(24)</b>
<b>Comprehensive loss for the year</b>	<b>(8,572)</b>	<b>(22,046)</b>

See accompanying notes

# STATEMENTS OF CASH FLOWS

For the years ended December 31, [In thousands of Canadian dollars]	2008 \$	2007 \$
<b>OPERATING ACTIVITIES</b>		
Net loss for the year	(8,979)	(22,022)
Items not affecting cash:		
Amortization of property, plant and equipment	1,170	1,307
Amortization of intangible assets	128	155
Lease abandonment cost [note 4]	80	345
Write-off of property, plant and equipment [note 1]	51	36
Write-off of intangible assets	97	642
Stock-based compensation expense [note 11]	410	547
Future income tax recovery [note 14]	(139)	—
Warrants related to license fees	—	5
	(7,182)	(18,985)
Net change in non-cash working capital balances related to operations [note 20]	(3,364)	842
Change in long-term portion of unearned revenue	(11,699)	(4,128)
<b>Cash flows related to operating activities</b>	<b>(22,245)</b>	<b>(22,271)</b>
<b>INVESTING ACTIVITIES</b>		
Acquisitions of property, plant and equipment	(263)	(767)
Acquisitions of intangible assets	(165)	(703)
Purchases of marketable securities	(87,352)	(134,820)
Proceeds from maturities of marketable securities	112,858	142,304
<b>Cash flows related to investing activities</b>	<b>25,078</b>	<b>6,014</b>
<b>FINANCING ACTIVITIES</b>		
Issuance of common shares [note 11]	—	20,193
Share issue costs [note 11]	—	(1,403)
<b>Cash flows related to financing activities</b>	<b>—</b>	<b>18,790</b>
Foreign exchange loss on cash equivalents held in foreign currency	(94)	(5)
<b>Increase in cash and cash equivalents</b>	<b>2,739</b>	<b>2,528</b>
Cash and cash equivalents, beginning of year	3,208	680
<b>Cash and cash equivalents, end of year</b>	<b>5,947</b>	<b>3,208</b>
<b>Cash and cash equivalents consist of:</b>		
Cash	2,535	622
Cash equivalents	3,412	2,586
	5,947	3,208

See accompanying notes

# NOTES TO FINANCIAL STATEMENTS

December 31, 2008

[In thousands of Canadian dollars, except share and per share amounts]

## 1. DESCRIPTION OF BUSINESS

MethylGene Inc. [the “Company”] was incorporated on December 13, 1995 under the *Quebec Companies Act* and is a biopharmaceutical company operating in one business segment focused on the discovery, development and commercialization of novel therapeutics with a focus on cancer. On June 29, 2004, the Company’s shares were listed on the Toronto Stock Exchange.

To date, the Company has not generated any revenue from product sales and has met its cash requirements primarily through share issuances, collaborative research agreements, government assistance programs including investment tax credits and government grants, and interest income. Until the Company attains profitability, it will be necessary to raise additional funds for the continuing development and commercialization of its programs.

### BUSINESS REALIGNMENT

During the year ended December 31, 2008, the Company realigned its operations to focus resources on the development of its clinical pipeline and as a result, began the process to discontinue discovery research. The reduction, of approximately 50% of the Company’s workforce, will be done in three phases. The first two phases have been completed as of January 22, 2009. The research is being phased in order to ensure the Company meets its commitments to the funded research programs including sirtuin inhibitors with Celgene Corporation [“Celgene”] and kinase inhibitors for ocular diseases with Otsuka Pharmaceutical Co. Ltd. [“Otsuka”]. The Company recorded charges of \$403 in the year ended December 31, 2008 including termination costs of \$352, of which \$61 remains as a liability at December 31, 2008, and impairment charges related to property, plant and equipment of \$51. The expected completion of this realignment is September 30, 2009.

## 2. CHANGES IN ACCOUNTING POLICIES

### 2008

The following *Handbook* Sections, released by the Canadian Institute of Chartered Accountants (CICA), were adopted by the Company on January 1, 2008 and applied prospectively without restatement:

Section 1535, “Capital Disclosures”, establishes standards for disclosing information about an entity’s capital and how it is managed. It describes the disclosure of the entity’s objectives, policies and processes for managing capital, the quantitative data about what the entity regards as capital, whether the entity has complied with any capital requirements, and, if it has not complied, the consequences of such non-compliance. Disclosure requirements pertaining to Section 1535 are included in note 17.

Section 3862, “Financial Instruments – Disclosures”, describes the required disclosure for the assessment of the significance of financial instruments for an entity’s financial position

and performance and of the nature and extent of risks arising from financial instruments to which the entity is exposed and how the entity manages those risks. Disclosure requirements pertaining to Section 3862 are included in note 18.

Section 3863, "Financial Instruments – Presentation", establishes standards for presentation of financial instruments and non-financial derivatives. It carries forward the presentation related requirements of Section 3861 "Financial Instruments – Disclosure and Presentation". Disclosure requirements pertaining to Section 3863 are included in note 18.

Section 1400, "General Standards of Financial Statement Presentation", has been amended to include requirements to assess and disclose an entity's ability to continue as a going concern. The adoption of this Section had no impact on the Company's annual financial statements.

## 2007

Effective January 1, 2007, the Company adopted the new recommendations of the *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 and resulted in changes in accounting for financial instruments and the recognition of unrealized gain and loss on these instruments. Disclosure requirements pertaining to Sections 3855 and 3865 are included in note 18, while those relating to Section 1530 are included in note 21.

The Company does not currently have any outstanding contracts with embedded derivatives; therefore, the adoption of Section 3855, "Financial Instruments – Recognition and Measurement", does not have any impact on the Company's financial statements as of January 1, 2007, except for the accumulated loss of \$72 on marketable securities included in other comprehensive loss [see note 21].

## 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

### USE OF ESTIMATES

The preparation of financial statements in conformity with Canadian GAAP requires management to make estimates and assumptions that 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 year. Significant estimates include, but are not limited to, revenue recognition, the period over which certain deferred revenue is recognized, the measurement of allowance for future tax assets, tax credits, impairment of long-lived assets, valuation of lease abandonment costs, as well as stock-based compensation. The Company reviews all significant estimates affecting the financial statements on a recurring basis and records the effect of any adjustments when necessary. Actual results could differ from those estimates, and such differences could be material.

### 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES [Cont'd]

#### CASH AND CASH EQUIVALENTS

Cash comprises cash on hand and demand deposits. Cash equivalents are marketable securities comprised of bankers' acceptances and short-term certificates of deposit, highly liquid investments that are readily convertible to known amounts of cash and have an original maturity of less than 90 days. The Company expenses transaction costs as incurred.

#### MARKETABLE SECURITIES

Marketable securities are classified as available-for-sale. They consist of commercial papers and corporate bonds and are recorded at their fair value based on quoted market prices. The Company expenses transaction costs as incurred.

#### PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment are recorded at cost and are depreciated based on their estimated useful lives according to the following methods and rates:

Computer hardware and software	straight-line	3 years
Office and other equipment	straight-line	6 years
Laboratory equipment	straight-line	6 years
Leasehold improvements	straight-line	over the lease term

#### INTANGIBLE ASSETS

Patents are recorded at cost and include the related legal fees. Patent costs are amortized on a straight-line basis over the remaining life of the patents, not exceeding 20 years.

#### IMPAIRMENT OF LONG-LIVED ASSETS

Property, plant and equipment and intangible assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. Impairment is assessed by comparing the carrying amount of an asset to be held and used with the sum of the undiscounted cash flows expected from its use and disposal. If such assets are considered impaired, the impairment loss to be recognized is measured by the amount by which the carrying amount of the assets exceeds its fair value generally determined on a discounted cash flow basis. Any impairment results in a write-down of the asset and a charge to income during the year.

## **REVENUE RECOGNITION**

The Company recognizes revenue from research collaboration agreements and licensing arrangements, which may include multiple elements. Revenue arrangements with multiple elements are reviewed in order to determine whether the multiple elements can be divided into separate units of accounting. If separable, the consideration received is allocated among the separate units of accounting based on their respective fair values, and the applicable revenue recognition criteria are applied to each of the separate units. Otherwise, the applicable revenue recognition criteria are applied to combined elements as a single unit of accounting.

Revenues from research collaboration agreements recognized as separate units are recognized as the contracted services are performed or when milestones are achieved, in accordance with the terms of the specific agreements and when collection is reasonably assured. Revenue recognized but not yet invoiced to partners is recorded as unbilled revenue.

Combined elements including up-front payments for the use of technology where further services are to be provided or fees received on the signing of research agreements are recognized over the period of performance of the related activities. As such, up-front licensing revenue is deferred and recognized over the term during which the Company maintains substantive contractual obligations, and amounts received in advance of recognition of revenue are reported as unearned revenues. In the event the period of substantive obligations changes, then the appropriate adjustment will be made to the amortization of unearned revenue.

Interest income is accrued and recognized on an accrual basis.

## **GOVERNMENT ASSISTANCE**

Grant amounts resulting from government assistance programs, including investment tax credits for research and development, are reflected as reductions of the cost of the assets or expenses to which they relate when there is reasonable assurance that the assistance will be received.

## **RESEARCH AND DEVELOPMENT EXPENSES**

Research costs are charged against income in the year of expenditure. Development costs are charged against income in the year of expenditure, unless a development project meets the criteria under Canadian GAAP for deferral and amortization. The Company has not deferred any such development costs to date.

### **3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES [Cont'd]**

#### **INCOME TAXES**

The Company 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 basis of assets and liabilities and are measured using substantively enacted tax rates and laws that are expected to be in effect in the years 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.

#### **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 statements of operations, with the exception of unrealized gains and losses arising from the translation of foreign currency on cash equivalents and marketable securities classified as available-for-sale, which are recognized in the statements of comprehensive loss until realized.

#### **LOSS PER SHARE**

Loss per share is calculated using the weighted average number of common shares outstanding during the year. Diluted loss per share is calculated using the treasury stock method, giving effect to the exercise of all dilutive factors. The treasury stock method assumes that any proceeds that could be obtained upon the exercise of options would be used to purchase common shares at the average market price during the year.

#### **STOCK-BASED COMPENSATION PLAN**

The Company has a stock-based compensation plan, which is described in note 11. The Company has applied the fair value-based method to expense all employee options awarded since January 1, 2003. All options granted to consultants were and continue to be expensed using the fair value-based method. The fair value of stock options granted is determined at the date of grant using the Black-Scholes option pricing model and expensed over the vesting period of the options. Any contributions paid by employees on exercise of the stock options or purchase of stock are credited to share capital.

#### **ISSUANCE COSTS OF CAPITAL STOCK**

The Company records share issuance costs as a reduction of capital stock.

#### **FINANCIAL INSTRUMENTS**

All financial assets and liabilities are classified based on their inherent characteristics, management's intended use, or the choice of category in certain circumstances. When they are initially recognized, all financial assets are classified as held for trading, held-to-maturity,

available-for-sale or loans and receivables, while financial liabilities are classified as held for trading or other financial liabilities. Upon initial recognition, all financial assets and liabilities are recorded at fair value in the balance sheet. In subsequent periods, they are measured at fair value, except for financial assets held-to-maturity, loans and receivables and financial liabilities not held for trading purposes which are measured at amortized cost calculated using the effective interest method.

	Classification	Measurement
<b>Financial assets</b>		
Cash and cash equivalents	Available-for-sale	Fair value
Marketable securities	Available-for-sale	Fair value
Interest receivable	Loans and receivables	Amortized cost
Unbilled revenue	Loans and receivables	Amortized cost
Security deposits	Loans and receivables	Amortized cost
<b>Financial liabilities</b>		
Accounts payable and accrued liabilities	Other financial liabilities	Amortized cost

#### RECENT ACCOUNTING PRONOUNCEMENTS

In February 2008, the CICA issued Section 3064, "Goodwill and Intangible Assets". Section 3064, which replaces Section 3062, "Goodwill and Other Intangible Assets" and Section 3450, "Research and Development Costs", establishes standards for the recognition, measurement, presentation and disclosure of goodwill and intangible assets. This standard is effective for the Company for interim and annual financial statements beginning on January 1, 2009 and it is expected that this new Section will result in the write-off against deficit as a retrospective adjustment, of \$1.9 million of intangible assets related to previously capitalized patent expenses as none of the Company's programs relating to these patents have received regulatory approval for commercialization.

#### 4. LEASE ABANDONMENT COST

In June 2005, the Company abandoned certain leased premises in order to consolidate its research and development operations, and accommodate its growing clinical development department. The Company recorded lease abandonment charges of \$476 during the year ended December 31, 2005, which represented management's best estimate of anticipated non-recoverable lease costs. The Company is seeking to sublease the abandoned facility.

During the years ended December 31, 2008 and 2007, the Company revised its best estimate of anticipated non-recoverable lease costs, taking into account current market information, and recorded additional lease abandonment charges of \$80 [2007 – \$345].

During the year ended December 31, 2008, \$199 of the lease abandonment cost liability was amortized, as payments were made under the terms of the lease [2007 – \$189].

## 5. MARKETABLE SECURITIES

	2008 \$	2007 \$
Commercial paper denominated in Canadian dollars, earning interest at rates ranging from 2.13% to 3.00% [2007 – 3.95% to 4.68%] and maturing on various dates from January 5, 2009 to March 10, 2009 [2007 – February 5, 2008 to May 5, 2008]	26,245	50,652
Commercial paper denominated in U.S. dollars [US\$800], [2007 – US\$5,932], earning interest at 3.41% [2007 – 3.90% to 4.95%] and maturing on January 29, 2009 [2007 – February 19, 2008 to April 14, 2008]	976	5,881
Promissory note issued in Canadian currency, earning interest at 2.05% and maturing on March 17, 2009	1,002	—
Promissory notes issued in U.S. currency [US\$3,631] earning interest ranging from 1.85% to 2.45% and maturing from February 19, 2009 to April 19, 2009	4,436	—
Fixed coupon bonds, in U.S. currency [US\$1,001] earning interest at effective interest rates ranging from 5.02% to 5.11% and matured in 2008	—	992
	<b>32,659</b>	<b>57,525</b>

Marketable securities consist of commercial papers issued by six [2007 – 11] public corporations and one commercial paper guaranteed by the Municipality of Montreal, promissory notes guaranteed by the Quebec Provincial or Federal Government [2007 – nil] and no fixed coupon bond [2007 – one fixed coupon bond issued by a Canadian public corporation]. Three corporations [2007 – four] account for \$19,285 [2007 – \$31,415].

## 6. OTHER CURRENT ASSETS

	2008 \$	2007 \$
Prepaid expenses	730	617
Commodity taxes and other receivables	304	269
	<b>1,034</b>	<b>886</b>

## 7. SECURITY DEPOSITS

Security deposits are comprised of cash held in escrow that serves to guarantee certain obligations reflected in the employment contracts of two executives. Included in the interest receivable is \$86 [2007 – \$84] related to the security deposits.

## 8. PROPERTY, PLANT AND EQUIPMENT

	Cost \$	Accumulated amortization \$	Net carrying value \$
<b>December 31, 2008</b>			
Computer hardware and software	1,614	1,271	343
Office and other equipment	123	104	19
Laboratory equipment	4,446	3,474	972
Leasehold improvements	3,273	2,476	797
	<b>9,456</b>	<b>7,325</b>	<b>2,131</b>
<b>December 31, 2007</b>			
Computer hardware and software	1,855	1,422	433
Office and other equipment	123	97	26
Laboratory equipment	5,405	3,921	1,484
Leasehold improvements	3,183	2,037	1,146
	<b>10,566</b>	<b>7,477</b>	<b>3,089</b>

Amortization expense included in research and development expenses amounted to \$1,153 for the year ended December 31, 2008 [2007 – \$1,290].

During the year ended December 31, 2008, the Company determined that certain of its property, plant and equipment were no longer being used in its operations. Consequently, the Company wrote off laboratory equipment with a carrying value of \$51 [2007 – \$5] net of accumulated amortization of \$978 [2007 – \$6] and computer hardware and software with a carrying value of nil [2007 – \$31] and accumulated amortization of \$345 [2007 – \$129].

## 9. INTANGIBLE ASSETS

	Cost \$	Accumulated amortization \$	Net carrying value \$
<b>December 31, 2008</b>			
Patents	2,595	648	1,947
<b>December 31, 2007</b>			
Patents	2,540	533	2,007

Amortization expense of patents has been charged to research and development expenses in the amount of \$128 for the year ended December 31, 2008 [2007 – \$155].

## 9. INTANGIBLE ASSETS [Cont'd]

The Company determined that intellectual property associated with certain of its patents were no longer required or no longer part of the Company's core business. As a result, patents included in the Company's portfolio with a carrying value of \$97 [2007 – \$642] net of accumulated amortization of \$13 [2007 – \$295] were written off during the year ended December 31, 2008.

In addition to patents disclosed above, the Company also has licenses with a cost of \$1,545 which are fully amortized.

## 10. BANK INDEBTEDNESS

In 2008, the Company renewed a revolving credit facility agreement, which has a one-year term, to a maximum of \$1,500 [or its U.S. equivalent]. The facility bears interest at a Canadian chartered bank's prime rate which was 3.5% as at December 31, 2008 [2007 – 6%] and is collateralized by a charge on certain marketable securities in the amount of \$1,560. The Company has not drawn any amount against this facility at December 31, 2008 and 2007.

Also, the Company has letters of guarantee outstanding related to future lease payments for an amount of \$630 [2007 – \$647]. These letters of guarantee are collateralized by a charge on specific marketable securities of \$672 [2007 – \$673].

## 11. CAPITAL STOCK

### AUTHORIZED

An unlimited number of voting common shares without par value.

### ISSUED AND OUTSTANDING – COMMON SHARES

	Year ended		Year ended	
	December 31, 2008		December 31, 2007	
	#	\$	#	\$
<b>Balance, beginning of year</b>	<b>36,682,398</b>	<b>118,095</b>	31,007,498	99,294
Issued for cash consideration	—	—	5,500,000	20,075
Share issue costs for the year	—	—	—	(1,403)
Options exercised	—	—	174,900	129
<b>Balance, end of year</b>	<b>36,682,398</b>	<b>118,095</b>	36,682,398	118,095

On March 2, 2007, the Company issued 5,500,000 common shares at \$3.65 per share for a total cash consideration of \$20,075. Syndicate commissions and other expenses of the offering amounted to \$1,403, resulting in net proceeds of \$18,672.

On May 4, 2006, the Company concluded a private placement of US\$19,900 (\$22,804) pursuant to which the Company issued 7,356,044 units at a subscription price per unit of \$3.10, each unit consisting of one common share and thirty one-hundredths (0.30) of a common share purchase warrant, exercisable for a period of three years from the date of issuance at an exercise price of \$3.90 for the initial year, \$4.10 for the second year, and \$4.25 for the third year. An aggregate of 7,356,044 common shares and 2,206,809 common share purchase warrants were issued in this transaction. The warrants expire on May 3, 2009, and none had been exercised as at December 31, 2008. The fair value of the warrants amounted to \$0.86 per warrant for a total of \$1,898 and this amount has been included in contributed surplus with a corresponding decrease in the value of the common shares issued on May 4, 2006.

### CONTRIBUTED SURPLUS

The changes to contributed surplus for the years ended December 31, are as follows:

	2008	2007
	\$	\$
<b>Balance, beginning of year</b>	<b>8,445</b>	7,909
Stock-based compensation expense	410	547
Options exercised	—	(11)
<b>Balance, end of year</b>	<b>8,855</b>	8,445

### STOCK-BASED COMPENSATION PLAN

The Company has in place a Stock Option Plan [the “Plan”] for the benefit of employees, directors, officers and consultants of the Company which was amended by resolution of the shareholders of the Company on September 17, 2002, April 23, 2004, and most recently on April 19, 2007. The Plan was amended to increase the authorized share options available to be purchased to 4,200,000 representing approximately 11.4% of the issued and outstanding common shares to facilitate the way in which future amendments can be made to the Plan and to add a provision relating to options exercisable during a blackout period. In addition, there were 192,500 options at \$0.36 per share granted prior to the establishment of the Plan, during the start-up phase of the Company [the “Founder Options”]. As at December 31, 2007, all of the 122,500 Founder Options outstanding at December 31, 2006 have been exercised. The terms and conditions of the Founder Options were similar to those of the Plan.

## 11. CAPITAL STOCK [Cont'd]

### STOCK-BASED COMPENSATION PLAN [Cont'd]

The vesting period of the stock options is at the discretion of the Company's Board of Directors. In 2008, the Board of Directors awarded a one-time fully-vested award of 345,000 options to the Directors and the executive management of the Company. The majority of the remaining options vest over a period of three years. The exercise price of any option granted under the Plan is based on the fair market value of common stock, determined by the closing sale price of the common shares on the Toronto Stock Exchange, on the day before the stock options are granted, or if no sale is reported on that day, the "Market price" shall be deemed to be the volume weighted average trading price for the common shares for the five days preceding the date of grant during which the common shares were traded. The term of an option will not exceed ten years from the date of the grant. Stock options awarded prior to March 8, 2005 and certain options awarded on March 8, 2005 had a ten-year term. All other options awarded on or subsequent to March 8, 2005 were awarded with a five-year term.

The changes to the number of stock options granted by the Company including the Founder Options, and their weighted average exercise price are as follows:

	2008		2007	
	#	\$	#	\$
<b>Balance, beginning of year</b>	<b>3,082,073</b>	<b>3.77</b>	3,035,335	3.68
Granted	796,900	1.19	363,750	2.99
Forfeited	(283,225)	3.16	(142,112)	3.64
Exercised	—	—	(174,900)	0.67
<b>Balance, end of year</b>	<b>3,595,748</b>	<b>3.25</b>	3,082,073	3.77
<b>Options exercisable, end of year</b>	<b>3,138,132</b>	<b>3.37</b>	2,579,169	3.89

Additional information concerning stock options as at December 31, 2008 is as follows:

Exercise price	Options outstanding		Options exercisable
	Number of options	Weighted average months to expiry	Number of options
\$0.19 – \$1.80	419,475	57.4	374,100
\$2.10 – \$2.95	716,225	34.8	395,400
\$3.10 – \$3.74	559,375	39.5	485,384
\$4.07 – \$4.50	1,900,673	32.3	1,883,248
	<b>3,595,748</b>	<b>36.9</b>	<b>3,138,132</b>

The Company recorded an expense of \$410 in the year ended December 31, 2008 [2007 – \$547] related to stock option awards with a credit to contributed surplus for the same amount.

The fair value of option grants are estimated at the date of grant using the Black-Scholes option pricing model and the following assumptions:

<b>Weighted average</b>	<b>Year ended December 31, 2008</b>	Year ended December 31, 2007
Risk-free interest rate	<b>2.40%</b>	4.22%
Dividend yield	<b>Nil</b>	Nil
Volatility factor	<b>60.70%</b>	40.62%
Expected life	<b>5 years</b>	5 years

The estimated fair value of the options is amortized to expense over the option's vesting period. The weighted average fair value of stock options granted during 2008 under the Black-Scholes option pricing model, and above assumptions was \$0.51 [2007 – \$1.26].

#### **LOSS PER SHARE**

There were no adjustments to the weighted average number of shares outstanding for the purpose of calculating diluted loss per share, because to do so would be anti-dilutive.

## **12. RELATED PARTY TRANSACTIONS**

The Company engaged in transactions with its corporate partners, Celgene and Taiho, who are also current shareholders. These transactions are accounted for at the contractually agreed upon exchange amount.

Significant transactions during the years ended December 31 between corporate partners are as follows:

	<b>2008</b>	2007
	<b>\$</b>	\$
Contract revenue and licensing fees	<b>27,537</b>	14,345

As at December 31, balances with the corporate partners recorded in the balance sheets are as follows:

	<b>2008</b>	2007
	<b>\$</b>	\$
Unbilled revenue	<b>3,795</b>	4,067
Accounts payable and accrued liabilities	<b>2,225</b>	1,082
Current and long-term portions of unearned revenue	<b>1,198</b>	18,275

## 12. RELATED PARTY TRANSACTIONS [Cont'd]

On October 24, 2008, the Company was informed by Celgene that they were terminating the license and collaboration agreement, subject to a 90-day transition period. As a result, the Company has reacquired exclusive rights as of January 23, 2009, for the oncology histone deacetylase ["HDAC"] inhibitors including MGCD0103 and sirtuin inhibitors in the territories licensed to Celgene. On September 17, 2008, the Company informed Celgene of the Company's right to convert the license and collaboration agreement, subject to a 90-day notice period. The Company would no longer have the right to co-promote and profit-share on commercialization in North America, but would receive future royalty and milestone payments.

As a result, Celgene was responsible for 100% of development costs for MGCD0103 for the period from December 17, 2008 to January 22, 2009, inclusive, and the Company is responsible for any future development costs thereafter. Celgene was responsible to continue funding the sirtuin research program up to January 22, 2009, inclusively. Also, as a result of converting the agreement, the Company no longer has any continuing obligations towards Celgene for this program, and recognized an additional \$14.2 million of license and up-front fees during the year ended December 31, 2008.

## 13. SEGMENTED INFORMATION

The Company operates in a single business segment focused on the discovery, development and commercialization of novel therapeutics. In addition, the Company earns interest income from the investment of its excess cash.

The Company operates out of its facilities in Canada and all of its assets are located in Canada. The Company's contract revenues and license fees were derived as follows:

	2008	2007
	\$	\$
United States	27,969	15,159
Japan	1,526	342
	<u>29,495</u>	<u>15,501</u>

## 14. INCOME TAXES

The income tax expense reported differs from the amount of the tax expense (recovery) computed by applying Canadian federal and the applicable provincial statutory rates to loss before income taxes. The combined statutory rates were 30.90% in 2008 and 32.02% in 2007. The reasons for the differences and the related tax effects are as follows:

	2008	2007
	\$	\$
Statutory federal and provincial taxes	(2,817)	(7,051)
Increase (decrease) in taxes recoverable resulting from:		
Non-deductible expenses	67	21
Non-deductible stock-based compensation and warrants issued	127	175
Unrecognized tax benefits of operating losses and other available deductions	3,334	7,382
Tax credits not taxable in Québec	(169)	(165)
Share issue costs	(296)	(306)
Permanent difference related to premium on shares	(246)	(56)
Tax benefits of losses not previously recognized	(139)	—
	(139)	—

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

	2008	2007
	\$	\$
<b>Future income tax liabilities</b>		
Carrying values of property, plant and equipment and intangible assets in excess of tax basis	159	463
Unrealized gains on cash equivalents and marketable securities	139	—
<b>Total future income tax liabilities</b>	298	463
<b>Future income tax assets</b>		
Deferred contract revenue	964	5,291
Net capital losses carryforward	253	253
Non-capital losses carryforward	4,275	2,850
Research and development expenditures	21,670	16,454
Share issue costs	363	659
Other	638	868
Total future income tax assets	28,163	26,375
Valuation allowance	(27,865)	(25,912)
<b>Net future income tax assets</b>	298	463
<b>Net future income taxes</b>	—	—

#### 14. INCOME TAXES [Cont'd]

The Company has research and development expenditures of \$89,346 [2007 – \$70,942] for federal income tax purposes and \$69,439 [2007 – \$48,844] for provincial income tax purposes which have not been deducted. These expenditures are available to reduce future taxable income and have an unlimited carryforward period. Research and development tax credits and expenditures are subject to verification by the tax authorities, and accordingly, these amounts may vary by a material amount.

The Company also has accumulated share issue costs amounting to approximately \$1,100 [2007 – \$2,057]. The benefits of these expenses have not been recorded in these financial statements.

As at December 31, 2008, the Company has non-capital losses of \$16,924 [2007 – \$11,558] that are available to offset future taxable income for Canadian federal and \$14,592 [2007 – \$9,384] for provincial tax purposes. These losses expire as follows:

	Federal \$	Provincial \$
2014	323	—
2015	1,851	—
2027	10,612	10,454
2028	4,138	4,138
	<u>16,924</u>	<u>14,592</u>

The benefit of non-capital losses has not been recognized in these financial statements.

#### 15. GOVERNMENT ASSISTANCE

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. These amounts have been recorded as a reduction of research and development expenses.

The government assistance recorded as a reduction of research and development expenses is as follows:

	2008 \$	2007 \$
Investment tax credits	1,480	1,668
Natural Sciences and Engineering Research Council of Canada	23	31
	<u>1,503</u>	<u>1,699</u>

The Company has available non-refundable investment tax credits of \$12,481 as at December 31, 2008 related to research and development expenditures which may be utilized to reduce federal income taxes payable in future years and expire as follows for the years ending December 31:

	\$
2015	2,759
2026	3,037
2027	3,482
2028	3,203
	12,481

The benefits of these non-refundable investment tax credits have not been recognized in the financial statements.

## 16. COMMITMENTS AND GUARANTEES

### [I] OPERATING LEASES

The Company is committed under five operating leases for the lease of premises; two until December 31, 2010, two until February 28, 2011 and one until December 31, 2012. Future minimum annual payments required over the next four years are as follows:

	\$
2009	1,372
2010	1,384
2011	303
2012	214
	3,273

The total operating lease commitments reported in the table above includes the lease abandonment cost recorded in the statements of operations and deficit for 2008 and 2007 [note 4].

In addition, the Company has future years' costs to be recovered of \$831 between 2009 and 2012 as a result of a cost-sharing arrangement with a third party. This amount has reduced the total operating lease commitments reported in the table above.

### [II] RESEARCH AND DEVELOPMENT CONTRACTS

The Company is committed to several ongoing clinical development contracts. Future commitments relating to these contracts at December 31, 2008 are approximately \$1,754 including US\$613. There are committed amounts of \$1,679 and \$75 in 2009 and 2010, respectively.

## 16. COMMITMENTS AND GUARANTEES [Cont'd]

### [III] OTHER AGREEMENTS

The Company has entered into a license agreement with a U.S. university for a patent covering the Company's small molecule beta-lactamase inhibitors. This agreement provides for a royalty payment of between 0.75% and 1.75% of net sales of any product derived therefrom or royalties varying from 10% to 20% of sub-licensing income.

### [IV] OTHER GUARANTEES

The Company regularly enters into research or licence agreements 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 the use of the intellectual property. In some cases, the maximum potential amount of future payments that could be required under these indemnification provisions is unlimited. 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. In addition, the Company has indemnifications to corporate partners, contract research organizations, contract manufacturers and clinical trial sites.

Historically, the Company has not made any indemnification payments under such agreements and no amount has been accrued in the accompanying financial statements with respect to these indemnification obligations.

## 17. MANAGEMENT OF CAPITAL

The Company's objectives when managing capital is to safeguard its ability to continue as a going concern, to provide returns for shareholders and to minimize its cost of capital.

In the management of capital, the Company includes shareholders' equity [excluding accumulated other comprehensive income (loss)] and unearned revenue in the definition of capital. As at December 31, 2008, the Company's capital included the following:

	\$
Shareholders' equity [excluding accumulated other comprehensive income (loss)]	36,775
Total unearned revenue	3,408
	<u>40,183</u>

The Company's primary objective with respect to its capital management is to ensure that it has sufficient cash resources to fund its research and clinical development activities and to maintain its ongoing operations. To secure the additional capital necessary to pursue these plans, the Company may attempt to raise additional funds through the issuance of debt or equity, by merger and acquisition, by securing additional partnerships or by disposing of assets.

The current world-wide economic climate/environment is making it relatively difficult for companies, including MethylGene, to raise capital. The Company has implemented several steps to extend cash by focusing its resources on its most promising clinical programs and has restructured by discontinuing its non-funded research programs. The Company believes that based on its current strategy, cash and investments plus revenues from current collaborators, tax credits and investment income that it will have sufficient resources to carry out planned research and development into the third quarter of 2010.

## 18. FINANCIAL INSTRUMENTS

### CLASSIFICATION OF FINANCIAL INSTRUMENTS

Financial assets and financial liabilities are measured on an ongoing basis at fair value or amortized cost. As at December 31, 2008 and 2007, the classification of financial instruments, as well as their carrying values and fair values, were as follows:

	Available- for-sale \$	Loans and receivables \$	Other financial liabilities \$	Total carrying value \$	Fair value \$
<b>2008</b>					
<b>Financial assets</b>					
Cash and cash equivalents	5,947	—	—	5,947	5,947
Marketable securities	32,659	—	—	32,659	32,659
Unbilled revenue	—	4,435	—	4,435	4,435
Interest receivable	—	326	—	326	326
Security deposits	—	325	—	325	325
	<b>38,606</b>	<b>5,086</b>	<b>—</b>	<b>43,692</b>	<b>43,692</b>
<b>Financial liabilities</b>					
Accounts payable and accrued liabilities <sup>1</sup>	—	—	7,859	7,859	7,859
	—	—	7,859	7,859	7,859
<b>2007</b>					
<b>Financial assets</b>					
Cash and cash equivalents	3,208	—	—	3,208	3,208
Marketable securities	57,525	—	—	57,525	57,525
Unbilled revenue	—	4,196	—	4,196	4,196
Interest receivable	—	612	—	612	612
Security deposits	—	325	—	325	325
	<b>60,733</b>	<b>5,133</b>	<b>—</b>	<b>65,866</b>	<b>65,866</b>
<b>Financial liabilities</b>					
Accounts payable and accrued liabilities <sup>1</sup>	—	—	7,680	7,680	7,680
	—	—	7,680	7,680	7,680

<sup>1</sup> Excluding certain provisions and reserves.

## 18. FINANCIAL INSTRUMENTS [Cont'd]

### FAIR VALUE OF FINANCIAL INSTRUMENTS

The Company has determined the estimated fair value of its financial instruments based on appropriate valuation methodologies. The estimated fair value amounts can be affected by the use of different assumptions or methodologies. The methods and assumptions used to estimate the fair value of financial instruments are described below:

- The fair value of cash and cash equivalents and marketable securities has been determined by reference to published price quotations when financial assets are quoted in active markets. At December 31, 2008, the fair value of cash and cash equivalents and marketable securities approximates their carrying value.
- Given their short-term maturity, the fair value of unbilled revenue, interest receivable, security deposits and accounts payable and accrued liabilities approximates their carrying value.

### CREDIT RISK

The maximum exposure to credit risk of the Company at December 31, 2008, is the carrying value of its cash and cash equivalents, marketable securities, unbilled revenue, interest receivable and security deposits. The Company has an investment policy that monitors the safety and preservation of principal and investments, which limits the amount invested in any one company or fund and requires the investments to be made in R1 low or higher companies or funds. The investments are reviewed quarterly by the Audit Committee. The Company does not have any investments in non-bank-sponsored asset-backed commercial paper.

The Company manages credit risk by maintaining bank accounts with reputable banks and financial institutions and investing only in R1 low or higher corporations with securities that are traded on active markets and are capable of immediate liquidation subject to some minor market price variations upon sale. The cash and cash equivalents are comprised of commercial papers, bankers' acceptances and bearer deposit notes at December 31, 2008 [term deposits and bankers' acceptances at December 31, 2007]. Cash and cash equivalents as at December 31, 2008 and 2007 are as follows:

	2008	2007
	\$	\$
Two Canadian chartered banks	5,947	3,208

The Company has a credit facility agreement and letters of guarantee outstanding related to future lease payments that are collateralized by a charge on certain cash equivalents and marketable securities for an amount of \$1,500 and \$630, respectively. The Company currently has no borrowing against the credit facility.

The unbilled revenue relates primarily to one partner, who is also a shareholder, and the Company expects to invoice and receive these amounts in the first quarter of 2009. Management has determined that all unbilled revenues are collectible and has not recorded a provision against these amounts. During 2008, the same partner, who is also a shareholder, represented 92% of revenues [2007 – 90%].

#### FOREIGN EXCHANGE RISK

The Company operates internationally and all of its revenue from research collaborations contracts, license and up-front fee agreements is denominated in U.S. dollars. This results in financial risk due to fluctuations in the value of the Canadian dollar relative to the U.S. dollar. The Company believes it has an economic hedge for a portion of this risk, in that many of its expenditures are in U.S. dollars. Fluctuations in payments made by the Company could cause unanticipated fluctuations in the Company's operating results.

The Company maintains cash and cash equivalents, marketable securities, interest receivable, unbilled revenue and accounts payable and accrued liabilities in U.S. dollars and is therefore exposed to foreign exchange risk on these balances.

The significant balances in U.S. dollars as at December 31 are as follows:

	2008 US\$	2007 US\$
Cash and cash equivalents	4,116	1,870
Marketable securities	4,442	6,933
Unbilled revenue	3,498	3,454
Interest receivable	35	95
Accounts payable and accrued liabilities	(3,645)	(3,072)
Net exposure	8,446	9,280

Based on the aforementioned net exposure as at December 31, 2008, and assuming that all other variables remain constant, a 5% rise or fall in the Canadian dollar against the U.S. dollar would have resulted in (increases) decreases in net loss and comprehensive loss as follows:

	Canadian Dollar:	
	Appreciates 5% \$	Depreciates 5% \$
Against U.S. dollar		
Net loss	7	(7)
Other comprehensive loss	(521)	521

## **18. FINANCIAL INSTRUMENTS [Cont'd]**

### **FAIR VALUE INTEREST RATE RISK**

Financial assets and financial liabilities that bear interest at fixed rates are subject to fair value interest rate risk. The Company's cash equivalents and marketable securities are the only financial assets bearing fixed interest rates. The Company does not believe that the results of operations or cash flows would be affected to any significant degree by a sudden change in market interest rates relative to fixed interest rates on cash equivalents and marketable securities, owing to their relative short-term nature.

To manage the fair value interest rate risk, the Company's investments are made to achieve the highest rate of return while complying with the two primary objectives for its investment portfolio which are to retain liquidity and to preserve capital.

### **LIQUIDITY RISK**

The Company is exposed to the risk of being unable to honour its financial commitments by the deadlines set out under the terms of such commitments and at a reasonable price. The Company manages its liquidity risk by forecasting cash flows from operations and anticipated investing and financing activities. Management regularly reviews all elements of the cash flows including revenues, ongoing research and development expenses and long-term commitments. Projected cash flows are reviewed at quarterly meetings of the Board of Directors.

At December 31, 2008, accounts payable and accrued liabilities, excluding certain provisions and reserves, were \$7,859. The contractual maturities of the undiscounted cash flows of financial liabilities are as follows: \$5,632 is expected to be paid within the first quarter of 2009, \$1,535 will be paid in the second quarter of 2009 and \$692 will be paid in the third and fourth quarters of 2009.

## **19. CORPORATE AND OTHER TRANSACTION COSTS**

During the year ended December 31, 2008, the Company recorded corporate and other transaction costs of \$725 [2007 – nil], incurred business consulting costs of \$445 and wrote off \$280 of corporate transaction costs related to the preparation and consultation for a financing opportunity that was not likely to be pursued.

## 20. STATEMENTS OF CASH FLOWS

The net change in non-cash working capital balances related to operations is as follows:

	2008	2007
	\$	\$
<b>Decrease (increase) in:</b>		
Research and development tax credits receivable	(181)	246
Unbilled revenue	(239)	(1,691)
Other current assets	(148)	(84)
Interest receivable	286	155
<b>Increase (decrease) in:</b>		
Accounts payable and accrued liabilities	685	2,613
Current portion of unearned revenue	(3,568)	(208)
Lease abandonment cost	(199)	(189)
	<b>(3,364)</b>	<b>842</b>

## 21. ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

	2008	2007
	\$	\$
<b>Balance, beginning of year</b>	<b>(96)</b>	<b>—</b>
Impact of adopting the new accounting policy regarding financial instruments – marketable securities	—	(72)
	<b>(96)</b>	<b>(72)</b>
Unrealized gain (loss) on cash equivalents	(63)	(5)
Unrealized gain (loss) on marketable securities	470	(19)
	<b>407</b>	<b>(24)</b>
<b>Balance, end of year</b>	<b>311</b>	<b>(96)</b>

## 22. COMPARATIVE FIGURES

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

# SHAREHOLDER INFORMATION

## BOARD OF DIRECTORS

**Raymond C. Egan,**  
**Chairman of the Board**

Former Executive and Senior VP,  
Bristol-Myers Squibb

**Donald F. Corcoran**

President and Chief Executive Officer  
MethylGene Inc.

**David J. Drutz, M.D.**

General Partner,  
Pacific Rim Ventures Co. Ltd.

**Martin Godbout, Ph.D.**

President and Chief Executive Officer  
Genome Canada

**Gaétan Gravel**

Portfolio Manager  
Solidarity Fund, QFL

**Louis Lacasse**

President, GeneChem Management, Inc.

**Colin R. Mallet**

Former President, Sandoz Canada

**Jay Moorin**

General Partner, ProQuest Investments

## MANAGEMENT TEAM

**Donald F. Corcoran**

President and Chief Executive Officer

**Jeffrey M. Besterman, Ph.D.**

Executive Vice President,  
Research and Development and  
Chief Scientific Officer

**Klaus B. Kepper, CMA**

Vice President Finance and  
Chief Financial Officer

**Robert E. Martell, M.D., Ph.D.**

Vice President and  
Chief Medical Officer

**Charles Grubsztajn**

Vice President, Business Development

## INVESTOR RELATIONS

**Karen McTavish**

Manager, Investor Relations &  
Communications

Tel.: 514 337-3333 ext. 373

mctavishk@methylgene.com

## TRANSFER AGENT

**Computershare Trust Company of Canada**

1500 University Street, Suite 700  
Montréal, Québec, Canada H3A 3S8

## STOCK EXCHANGE LISTING

The Company is listed  
on the Toronto Stock Exchange (TSX)  
under the symbol "MYG"

## AUDITORS

**Ernst & Young LLP**

**Chartered Accountants**

800 René-Lévesque Blvd West, Suite 1900  
Montréal, Québec, Canada H3B 1X9

## CORPORATE COUNSEL

**Davies Ward Phillips & Vineberg LLP**

1501 McGill College Avenue, 26<sup>th</sup> Floor  
Montréal, Québec, Canada H3A 3N9

## ANNUAL GENERAL MEETING

May 1, 2009 at 10:00 a.m.

Davies Ward Phillips & Vineberg LLP  
1501 McGill College Avenue, 26<sup>th</sup> Floor  
Montréal, Québec, Canada H3A 3N9

## CURRENCY

All amounts are in Canadian dollars  
unless otherwise indicated.

EXEMPLAIRE FRANÇAIS

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