



OSTA BIOTECHNOLOGIES INC.

2006 ANNUAL REPORT

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OSTA BIOTECHNOLOGIES INC.

MESSAGE FROM THE CHAIRMAN

Dear Shareholders:

We are pleased to provide you with the 2006 Annual Report of our company.

Last year, our company made significant progress on several research fronts. Our scientists were awarded a prestigious Canadian Space Agency contract to investigate bone loss in zero gravity. Our company announced the clinical results from the study on 234 Finnish males in collaboration with Helsinki University, Finland for the development of a novel prognostic test for osteoporosis. Our company announced significant clinical results on 123 subjects on the Alzheimer's disease (AD) blood test which it licensed from the Sir Mortimer B. Davis – Jewish General Hospital. Our company announced significant clinical results on 81 subjects on the Parkinson's disease (PD) and Alzheimer's disease (AD) blood tests. These clinical findings made a very important contribution to our company's plan to develop a novel blood test for AD and a novel blood test for assessing the risk of developing low bone mass and osteoporosis and provided an important advancement towards generating sufficient clinical data in order for our company to enter into co-development/commercialization agreements with pharmaceutical/diagnostic companies world-wide.

2007 is a critical year for our company as we continue to advance the clinical development of a novel blood test for AD and novel therapeutic agents for AD, cancer and X-linked hypophosphatemic rickets while continuing to seek partnerships for commercialization of our blood tests for AD and osteoporosis. In addition, our company is looking to raise money to support its business objectives for the next 2 years.

We are confident that the various research and development activities at our Company will bring long-term value to its shareholders.

We thank you for your continued support.

Sincerely,

A handwritten signature in black ink, appearing to read 'Ajay Gupta', with a horizontal line underneath.

Dr. Ajay Gupta
Chairman and Chief Executive Officer

KEY HIGHLIGHTS FOR FISCAL 2006

February 2006	OSTA'S SCIENTISTS AWARDED THE CANADIAN SPACE AGENCY CONTRACT
March 2006	PROMISING RESULTS FROM A CLINICAL STUDY WITH A NOVEL BLOOD TEST FOR OSTEOPOROSIS CONDUCTED IN COLLABORATION WITH HELSINKI UNIVERSITY, FINLAND
June 2006	PROMISING RESULTS FROM A CLINICAL STUDY WITH A NOVEL BLOOD TEST FOR ALZHEIMER'S DISEASE
October 2006	PROMISING RESULTS FROM A CLINICAL STUDY WITH NOVEL BLOOD TESTS FOR PARKINSON'S DISEASE AND ALZHEIMER'S DISEASE
December 2006	OSTA ANNOUNCED CLOSING OF PRIVATE PLACEMENT FOR \$1.1 MILLION

LATEST DEVELOPMENTS

April 2007	OSTA ANNOUNCED CLOSING OF PRIVATE PLACEMENT FOR \$500,000
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OSTA BIOTECHNOLOGIES INC.

Management's Discussion and Analysis

**For the twelve months ended
December 31, 2006**

April 20, 2007

INTRODUCTION

The following discussion is management's analysis of the consolidated operating and financial data for Osta Biotechnologies Inc. (the "Company") and its wholly owned subsidiary, Osta BioPharma Inc. ("Osta"), for the twelve months ended December 31, 2006. It should be read in conjunction with the accompanying consolidated audited financial statements and related notes for the twelve months ended December 31, 2006 prepared in accordance with Canadian generally accepted accounting principles. This discussion and analysis takes into account material events up to April 20, 2007. All amounts are expressed in Canadian dollars.

Inherent Risk Factors

The Company's products and technologies are currently in the research and developmental stage. The Company does not and may never have commercially viable products approved for commercialization. To date, the Company has not generated any revenues from sales. The Company's financial condition will depend on its ability to obtain additional funding through the capital markets. The availability of such funding may not be under favorable terms or may not be available at all. The ability of the Company to successfully obtain additional financing in the future will depend partly on the condition of capital markets at the time and partly of the future performance of the Company.

Forward Looking Statements

The following discussion contains forward looking statements regarding the Company's financial condition and the results of operation that are based on its consolidated financial statements. The Company operates in a highly competitive environment that involves significant risks and uncertainties, some of which are outside the Company's control. The Company is subject to risks inherent in the biopharmaceutical industry, including risks associated with research, preclinical testing, manufacture of drug substance to support clinical studies, toxicology studies, uncertainty of regulatory agencies, enforcement and protection of the Company's patent portfolio, the need for future capital, potential competitors, the ability to attract and maintain collaborative partners, dependence on key personnel and the ability to successfully market the Company's product candidates. The Company's actual results could differ materially from those expressed or implied in these forward looking statements. For a more detailed discussion of related risks, please refer to the Company's public filings available on www.sedar.com.

CHANGES IN ACCOUNTING POLICIES

There were no changes in the accounting policies during the period.

SELECTED ANNUAL INFORMATION

The following table summarizes selected financial information of the Company for its 2005 and 2006 fiscal years.

	Year ended December 31, 2006	Year ended December 31, 2005
Revenue	\$16,708	\$12,488
Research & development expenses	265,092	255,059
General & administrative expenses	304,257	329,901
Net Loss	(716,991)	(762,659)
Loss per share basic & diluted	(0.02508)	(0.02973)
Total assets	1,753,726	1,231,298
Total liabilities	112,367	96,444
Deficit	2,497,305	1,646,465
Total capital stock and contributed surplus	4,138,664	2,781,319

Consolidation of Financial Statements

For the twelve months ended December 31, 2006, the financial statements of the Company and Osta are presented on a consolidated basis.

Outstanding Shares

At December 31, 2006, the Company had 32,706,196 common shares issued and outstanding. Options to acquire an aggregate of 3,310,000 common shares have been granted to directors, officers and consultants of the Company pursuant to the terms of the Company's incentive stock option plan. In addition, 4,828,410 Common Shares have been reserved for issuance pursuant to all outstanding common share purchase warrants.

Equity Financing by way of Private Placement

In a press release dated December 11, 2006, the Company announced that it had completed a private placement in the amount of \$1,090,250 by issuing a total of 4,361,000 common shares at a price of \$0.25 per share. Each common share was accompanied by one common share purchase warrant. Each warrant entitles the holder thereof to acquire one additional common share of the Company at a price of \$0.40 per share until December 8, 2008.

RESULTS OF OPERATIONS

The Company is engaged in research and development and does not have any products that are presently at commercialization stage. The Company continues to incur expenses related to research and development and as such anticipates that losses will continue until such time as the Company is able to successfully commercialize one of its products, which may never occur.

Investment Income

During the twelve month period ended December 31, 2006, the Company had revenues of \$16,708 consisting of interest income as compared to \$12,488 for the twelve month period ended December 31, 2005. The increase in revenue is due to higher cash balances as compared to the same period of the previous year.

The following table summarizes changes in the investment income of the Company for its 2005 and 2006 fiscal years:

	December 31, 2006	December 31, 2005	Increase (Decrease)
Investment Income	\$16,708	\$12,488	\$4,220

Expenses

The Company had gross expenses during the fiscal year of \$733,699 resulting in a loss per share of \$0.026. The Company spent approximately \$ 265,092 on research and development (R&D). These expenses primarily consisted of R&D salaries, consulting fees, supplies and research contracts.

General & Administrative

The following table summarizes changes in the general and administrative expenses of the Company for its 2005 and 2006 fiscal years:

	December 31, 2006	December 31, 2005	Increase (Decrease)
General and Administrative Expenses	\$304,257	\$329,901	\$(25,644)

The decrease in general and administrative expenses in 2006 compared to 2005 is due mainly to a decrease in salaries and wage levies, professional fees and research and development expenses.

Summary of Research and Development Activities

The Company is a biopharmaceutical Company whose principal business is to carry out research and development work for the development of novel diagnostic and therapeutic products specific to Alzheimer's disease, cancer, XLH and osteoporosis.

Diagnostic Test for Alzheimer's Disease

The Company is currently focusing on the development of a novel blood test for Alzheimer's disease (AD). At present, the Company is continuing to advance the clinical studies for the development of its AD blood test and plans to complete these studies in 2008 and pending a successful outcome, the Company will explore the possibility of entering into a co-development and/or licensing agreement for commercialization. The Company's AD test is expected to be classified as a class III In-Vitro Diagnostic Device (IVDD) requiring a Pre-Market Approval ("PMA") filing with FDA anticipated in 2009. Given the low-risk assumed by patients, the Company anticipates that the test will not require an Investigational Device Exemption ("IDE") filing. As such, subject to satisfactory completion of the currently on-going clinical development of its test, the Company intends to license it out to pharmaceutical/diagnostic companies world-wide with a view to initiating its commercialization. If it is successful in this regard, the Company could begin to generate up-front licensing fees in 2008. The Company expects that it will cost approximately \$500,000 to complete the additional clinical studies required for completing the clinical development of its diagnostic test for AD. At present, the Company is looking to raise additional capital in order to conduct the remaining clinical studies required for the completion of the clinical development of its novel blood test for AD. The future development of this test is heavily dependent on the Company's ability to raise the additional capital in a timely fashion as well as to license out this test to commercial partner(s) for regulatory filing, approvals and commercialization.

Therapeutic Agent for treatment of Alzheimer's Disease

The Company is developing of a novel therapeutic for the treatment of Alzheimer's disease and is at the lead optimization stage. The efficacy of the lead molecule will be evaluated using the most suitable animal model and a promising drug candidate will be taken into pre-clinical and clinical development. The Company needs additional capital to pursue the development of its osteoporosis therapeutic. Upon successful completion of financing in a timely fashion, it plans to complete GLP non-clinical toxicology and safety pharmacology studies in 2009 and plans to file an IND application in 2010 to initiate Phase-I trials in the US. The Company expects that it will cost approximately \$2,000,000 to complete the various pre-clinical studies.

Cancers Therapeutic Agents

The Company is developing novel therapeutic agents that could be used as adjuvant chemotherapeutic agents to treat aggressive metastatic, invasive and drug resistant tumors. The Company plans to identify the lead molecule for the treatment of pancreatic cancer & melanoma by the end of 2007, complete the pre-clinical studies in 2008 and file an IND application in 2009 to initiate human clinical studies in North America. The Company

expects that it will cost approximately \$1,500,000 to complete the various pre-clinical studies. Both melanoma and pancreatic cancer are very aggressive types of cancers. Incidence of Melanoma is rising faster than any other type of cancer. 59,940 new cases are expected this year in the US (Source: www.nationalcancerinstitute.com). In 2000, the rate was 1 in 75 and accounted for 160,000 cases worldwide. Although pancreatic cancer accounts for just two percent of new cancer cases in the United States, it is the fourth leading cause of all cancer deaths. The American Cancer Society predicts that in 2006 about 33,730 people in the United States will be diagnosed with pancreatic cancer and about 32,300 will die of the disease (Source: www.gene.com).

Therapeutic Agent for treatment of XLH

X-Linked Hypophosphatemic rickets (XLH) is a familial form of rickets which results from defects in the PHEX gene. Most cases of XLH, which shows a prevalence of about 1 in 20,000 (Source: www.athendiagnosics.com), are believed to be associated with X-linked dominant loss-of-function mutations in the gene *PHEX* or autosomal dominant gain-of-function mutation in the gene *FGF23*. No cure exists for XLH, but early initiation of treatment significantly improves the outcome. XLH being a rare disease, the drug for treating XLH is eligible for orphan drug status and, therefore, qualifies for an expedited review process with significantly shorter regulatory development time. The Company is developing novel therapeutic agents that could be used to treat XLH. The Company plans to identify the lead molecule for the treatment of XLH by the end of 2007, complete the pre-clinical studies in 2008 and file an IND application in 2009 to initiate human clinical studies in North America. The Company expects that it will cost approximately \$1,500,000 to complete the various pre-clinical studies.

Osteoporosis Prognostic Test

The Company is developing a novel prognostic test for assessing the risk of developing low bone mass and osteoporosis. To date, the Company has generated promising results in 264 males and 33 pre-menopausal females. The Company will require additional clinical studies, especially in young males and pre-menopausal females, as well as in multi-race multi-ethnic male and female cohorts prior to licensing out its prognostic test to potential commercial partners and obtaining marketing approval from the FDA. Pending successful completion of additional clinical studies, the Company intends to license out its test to pharmaceutical/diagnostic companies world-wide in 2009. The Company expects that it will cost approximately \$550,000 to complete the clinical studies prior to licensing the test out to potential commercial partners. At present, the Company is looking to raise additional capital in order to conduct the remaining clinical studies required for the completion of the clinical development of its novel prognostic blood test for osteoporosis. The future development of this test is heavily dependent on the Company's ability to raise the additional capital in a timely fashion as well as to license out this test to commercial partner(s) for regulatory filing, approvals and commercialization.

Osteoporosis Therapeutic Agent

The Company is developing of a novel oral bone forming agent for the treatment of osteoporosis and is at the lead generation stage. The lead molecule(s) will be tested on the Company's proprietary transgenic mouse models to generate a drug candidate which will be taken into pre-clinical and clinical development. The Company needs additional capital to pursue the development of its osteoporosis therapeutic and upon successful completion of financings in a timely fashion, it plans to initiate pre-clinical studies towards the end of 2007, with the goal of submitting an IND filing in 2010. The Company expects that it will cost approximately \$2,000,000 to complete the various pre-clinical studies.

Working Capital

As at December 31 2006, the Company had cash and cash equivalents, sundry receivables, investment tax credit receivables and deposits in the aggregate amount of \$1,408,490 and accounts payable and accrued liabilities of \$112,367, resulting in a working capital of \$1,296,123 compared to a working capital of \$858,874 as at December 31, 2005. The increase in working capital is due to a decrease in salaries and wage levies, professional fees and research and development expenses and the closing of a private placement of \$1,090,250.

Liquidity

The Company believes that the cash at hand at the end of December 31, 2006 is sufficient for conducting the business of the Company for the next 16 months.

Capital Resources

The Company will need to raise additional capital in the near term. As the research and development activities increase, it is anticipated that the Company's capital requirements will also increase proportionately. At present, the Company is looking to raise additional capital through the issuance of equity. In order to manage the developmental activities with the current cash at hand, the Company has prioritized its research and development activities on the development of a novel blood test for Alzheimer's disease (AD) as well as a novel therapeutic for AD, cancer and XLH. The Company's research and development programs related to the development of novel diagnostic and therapeutic products for osteoporosis are currently on hold at present till further financing is secured. The Company has halted the development of novel therapeutics for osteoarthritis and aging, which may be reactivated at a later stage once further financing has been secured and the products specifically related to Alzheimer's disease, cancer and XLH have been advanced significantly. It is estimated that the Company will require approximately \$4 million in additional capital over the next two years to continue the development of the various products described above. However, there can not be any guarantee that the Company will be able to successfully raise the required capital to continue its operations or to be able to complete the various research & development milestones in a timely

fashion. The Company's working capital requirements and its ability to raise additional capital are dependent on various factors, including, but not limited to, obtaining satisfactory pre-clinical and clinical data, successfully entering into collaborations and partnerships for product development, regulatory approvals and commercialization, successfully filing patent applications and obtaining issued patents, maintaining, enforcing and defending patent claims, in-license outside patents as potentially needed, favourable outcome of regulatory review processes in a timely fashion and other factors that may be beyond the control of Management.

QUARTERLY FINANCIAL INFORMATION FOR 2006

The following table summarizes selected comparative quarterly financial information of the Company for the year ended December 31, 2006.

The progressive decrease in the net loss in the last two quarters is due mainly to a decrease in salaries and wage levies, professional fees and research and development expenses.

Summary of Quarterly Results for 2006				
	Q1	Q2	Q3	Q4
Net Loss	\$207,318	\$208,850	\$153,234	\$147,589
Loss per share basic and diluted	\$0.0073	\$0.0074	\$0.0054	\$0.0052

FOURTH QUARTER

The decrease in the net loss in the fourth quarter of 2006 compared to the third quarter of 2006 is attributable to a decrease in salaries and wage levies, professional fees and research and development expenses.

RELATED PARTY TRANSACTIONS

During the year ended December 31, 2006, the Company paid a total of \$58,350 to several officers and shareholders for consulting fees.

SUBSEQUENT EVENTS

In a press release dated April 17, 2007, the Company announced that it had completed a private placement in the amount of \$500,000 by issuing a total of 2,000,000 units at a price of \$0.25 per unit. Each unit consists of one common share of Osta and one common share purchase warrant. Each warrant entitles the holder to purchase one additional common share at a price of \$0.40

per share until April 17, 2009. The closing of this private placement has increased the number of outstanding common shares of Osta to 34,706,196.

OUTLOOK

At present the Company is a research and development company that has yet to generate any revenues. The Company is expected to continue to incur operating losses as it continues with the research and development of various products. The Company is currently focusing on the completion of currently on-going clinical studies for the development of a novel blood test for Alzheimer's disease (AD) and pending successful completion of these studies, the Company anticipates that it would be in a position to potentially establish partnerships with pharmaceutical and/or diagnostic companies for the regulatory approvals and commercialization of the blood test at which stage, the Company is expected to start generating revenues by way of obtaining upfront licensing fees, milestone payments and royalties resulting from the sale of the blood test. In addition, the Company is continuing the development of novel therapeutic agents for AD, cancer and XLH and expects to establish a proof of principle *in vivo* of the efficacy of its lead molecules in about one year, at which stage, the Company will require substantial additional capital resources to complete the pre-clinical development of its lead molecules and initiate Phase-I clinical studies in North America. The Company is looking to raise additional capital by way of equity financings in order to continue the development of its products and it is anticipated that the total expenses will increase during fiscal 2007 should the Company successfully complete such additional financings.

MANAGEMENTS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Management, including the President, Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Multilateral Instrument 52-109 of the Canadian Securities Administrators) as of December 31, 2006.

Management has concluded that, as of December 31, 2006, the Company's disclosure controls and procedures were effective to provide reasonable assurance that material information relating to the Company would be made known to them by others within the Company and its subsidiaries, particularly during the period in which this report was being prepared.

Management is responsible for and has designed internal controls over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with Canadian GAAP. There were no changes in internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Consolidated financial statements of
OSTA BIOTECHNOLOGIES INC.
December 31, 2006 and 2005

OSTA BIOTECHNOLOGIES INC.

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Auditors' Report

To the Shareholders of,
OSTA Biotechnologies Inc.

We have audited the consolidated balance sheets of **OSTA Biotechnologies Inc.** as at December 31, 2006 and 2005 and the statements of loss and deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of Company as at December 31, 2006 and 2005 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

WSBG LLP

Chartered Accountants

Montreal, Quebec
March 20, 2007

OSTA BIOTECHNOLOGIES INC.
(Incorporated under the Canada Business Corporations Act)
Consolidated Balance Sheets
As at December 31, 2006

	2006	2005
	\$	\$
Assets		
Current		
Cash	118,015	125,210
Short-term investments (note 3)	1,138,088	700,000
Receivables	707	6,611
Investment tax credits receivable	151,680	123,497
	1,408,490	955,318
Property and equipment (note 4)	12,967	16,100
Patents	301,489	227,080
Licenses (note 5)	30,780	32,800
	1,753,726	1,231,298
Liabilities		
Current		
Accounts payable and accrued liabilities	112,367	96,444
Contingencies and commitments (note 12)		
Shareholders' equity		
Capital stock (note 6)	3,492,776	2,392,532
Contributed surplus (note 7)	645,888	388,787
Deficit	(2,497,305)	(1,646,465)
	1,641,359	1,134,854
	1,753,726	1,231,298

See accompanying notes to consolidated financial statements.

Approved on Behalf of the Board:

.....Director
Ajay Gupta

.....Director
Leontis Teryazos

OSTA BIOTECHNOLOGIES INC.
Consolidated Statements of Deficit
Year Ended December 31, 2006

	2006	2005
	\$	\$
Deficit - beginning of year	(1,646,465)	(303,421)
Net loss	(716,991)	(762,659)
Share issue costs (note 6(b))	(133,849)	(580,385)
Deficit - end of year	(2,497,305)	(1,646,465)

See accompanying notes to consolidated financial statements.

OSTA BIOTECHNOLOGIES INC.

Consolidated Statements of Loss

Year Ended December 31, 2006

	2006	2005
	\$	\$
Investment income	16,708	12,488
Expenses		
Salaries and wage levies	267,107	258,741
Professional and consulting fees	197,747	243,464
Royalties	10,000	
Travel and automobile	8,165	19,523
Office and general	19,085	20,575
Interest and bank charges	546	132
Rent	8,545	12,930
Taxes and insurance	18,153	15,798
Interest on debentures	-	3,091
Other research costs	40,001	10,706
Research and development tax credits (note 10)	(81,496)	(88,645)
Stock option compensation (note 8)	238,347	274,329
Amortization	7,499	4,503
	733,699	775,147
Net loss	(716,991)	(762,659)
Loss per share basic and diluted	(0.02508)	(0.02973)
Weighted average number of common shares outstanding for the year	28,587,470	25,656,244

See accompanying notes to consolidated financial statements.

OSTA BIOTECHNOLOGIES INC.
Consolidated Statements of Cash Flows
Year Ended December 31, 2006

	2006	2005
	\$	\$
Cash flows from (used in) operating activities		
Net loss	(716,991)	(762,659)
Amortization of property and equipment	5,479	3,303
Amortization of licences	2,020	1,200
Stock option compensation	238,347	274,329
Write-off of deferred charges	-	7,532
	(471,145)	(476,295)
Changes in non-cash working capital (note 9)	(6,356)	(176,574)
	(477,501)	(652,869)
Cash flows from (used in) investing activities		
Redemption of short-term investments	700,000	550,000
Purchase of short-term investments	(1,138,088)	
Acquisition of property and equipment	(2,346)	(16,785)
Patents	(74,409)	(70,096)
Acquisition of intangible assets	-	(10,000)
Deferred business acquisition costs	-	(40,837)
Assets acquired net of cash and term deposits	-	189,177
	(514,843)	601,459
Cash flows from (used in) financing activities		
Issuance of capital stock	1,100,244	150,000
Issue costs	(115,095)	
	985,149	150,000
Net increase (decrease) in cash	(7,195)	98,590
Cash - beginning of year	125,210	26,620
Cash - end of year	118,015	125,210

See accompanying notes to consolidated financial statements.

OSTA BIOTECHNOLOGIES INC.
Notes to Consolidated Financial Statements
Year Ended December 31, 2006 and 2005

1. Nature of business

The Company is a biopharmaceutical company whose principal business is to carry out research and development work for the development of diagnostic and therapeutic products specific to Alzheimer's' disease, osteoporosis, cancer and rickets.

2. Significant accounting policies

Basis of presentation

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiary Osta Biopharma Inc.

Use of estimates

The preparation of the financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. By their nature, these estimates are subject to measurement uncertainty and the effect on the financial statements of changes in such estimates in future periods may be significant.

Cash and cash equivalents

Highly liquid investments with a maturity of three months or less from the date of purchase are classified as cash and cash equivalents. High liquid investments with a maturity of more than three months are classified as short-term investments.

Property and equipment

Property and equipment are recorded at cost and amortized over their estimated useful lives, as follows:

On the declining balance method -

Office equipment	-	30%
Lab equipment	-	30%

OSTA BIOTECHNOLOGIES INC.
Notes to Consolidated Financial Statements
Year Ended December 31, 2006 and 2005

2. Significant accountings policies (cont'd.)

Patents

Patent costs are to be amortized on a straight line basis over the expected useful lives of the related patents, ranging from 11 years to 19 years. The amortization will commence upon final approval of the related patents by the regulatory authorities.

Licenses

The licenses are amortized on a straight line basis over the remaining life of the underlying patents.

Research and development

The Company annually incurs costs on activities that relate to research and development of new products. Research costs are expensed as they are incurred. The Company has also expensed development costs as incurred because the costs do not meet the generally accepted criteria for deferral and amortization. Costs are reduced by investment tax credits where applicable.

Investment tax credits

The Company claims investment tax credits as a result of incurring scientific research and experimental development expenditures. Investment tax credits are recognized when the related expenditures are incurred and there is reasonable assurance of their realization. Management has made a number estimates and assumptions in determining the expenditures eligible for the investment tax credit claim. It is possible that the allowed amount of the investment tax credit claim could be materially different from the recorded amount upon assessment by the governments.

Income taxes

The Company follows the liability method of accounting for income taxes. Under this method, future income tax assets and liabilities are accounted for based on the difference between the carrying amounts and tax basis of assets and liabilities and are measured using enacted tax rates and laws in effect as at the date of the financial statements. Changes in these balances are charged to income of the year in which they arise. Future tax assets are accounted for only if management believes it is more likely than not that they will be realized.

OSTA BIOTECHNOLOGIES INC.
Notes to Consolidated Financial Statements
Year Ended December 31, 2006 and 2005

2. Significant accounting policies (cont'd.)

Stock based compensation plan

The Company has adopted the recommendations of the Canadian Institute of Chartered Accountants' Handbook Section 3870, entitled "Stock Based Compensation and Other Stock Based Payments". Under this method, the fair value of options granted to directors, officers, employees and technical consultants, is recognized over the applicable vesting period, based on the estimated fair value of the options on the grant date determined using an option-pricing model. The expense is charged to stock option compensation expense with a corresponding credit to contributed surplus. When the options are exercised, capital stock is credited by the sum of the consideration paid, together with the related portion previously recorded as contributed surplus. Details of the Company's stock option plan and related disclosure are recorded in Note 8.

Share issue costs

Share issue costs are charged against the deficit in the year incurred.

Loss per share

Basic loss per common share is calculated by dividing the applicable net loss by the weighted average number of shares outstanding during the year. Diluted loss per common share is calculated by dividing the applicable net loss by the sum of the weighted average number of shares outstanding during the year based on the application of the treasury stock method for the calculation of the dilutive effect of stock options.

The computation of diluted loss per common share is equal to the basic loss per common share due to the anti-dilutive effect of the stock options.

Future accounting changes

In January 2005, the CICA issued Handbook Section 1530, "Comprehensive Income", Section 3251, "Equity", Section 3855, "Financial Instruments – Recognition and Measurement" and Section 3865, "Hedges". These new standards will require the following:

OSTA BIOTECHNOLOGIES INC.
Notes to Consolidated Financial Statements
Year Ended December 31, 2006 and 2005

2. Significant accounting policies (cont'd.)

- Financial assets will be classified as either held-to-maturity, held-for-trading, loans and receivables or available-for-sale. Held-to-maturity classification will be restricted to fixed maturity instruments that the Company intends and is able to hold to maturity and will be accounted for at the discounted amount, based on the effective interest method. Held-for-trading instruments will be recorded at fair value each period with realized and unrealized gains and losses reported in net income. Loans and receivables will be accounted for at the discounted amount, based on the effective interest method. The remaining financial assets will be classified as available-for-sale. These will be recorded at fair value each period with unrealized gains and losses reported in a new category of the Consolidated Balance Sheet under shareholders' equity called other comprehensive income ("OCI");
- Financial liabilities will be classified as either held-for-trading or other liabilities. Held-for-trading instruments will be recorded at fair value each period with realized and unrealized gains and losses reported in net income. Other instruments will be accounted for at amortized cost with gains and losses reported in net income in the period that the liability is derecognized;
- Derivatives will be classified as held-for-trading unless designated as hedging instruments. All derivatives, including embedded derivatives that must be separately accounted for, will be recorded at fair value each period on the Consolidated Balance Sheet; and
- A new financial statement, Consolidated Statement of Comprehensive Income, has been introduced. Comprehensive income is defined as all changes in equity other than those resulting from investments by owners and distributions to owners. Comprehensive income is comprised of two components, net income and OCI. OCI refers to amounts that are recorded as an element of shareholders' equity but are excluded from net income because these transactions or events were attributed to changes from non-owner sources.

The guidance will apply for interim and annual financial statements relating to fiscal years beginning on or after December 31, 2006. Although Osta Biotechnologies is in the process of evaluating the impact of these standards, the Company does not expect these standards to have a material impact on its consolidated financial statements.

OSTA BIOTECHNOLOGIES INC.
Notes to Consolidated Financial Statements
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3. Short-term investments

Short-term investments consist of guaranteed investment certificates and discount notes bearing interest from 3.80% to 3.85%, with maturity dates ranging from January 2007 to December 2007.

4. Property and equipment

	2 0 0 6			2 0 0 5
	Cost	Accumulated Amortization	Net Carrying Amount	Net Carrying Amount
	\$	\$	\$	\$
Office equipment	18,278	11,259	7,019	7,603
Lab equipment	9,997	4,049	5,948	8,497
	28,275	15,308	12,967	16,100

5. Licenses

The licenses acquired allow the Company to perform research on patented technology. The licenses have a net carrying amount of \$30,780, net of accumulated amortization of \$3,220.

6. Capital stock

The authorized, issued and fully paid capital stock consists of the following:

Authorized: An unlimited number of common shares and an unlimited number of preferred shares without nominal or par value.

OSTA BIOTECHNOLOGIES INC.
Notes to Consolidated Financial Statements
Year Ended December 31, 2006 and 2005

6. Capital stock (cont'd.)

Issued:

	# of Shares	\$
<u>2006</u>		
Balance, beginning of year	28,305,219	2,392,532
(a) Shares for debt	39,977	9,994
(b) Private placement	4,361,000	1,090,250
Balance, end of year	32,706,196	3,492,776
<u>2005</u>		
Balance, beginning of year	5,980,000	260,061
(c) Issued pursuant to "RTO"	20,903,790	1,616,221
(d) Issued as a finders fee	675,000	236,250
(e) Conversion of debt	371,429	130,000
(g) Issued for cash	375,000	150,000
Balance, end of year	28,305,219	2,392,532

Capital stock transactions are summarized as follows:

- a) During the year, the Company issued 39,977 shares having a total value of \$9,994 as settlement of interest owed to convertible debenture holders.
- b) During the year the Company filed with the TSX Venture Exchange for a private placement of up to 8,000,000 common shares at a price of \$0.25 per common share for gross proceeds to the Company of up to \$2,000,000. Pursuant to an Agency Agreement between the Company and Sherbrooke Street Capital Inc. (the "Agent"), the Company agreed to issue up to 8,000,000 common shares, each common share having an attached common share purchase warrant entitling the holder to acquire one additional share for a period of up to 24 months from the date of issuance. As compensation, the Agents were paid a commission of \$69,778 and were granted 279,910 broker warrants allowing them to purchase common shares of the Corporation for a period of up to 24 months from the date of the closing of the private placement. The estimated fair value of the broker warrants of \$18,754 was calculated using the Black-Scholes option pricing method and is included as part of share issue costs of \$133,849. On December 8, 2006, the Company issued 4,361,000 common shares and common share purchase warrants for proceeds to the Company of \$1,090,250.

OSTA BIOTECHNOLOGIES INC.
Notes to Consolidated Financial Statements
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6. Capital stock (cont'd.)

- c) On May 3, 2005, following a reverse takeover ("RTO"), the Company issued 20,903,790 shares in exchange for all the issued and outstanding shares of Osta Biopharma Inc. ("Osta"). The fair value ascribed to those shares as of the date of the RTO was \$1,616,221.
- d) Pursuant to the closing of the RTO, the Company issued 675,000 shares as a finder's fee to an arm's length company having a value of \$236,250.
- e) Convertible debentures issued by Osta, having a value of \$130,000 were converted into 371,429 common shares of the Company.
- f) During the year, the Company issued 375,000 common shares to arm's length investors for total cash consideration of \$150,000.

As of December 31, 2006, 9,283,500 of the issued and outstanding shares are subject to escrow conditions.

Share Purchase Warrants

Share purchase warrants outstanding and exercisable as at December 31, 2006 are summarized as follows:

	2 0 0 6		2 0 0 5	
	Number of Warrants	Weighted Average Exercise Price	Number of Warrants	Weighted Average Exercise Price
	#	\$	#	\$
Balance - beginning of year	258,929	0.63	71,429	0.45
Granted during the year	4,828,410	0.41	187,500	0.70
Expired	(258,929)	0.63		
Balance - end of year	4,828,410	0.41	258,929	0.63

Each warrant entitles the holder to purchase one common share of the Company. The warrants are summarized as follows:

Number of Warrants	Exercise Price	Expiry Date
#	\$	
187,500	0.70	November 2007
4,640,910	0.40	December 2008

OSTA BIOTECHNOLOGIES INC.
Notes to Consolidated Financial Statements
Year Ended December 31, 2006 and 2005

7. Contributed surplus

Contributed surplus consists of the following:

	2006	2005
	\$	\$
Balance, beginning of year	388,787	114,458
Stock based compensation (note 8)	238,347	274,329
Broker warrants issued upon private placement (note 6(b))	18,754	-
	645,888	388,787

8. Incentive stock options

The Company maintains an incentive stock option plan (the "Stock Option Plan") which provides that the Board of Directors of the Company may from time to time, in its discretion, grant to directors, officers, employees and technical consultants of the Company, non-transferable options to purchase common shares for a period of up to five (5) years, provided that the number of common shares reserved for issuance under the Stock Option Plan does not exceed 4 million shares. The Board of Directors determines the price per common share and the number of common shares that may be allotted to each director, officer, employee and consultant of the Company and all other terms and conditions of the options granted under the Stock Option Plan.

The Company has accounted for options granted using the fair value method. The fair value of the options granted after May 3, 2005 was estimated using the Black-Scholes option pricing model based on the following assumptions:

Risk-free interest rate	Between 3.53% and 4.08%
Expected volatility	71%
Dividend yield	Nil
Average expected life	Between 3 months and 5 years
Fair value on grant date	Between \$0.154 - \$0.215

The fair value of options granted before May 3, 2005 was estimated using the Black-Scholes option pricing model based on the following assumptions:

Risk-free interest rate	Between 3.00% and 4.01%
Expected volatility	36%
Dividend yield	Nil
Average expected life	Between 3 months and 5 years
Fair value on grant date	Between \$0.066 - \$0.131

OSTA BIOTECHNOLOGIES INC.
Notes to Consolidated Financial Statements
Year Ended December 31, 2006 and 2005

8. Incentive stock options (cont'd.)

Total Stock option compensation costs for the year amounted to \$238,347 (2005 - \$274,329).

A summary of changes in the company's common share purchase options is presented below:

	2 0 0 6		2 0 0 5	
	Number of Options #	Weighted Average Exercise Price \$	Number of Options #	Weighted Average Exercise Price \$
Balance - beginning of year	3,024,500	0.3435	198,000	0.3500
Shares reserved for options granted under Osta option plan		-	1,176,500	0.3334
Granted during the year	500,000	0.3350	1,650,000	0.3500
Expired during the year	(214,500)	0.2952	-	-
Balance - end of year	3,310,000	0.3453	3,024,500	0.3435

Common share purchase options outstanding, exercisable, granted to directors, officers and consultants of the Company as at December 31, 2006 are summarized as follows:

Number of Options #	Exercise Price \$	Expiry Date
15,000	0.35	January 2007
235,000	0.30	November 2007
450,000	0.35	December 2007
20,000	0.35	June 2008
20,000	0.30	July 2008
10,000	0.35	October 2008
385,000	0.35	April 2009 to June 2009
1,750,000	0.35	March 2010 to December 2010
425,000	0.35	January to February 2011

OSTA BIOTECHNOLOGIES INC.
Notes to Consolidated Financial Statements
Year Ended December 31, 2006 and 2005

9. Statement of cash flows

Changes in non-cash working capital

	2006	2005
	\$	\$
Sundry receivables	(5,904)	(2,625)
Investment tax credits receivable	(28,183)	(2,012)
Accounts payable and accrued liabilities	15,923	(171,937)
	(6,356)	(176,574)

10. Research and development

Research and development costs are calculated net of government assistance, which is recorded as an investment tax credit receivable. Details of amounts expended on research and development and the related assistance are summarized as follows:

	2006	2005
	\$	\$
Gross amount incurred	265,092	255,059
Less: Investment tax credits earned	(81,496)	(88,645)
	183,596	166,414

11. Income taxes

A. The Company has tax losses available which can be used to reduce future years' taxable income. These losses expire as follows:

	Federal	Quebec
	\$	\$
2026	485,000	485,000
2015	473,000	707,000
2014	75,000	81,000
2013	206,000	234,000
2009	186,000	177,000
2008	15,000	5,000
	1,440,000	1,689,000

The benefit of these tax losses have not been reflected in the accounts of the Company.

OSTA BIOTECHNOLOGIES INC.
Notes to Consolidated Financial Statements
Year Ended December 31, 2006 and 2005

11. Income taxes (cont'd.)

- B. The Company has available for tax purposes approximately \$543,000 of share issue costs which will be deductible over the next four years.
- C. The Company has available approximately \$359,000 Federal and \$109,000 Quebec of eligible SR&ED expenditures which may be deducted against future revenues.
- D. The Company has investment tax credits available which can be used to reduce taxes payable, and expire as follows:

2026	\$ 58,000
2015	<u>51,000</u>
	<u>\$ 109,000</u>

The benefits of these items have not been reflected in the accounts of the Company.

12. Contingencies and commitments

- A. The Company has entered into two licensing agreements with a licensor with the following terms and conditions.

(i) Royalties

- a) A minimum annual royalty of \$5,000 is due on each of the two licenses commencing in 2006.
- b) Royalties due to the licensor for each of the two licenses are calculated as follows:

The greater of \$5,000 or;

- on the first \$100 M. of net revenues; 2% and 2.5% respectively;
- on net revenues between \$100 M. and \$300 M.; 1.5% and 2% respectively;
- on net revenues greater than \$300 M.; 1% for both licenses.

Net revenues are specifically defined in both licensing agreements.

OSTA BIOTECHNOLOGIES INC.
Notes to Consolidated Financial Statements
Year Ended December 31, 2006 and 2005

12. Contingencies and commitments (cont'd.)

- (ii) On one license, a milestone fee of \$25,000 is due upon acceptance of an "investigational new drug application" with the United States Food and Drug Administration (FDA) or its equivalent in another jurisdiction. A further milestone of \$100,000 is due on this license pursuant to the company realizing \$1 M. of gross revenue as specifically defined in the license agreement on sales of products related to this license.
 - (iii) Marketing approval fees of \$200,000 and \$150,000 respectively are payable to the licensor on the licences upon approval by the FDA or other regulatory agencies for the manufacture and sale of licensed products.
 - (iv) Under the terms of one of the licence agreements, the Company has committed to allocating a minimum of \$40,000 per year for the further development of technology for two years commencing February 2004.
- B. The Company entered into two licensing agreements with a second licensor having the following terms and conditions
- (i) In consideration of the licenses granted herein and the costs incurred therefore, Licensee shall pay to Licensor a license issue fee of \$5,000 for one of the licenses, payable 30 days upon the Effective Date of the Agreement. As at December 31, 2006, the fee has been accrued in the Company's records.
 - (ii) (a) A minimum annual royalty of \$5,000 is due on each license commencing in 2009.

(b) Royalties due to the licensor for each of the two licenses are to be calculated as follows:

 - 2.5% of the first \$100 M. of net revenues;
 - 2.0% of net revenues between \$100 M. and \$300 M.
 - 1% of net revenues in excess of \$300 M.

Net revenues are specifically defined in the licensing agreement.
 - (iii) Milestone fees for both licenses of \$25,000 per product are due to the licensor upon acceptance of an "investigational new drug application" with the United States Food and Drug Administration (FDA). A further milestone of \$100,000 is due to the licensor pursuant to the Company realizing \$1 M of gross revenue as specifically defined in the license agreement on sales of products related to the specific licenses.

OSTA BIOTECHNOLOGIES INC.
Notes to Consolidated Financial Statements
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12. Contingencies and commitments (cont'd.)

- (iv) A marketing approval fee for both licenses of \$100,000 per product is to be paid to the licensor pursuant to FDA approval for the manufacture and sale of products based on the license patents defined in each of the agreements.

13. Related party transactions

The company entered into the following transactions with its officers and shareholders:

	2006	2005
	\$	\$
Consulting fees paid to officers and shareholders	58,350	112,000

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

14. Subsequent Events

On February 27, 2007, the Company entered into a licensing agreement with a third licensor having the following terms and conditions

- (i) In consideration of the license granted herein and the costs incurred therefore, Licensee shall pay to Licensor a license issue fee of \$5,000 payable 30 days upon the Effective Date of this Agreement.

In consideration for the license granted in this Agreement, Licensee shall pay to Licensor an annual earned royalty on Net Sales of Licensed Products sold by Licensee and its Sublicensee(s) in the following manner:

- 2.25% of Net Sales for up to and including \$100 M. per annum;
- 1.75% of Net Sales greater than \$100 M. per annum and up to and including \$500 M. per annum; and
- 1.5% of Net Sales greater than \$500 M. per annum.

OSTA BIOTECHNOLOGIES INC.
Notes to Consolidated Financial Statements
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14. Subsequent events (cont'd.)

- (ii) In consideration for the license granted herein, Licensee shall pay to Licensor the following amounts within 30 days of achievement of the following milestones:
- \$10,000 upon submission of an Investigational New Drug (“IND”) Application to the United States Food & Drug Administration (“FDA”) or European Union equivalent for a License Product,
 - \$25,000 upon the initiation of the first Phase II clinical trial for a Licensed Product,
 - \$50,000 upon initiation of the first Phase III clinical trial for a Licensed Product,
 - 100,000 upon the first approval action letter issued by the FDA or European Union equivalent with respect to a New Drug Application for a Licensed Product (“FDA” Approval), and
 - \$500,000 upon Licensee and/or its Sublicensee(s) reaching Net Sales of Licensed Product of \$100 M.
- (iii) As a condition to maintain the license granted herein, subject to the terms and conditions of this Agreement, Licensee shall pay to Licensor minimum annual royalties of:
- \$2,500 payable on the first anniversary of the Effective Date,
 - \$5,000 payable on the second anniversary of the Effective Date, and
 - \$10,000 payable on the third anniversary of the Effective Date and through each subsequent anniversary.
 - Licensee shall pay to Licensor a minimum royalty of \$25,000 on each anniversary of the Effective Date upon the first Commercial Sale of Licensed Product.
- (iv) As a minimum, Licensee must invest in aggregate \$40,000 per year into the laboratories of the Principal Investigators for research and development of the Licensed Technology for the first two years of this Agreement via a separate research and development agreement with Queens University and in addition Licensee must invest in aggregate at least \$40,000 for each year thereafter toward patent protection, development and commercialization of a Licensed Product.

OSTA BIOTECHNOLOGIES INC.
Notes to Consolidated Financial Statements
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15. Financial Instruments

Fair value

Cash, short-term investments, receivables, accounts payable and accrued liabilities are all short-term in nature and as such, their carrying values approximate fair values.

16. Comparative Figures

Certain reclassifications of 2005 amounts have been made in order to conform to the method of presentation adopted in the current year.