Consolidated Financial Statements

Quest PharmaTech Inc.

Six months ended July 31, 2012

(Unaudited)

Quest PharmaTech Inc.

National Instrument 51 – 102
Continuous Disclosure Obligations

Notice

Pursuant to Part 4.3 (3) of National Instrument 51 – 102, these unaudited interim consolidated financial statements of Quest PharmaTech Inc. for the six month period ended July 31, 2012 have not been reviewed by the Company's auditors.

Quest PharmaTech Inc.

CONSOLIDATED STATEMENTS OF FINANCIAL POSITION

(see note 1 – going concern uncertainty)

As at

	Jul 31, 2012 (Unaudited) $	Jan 31, 2012 (Audited) $
ASSETS		
Current		
Cash	**141,575**	74,975
Accounts receivable	**30,800**	3,051
Prepaid expenses	**28,979**	30,584
	201,354	108,610
Non current		
Property and equipment *[note 4]*	**77,888**	86,130
Intangibles *[note 3]*	**41,428**	81,010
	119,316	167,140
	320,670	275,750
LIABILITIES		
Current		
Accounts payable and accrued liabilities	**834,120**	1,043,486
Share subscriptions *[note 7]*	**500,000**	—
Demand loans *[note 11]*	**980,000**	1,020,000
Interest free loan *[note 11]*	**500,000**	—
Convertible debenture *[note 6]*	**500,000**	500,000
	3,314,120	2,563,486
SHAREHOLDERS' DEFICIENCY		
Common shares *[note 7]*	**24,598,875**	24,598,875
Warrants *[note 7]*	**200,000**	200,000
Equity portion of convertible debenture	**60,000**	60,000
Contributed surplus	**1,867,965**	1,830,365
Deficit	**(29,720,290)**	(28,976,976)
	(2,993,450)	(2,287,736)
	320,670	275,750

See accompanying notes

Quest PharmaTech Inc.

CONSOLIDATED STATEMENTS OF LOSS AND COMPREHENSIVE LOSS

	For the three months ended July 31		For the six months ended July 31	
	2012	**2011**	**2012**	**2011**
	$	$	$	$
REVENUE				
Market distribution rights *[note 10]*	—	2,000	—	4,000
EXPENSES				
General and administrative	**206,793**	158,246	**316,735**	254,812
Research and development, net *[note 15]*	**198,108**	102,936	**362,733**	235,179
	404,901	261,182	**679,468**	489,991
Loss before the undernoted	**(404,901)**	(259,182)	**(679,468)**	(485,991)
Other income (expense)				
Financial income	**112**	—	**217**	—
Financial expenses *[notes 6 and 11]*	**(32,709)**	(30,606)	**(65,826)**	(57,742)
Foreign exchange gain (loss)	**3,575**	(486)	**1,763**	(261)
Loss on fair value adjustment of marketable securities *[note 5]*	—	(250)	—	(3,901)
Loss on sale of marketable securities *[note 5]*	—	(6,163)	—	(14,003)
	(29,022)	(37,505)	**(63,846)**	(75,907)
Net and comprehensive loss for the period	**(433,923)**	(296,687)	**(743,314)**	(561,898)
Basic and diluted loss per share	**($0.01)**	($0.00)	**($0.01)**	($0.01)

See accompanying notes

Quest PharmaTech Inc.

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' DEFICIENCY

	Common Shares $	Equity Portion of Convertible Debenture $	Warrants $	Contributed surplus $	Deficit $	Total Shareholders' Deficiency $
Balance, February 1, 2011	24,198,875	60,000	—	1,746,365	(27,608,441)	(1,603,201)
Shares issued	—	—	—	—	—	—
Share-based payments	—	—	—	82,000	—	82,000
Net loss for the period	—	—	—	—	(561,898)	(561,898)
Balance, July 31, 2011	24,198,875	60,000	—	1,828,365	(28,170,339)	(2,083,099)
Balance, February 1, 2012	24,598,875	60,000	200,000	1,830,365	(28,976,976)	(2,287,736)
Shares issued	—	—	—	—	—	—
Warrants issued	—	—	—	—	—	—
Share-based payments	—	—	—	37,600	—	37,600
Net loss for the period	—	—	—	—	(743,314)	(743,314)
Balance, July 31, 2012	24,598,875	60,000	200,000	1,867,965	(29,720,290)	(2,993,450)

See accompanying notes

Quest PharmaTech Inc.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	For the three months ended July 31		For the six months ended July 31	
	2012	**2011**	**2012**	**2011**
	$	$	$	$
CASH FLOWS FROM (USED IN) OPERATING ACTIVITIES				
Net loss for the period	**(433,923)**	(296,687)	**(743,314)**	(561,898)
Add (deduct) items not involving cash				
Amortization	**26,479**	29,320	**52,730**	58,641
Share-based compensation *[note 9]*	**37,600**	78,000	**37,600**	82,000
Loss on sale of marketable securities *[note 5]*	—	6,163	—	14,003
Loss on fair value adjustment of marketable securities *[note 5]*	—	250	—	3,901
Deferred revenue recognized in the period	—	(2,000)	—	(4,000)
Net changes in working capital *[note 12]*	**(429,925)**	37,032	**(235,510)**	131,402
NET CASH FLOWS FROM (USED IN) OPERATING ACTIVITIES	**(799,769)**	(147,922)	**(888,494)**	(275,951)
CASH FLOWS FROM (USED IN) FINANCING ACTIVITIES				
Increase in demand and other loans *[note 11]*	**500,000**	130,000	**534,000**	220,000
Repayment of demand loans	**(74,000)**	—	**(74,000)**	—
Share subscriptions received *[note 7]*	**500,000**	—	**500,000**	—
NET CASH FLOWS FROM (USED IN) FINANCING ACTIVITIES	**926,000**	130,000	**960,000**	220,000
CASH FLOWS FROM (USED IN) INVESTING ACTIVITIES				
Proceeds from sale of marketable securities *[note 5]*	—	30,346	—	56,658
Purchase of property and equipment	**(4,906)**	—	**(4,906)**	—
NET CASH FLOWS FROM (USED IN) INVESTING ACTIVITIES	**(4,906)**	30,346	**(4,906)**	56,658
Net increase in cash and cash equivalents	**121,325**	12,424	**66,600**	707
Cash and cash equivalents, beginning of period	**20,250**	1,677	**74,975**	13,394
Cash and cash equivalents, end of period	**141,575**	14,101	**141,575**	14,101

See accompanying notes

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

For the six months ended July 31, 2012

1. CORPORATE INFORMATION AND GOING CONCERN UNCERTAINTY

Corporate information

Quest PharmaTech Inc. (the "Company") is a biotechnology company committed to the development and commercialization of oncology product candidates. It is developing a series of products for the treatment of cancer based on its pipeline of SonoLight compounds and monoclonal antibodies which target certain tumor antigens that are presented in a variety of cancers. The Company believes that by combining these antibodies with other cancer therapies such as chemotherapy, photodynamic therapy or radioimmuno therapy, it can potentially further complement and enhance treatment outcomes compared to antibody treatment alone.

The Company is incorporated under the Business Corporations Act (Alberta). The Company's functional currency is the Canadian dollar. The principal address of the Company is 8123 Roper Road NW, Edmonton, Alberta, T6E 6S4.

The Company is publicly traded on the TSX Venture Exchange under the symbol "QPT".

Going concern uncertainty

The Company's consolidated financial statements have been prepared on a going concern basis which presumes the realization of assets and discharge of liabilities in the normal course of business for the foreseeable future. The Company has experienced significant operating losses and cash outflows from operations since its inception.

The Company has incurred a net loss of $ 743,314 for the six months ended July 31, 2012 and as at July 31, 2012 had a working capital deficiency of $3,112,766 (January 31, 2012 - $2,454,876) and a shareholders' deficiency of $2,993,450 (January 31, 2012 - $2,287,736). Accordingly, there is doubt regarding the Company's ability to continue as a going concern.

1. CORPORATE INFORMATION AND GOING CONCERN UNCERTAINTY [CONTINUED]

The Company's ability to continue as a going concern is uncertain and is dependent upon its ability to raise additional capital to successfully complete its research and development programs, commercialize its technologies, conduct clinical trials and receive regulatory approvals for its products. It is not possible at this time to predict the outcome of these matters. The Company's consolidated financial statements do not reflect any adjustments to the classifications and carrying values of assets and liabilities that may be required should the Company be unable to continue as a going concern and therefore be required to realize its assets and discharge its liabilities in other than the normal course of business. The Company intends to address this uncertainty through issuing new share capital through equity financing, licensing arrangements and/or strategic partnerships.

2. BASIS OF PREPARATION

The unaudited consolidated financial statements of the Company were prepared following the same accounting policies as disclosed in Note 3 in the audited consolidated financial statements for the years ended January 31, 2012 and 2011. These unaudited consolidated financial statements for the six months ended July 31, 2012 should be read in conjunction with the consolidated financial statements for the years ended January 31, 2012 and 2011 and the notes thereto. These unaudited consolidated financial statements for the six months ended July 31, 2012 do not include all of the required disclosures for annual consolidated financial statements.

Statement of Compliance

These consolidated financial statements have been prepared by management in accordance with IAS 34 "Interim Financial Reporting" using accounting principles consistent with International Financial Reporting Standards ("IFRS") issued by the International Accounting Standards Board ("IASB").

These consolidated financial statements were approved and authorized for issuance by the Board of Directors on September 17, 2012.

Basis of measurement

The consolidated financial statements have been prepared under the historical cost convention with the exception of financial instruments which have been measured at fair value.

3. INTANGIBLE ASSETS

	July 31, 2012		January 31, 2012	
	Cost $	**Accumulated amortization** $	**Cost** $	**Accumulated amortization** $
Immunotherapy technology	**237,500**	**196,072**	237,500	156,490
Hypocrellin based technology and licenses	**2,476,822**	**2,476,822**	2,476,822	2,476,822
CDK technology	**225,000**	**225,000**	225,000	225,000
	2,939,322	**2,897,894**	2,939,322	2,858,312
Net book value	**41,428**		81,010	

During the three and six months ended July 31, 2012, amortization of intangible assets was $19,791 and $39,583, respectively (2011 – $19,791 and $39,582, respectively).

CORE TECHNOLOGIES

Immunotherapy technology and licenses ("Immunotherapy technology")
During September, 2009, the Company signed a technology purchase agreement with Paladin Labs Inc. ("Paladin") to acquire the proprietary rights and intellectual property related to an antibody immunotherapy technology. Under this technology, the Company acquired product candidates consisting of five monoclonal antibodies targeting certain tumor antigens that are presented in a variety of cancers. Under the terms of the agreement, consideration for the purchase consisted of a cash payment of $37,500 and the issuance of 1,500,000 common shares upon the effective date of the purchase and an additional 1,500,000 common shares to be issued no later than December 31, 2010. The common shares issued on the effective date and those issued prior to December 31, 2010 were valued for accounting purposes at $0.04 per share which reflected the closing price of the common shares on the effective date of the purchase ($60,000 and $60,000 respectively). Under the terms of the agreement a further 2,000,000 common shares were contingently issuable upon successful future financing initiatives by the Company. On October 22, 2010, the Company decided to take control over the technology and issued the final 3,500,000 common shares under the agreement. The 2,000,000 common shares issued on October 22, 2010 reflecting the contingent consideration were valued for accounting purposes at $0.04 per share which reflected the closing price of the common shares at that date ($80,000). The agreement also requires the Company to make milestone and royalty payments to Paladin on future revenues. The Company is amortizing this asset on a straight-line basis over a three-year period.

Hypocrellin-based technology and licenses (proprietary rights)
The Company's subsidiary, Sonolight, holds the exclusive worldwide license to develop,

3. INTANGIBLE ASSETS [CONTINUED]

commercialize and exploit several proprietary inventions involving a class of sonosensitizers and their use in cancer and non-cancer therapies. Sonolight signed a licensing agreement dated March 6, 2001 with the University of Alberta. The license agreement is for a term of 25 years. The agreement requires royalty payments upon successful sales and marketing of products developed using the technology. The Company has amortized this asset on a straight-line basis over a three-year period that commenced August 1, 2001. This intangible asset is fully amortized. The Company has pledged this technology as collateral in connection with the convertible debenture (note 6).

NON-CORE TECHNOLOGIES (CDK technology (proprietary rights)
The Company owns the worldwide rights to develop, manufacture and sell the CDK technology, a novel immunomodulator with anti-cancer properties. As consideration for its acquisition of the technology, the Company must issue 400,000 common shares as certain milestones outlined in the technology purchase agreement are met. To date, the Company has issued 200,000 shares under the agreement: 100,000 shares issued in fiscal 2004 and 100,000 shares in fiscal 2003. These shares have been recorded at a value that represents the closing price of the common shares on the date the shares were issued. The Company amortized this asset on a straight-line basis over a three-year period, which commenced on August 1, 2002. This intangible asset is fully amortized. During fiscal 2009, the Company determined that it will not proceed with further development with respect to the CDK technology.

4. PROPERTY AND EQUIPMENT

	July 31, 2012		January 31, 2012	
	Cost $	Accumulated amortization $	Cost $	Accumulated amortization $
Computer equipment	**82,149**	**76,118**	80,744	75,241
Furniture and fixtures	**12,114**	**11,708**	12,114	11,636
Office equipment	**31,494**	**30,838**	31,494	30,722
Manufacturing and research and development equipment	**456,084**	**388,614**	456,084	376,707
Leasehold improvements	**5,805**	**2,480**	2,305	2,305
	587,646	**509,758**	582,741	496,611
Net book value	**77,888**		86,130	

During the three and six months ended July 31, 2012, amortization of property and equipment was $6,687 and $13,147, respectively (2011 - $9,529 and $19,058, respectively).

5. MARKETABLE SECURITIES

The Company held the following marketable securities which were recorded as follows:

	January 31, 2012 $	January 31 2011 $
Common shares of Brand Marvel Worldwide Consumer Products Corporation ("BMW.v")	—	74,312
Common shares of Samaritan Pharmaceuticals Inc. ("SPHC")	—	333
	—	74,645

At January 31, 2011, the Company held 1,351,111 common shares of BMW.v and 8,334 common shares of SPHC. During the six month period ended July 31, 2011, the Company sold all 1,351,111 common shares of BMW.v. Activity related to the Company's marketable securities is as follows:

	Three months ended July 31		Six months ended July 31	
	2012 $	2011 $	2012 $	2011 $
Net sale proceeds	—	30,346	—	56,658
Loss on sale	—	6,163	—	14,003
Loss on fair value adjustment	—	250	—	3,901

6. CONVERTIBLE DEBENTURE

On March 23, 2005, the Company entered into an agreement to issue a $1,000,000 principal amount 8% convertible debenture with a one-year maturity to two arm's-length parties. The debenture is collateralized by the Company's Hypocrellin-based technology, one of its core technologies (note 3). The debenture was repayable in blended monthly installments of $6,667 with the balance, including accrued interest, due on March 22, 2006. The debenture had a conversion feature whereby it could be converted into common shares of the Company at a price of $0.45 per common share and could be redeemed at any time by the Company. The Company obtained extensions to the maturity date and as at April 30, 2012, the maturity date had been extended to September 22, 2012. In connection with the extensions the debenture interest rate was revised from 8% to 9% per annum and the debenture conversion price was amended from $0.45 to $0.25 per common share. During 2008, the Company made principal payments of $500,000 against the convertible debenture.

During the three and six months ended July 31, 2012, the Company incurred $11,250 and $22,500, respectively (2011 - $11,250 and $22,500, respectively) in interest under this convertible debenture.

7. SHARE CAPITAL

Authorized

Unlimited number of common shares without nominal or par value
Unlimited number of first preferred shares
Unlimited number of second preferred shares

The first and second preferred shares may be issued in one or more series and the directors are authorized to fix the number of shares in each series and to determine the designation, rights, privileges, restrictions and conditions attached to the shares of each series.

Issued

	Number of common shares	Amount $
Common shares		
At January 31, 2011	73,197,580	24,198,875
Shares issued pursuant to a private placement	10,000,000	400,000
At January 31, 2012	83,197,580	24,598,875
At July 31, 2012	83,197,580	24,598,875

On October 25, 2011, the Company raised $600,000 through the issuance of 10,000,000 units at $0.06 per unit, each unit comprised of one common share and one common share purchase warrant. Each warrant entitles the holder to purchase one common share at $0.10 per common share. The warrants expire on October 25, 2013.

In May 2012, the Company closed a $500,000 private placement of 5,000,000 common shares at $0.10 per share. This transaction is subject to TSX Venture Exchange approval.

7. SHARE CAPITAL [CONTINUED]

The following options to purchase common shares were outstanding as at July 31, 2012:

Exercise price $	**Options outstanding** #	**Weighted average remaining life** (years)	**Options exercisable** #
0.10	**5,640,000**	**6.40**	**5,640,000**
0.15	**500,000**	**0.07**	**500,000**
0.25	**1,250,000**	**0.05**	**1,250,000**
	7,390,000	**6.52**	**7,390,000**

The following schedule details the warrants and share-based payment transactions granted and expired:

	Shares issuable on exercise of			
	Warrants		**Share options**	
	Number of shares #	**Weighted average exercise price** $	**Number of shares** #	**Weighted average exercise price** $
Balance, January 31, 2011	—	—	5,040,000	0.16
Granted	10,000,000	0.10	2,150,000	0.10
Expired	—	—	(715,000)	0.25
Balance, January 31, 2012	10,000,000	0.10	6,475,000	0.13
Granted	—	—	940,000	0.10
Expired	—	—	(25,000)	—
Balance, July 31, 2012	**10,000,000**	0.10	**7,390,000**	**0.13**

Warrants

In October 2011, the Company issued 10,000,000 share purchase warrants exercisable at $0.10 per common share pursuant to a private placement of units. The warrants were valued at $0.02 per warrant using the Black-Scholes option valuation model with the following assumptions (dividend rate – 0.00%, volatility – 151.7%, risk-free interest rate – 1.20%, expected life – 2 years). The warrants are set to expire 24 months from the date of issue.

7. SHARE CAPITAL [CONTINUED]

Share options

For the six month period ended July 31, 2012, the Company granted 940,000 share options, as per the Company's Share Option Plan. These share options had an exercise price of $0.10 and were granted to employees (note 9).

For the three and six months ended July 31, 2011, the Company granted 1,950,000 and 2,050,000 share options, respectively, as per the Company's Share Option Plan. These share options all had an exercise price of $0.10. 1,950,000 were granted to employees and 100,000 to non-employees (note 9).

On July 26, 2012, the Company obtained shareholder approval to amend its share option plan such that the aggregate number of common shares eligible for issuance under the Share Option Plan shall not exceed 12,000,000. At July 31, 2012, 4,585,000 options are available for issue.

Basic and diluted loss per share

Basic loss per share has been calculated using the weighted average number of common shares outstanding during the period (2012 – 83,197,580; 2011 – 73,197,580). For the periods presented, the calculation of loss per common share on a diluted basis excluded all potential common shares because the effect was anti-dilutive.

8. CAPITAL DISCLOSURES

The Company is a biotechnology company and consistent with other companies in the industry, the Company's objectives when managing capital are to safeguard its accumulated capital in order to maintain its ability to continue as a going concern so that it can continue with its drug development program and strive to maximize shareholder value. Note 1 provides a discussion surrounding the Company's ability to continue as a going concern. Capital is defined by the Company as shareholders' deficiency (primarily comprised of share capital, contributed surplus and deficit) and current term debt consisting of a convertible debenture and demand loans. The Company manages its capital structures, and makes adjustments to it based on the needs of the Company's operations and the requirement for funding to continue with the Company's drug development program. The Company does this through new share or debt issuances, selling assets or licensing its technologies to third parties to fund operations. The Company is not subject to any externally imposed capital requirements.

9. SHARE-BASED PAYMENTS

For the three and six months ended July 31, 2012, the Company granted a total of 940,000 (2011 – 1,950,000 and 2,050,000, respectively) share options under the Company's Share Option Plan. Options vest immediately on date of grant. The fair value of options vesting in 2012 of $37,600 (2011 - $78,000 and $82,000, respectively) was recognized as a s share-based payment expense and credited to contributed surplus for the three and six months ended July 31, 2012and 2011. There were no forfeitures of Company's share options during the three and six months ended July 31, 2012 and 2011.

The Company used the Black-Scholes option pricing model to estimate the fair value of these options. The Company considers historical volatility of its common shares in estimating future share price volatility. The following assumptions were used:

Six months ended July 31	**2012** $	**2011** $
Dividend yield	0.00%	0.00%
Volatility	145.4%	135.2 - 136.2%
Risk-free interest rate	1.88%	2.70 - 3.20%
Expected life (years)	10	10
Fair value per option	$0.04	$0.04

10. SEGMENT DISCLOSURES

The Company is managed as one operating segment – biopharmaceutical/pharmaceutical products. Management assesses performance and makes resource decisions based on the consolidated results of operations of this operating segment. Substantially all of the operations of the Company are directly engaged in or support this operating segment. The following table presents information on the Company's operating results for the three and six months ended July 31, 2012 and 2011, by geographic area.

Revenues by geographic area

	Three months ended July 31		**Six months ended July 31**	
	2012 $	**2011** $	**2012** $	**2011** $
Asia	—	2,000	—	4,000
	—	2,000	—	4,000

Revenues are attributed to countries based on location of customers or counterparties. Revenues represent market distribution rights recognized during the period.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

For the six months ended July 31, 2012

11. DEMAND LOANS, INTEREST FREE LOAN AND RELATED PARTY TRANSACTIONS

During the year ended January 31, 2011, the Company entered into a demand loan agreement with one of its officers to provide up to $1,000,000 bearing interest at 8% compounded annually to be used for the Company's operating expenditures. This financing is unsecured, with principal repayment to be made 30 days after demand and interest is payable monthly. As at July 31, 2012, the Company had drawn $680,000 on this financing. During the year ended January 31, 2012, the Company secured additional demand loan financing of $100,000 from a director of the Company. This demand loan financing bears interest at 8% per annum, interest payable monthly and is unsecured with principal repayment to be made 30 days after demand. As at July 31, 2012, the Company had demand loan financing of $90,000 from an officer of the Company and $110,000 from an unrelated third party to the Company. These demand loan financings bear interest at 8% per annum, interest payable monthly and are unsecured with principal repayment to be made 30 days after demand. During the three month period ended July 31, 2012, the Company received $500,000 in an interest free loan from an insider of the Company. These funds are scheduled to be returned as funding under the Company's 8,000,000 investment arrangement is received. During the three and six month periods ended July 31, 2012, the Company incurred $20,037 and $40,419, respectively (2011 – $18,158 and $33,462, respectively) in interest under the demand loan financing, $17,475 and $34,884, respectively, with related parties (2011 – $15,048 and 27,652, respectively).

12. SUPPLEMENT CASH FLOW INFORMATION

NET CHANGE IN NON-CASH WORKING CAPITAL ITEMS RELATED TO OPERATING ACTIVITIES

	Three months ended July 31		**Six months ended July 31**	
	2012 $	**2011** $	**2012** $	**2011** $
Accounts receivable	**(25,864)**	(50,288)	**(27,749)**	(51,906)
Prepaid expenses	**7,884**	3,428	**1,605**	(2,235)
Accounts payable and accrued liabilities	**(411,945)**	83,892	**(209,366)**	185,543
	(429,925)	37,032	**(235,510)**	131,402

13. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

The Company's financial instruments include cash and cash equivalents, accounts receivable, marketable securities, accounts payable and accrued liabilities, and the convertible debenture and the demand loans.

a) Carrying value and fair value

The carrying values of cash and cash equivalents, accounts receivable, marketable securities, accounts payable and accrued liabilities, the convertible debenture and the demand loans approximate their fair value due to the immediate or short term maturity of these financial instruments. The fair value of the Company's financial instruments of cash and cash equivalents and marketable securities are measured using the Level 1 classification of the fair value hierarchy.

b) Risks

i) Foreign currency risk

The Company has certain assets and liabilities that are denominated in foreign currencies and are exposed to risks from changes in foreign exchange rates and the degree of volatility of these rates. Due to the limited number of transactions that are denominated in foreign currencies, the Company does not consider its exposure to foreign currency risk to be significant and currently does not use derivative instruments to reduce its exposure to this.

ii) Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they become due. The Company's exposure to liquidity risk is dependent on its ability to raise funds to meet its commitments and sustain its operations. The Company controls liquidity risk by managing its working capital and by securing additional funds through equity, debt or partnering transactions (see Capital Disclosures, note 8). In fiscal 2011, 2012 and 2013, the Company secured debt financing from its officers and from unrelated third parties to provide demand loan financing for operational expenditures. During Fiscal 2013, the Company closed a $500,000 private placement, received a $500,000 interest free loan and signed an $8,000,000 investment financing agreement.

iii) Credit risk

Financial instruments that subject the Company to credit risk consist primarily of cash and cash equivalents and accounts receivable. To minimize its exposure to credit risk for cash equivalents, the Company invests surplus cash in short-term deposits that are fully guaranteed by the Company's financial banker, a major Canadian chartered bank. As the Company is a research and development company, the Company's exposure to credit risk related to accounts receivable is not considered to be significant. At year end, 75% of accounts receivable was due from one provincial government agency.

13. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT [CONTINUED]

iv) Interest rate risk

Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.

Financial assets and financial liabilities with variable interest rates expose the Company to cash flow interest rate risk. The Company's cash and cash equivalents are comprised of highly liquid deposits or investments that earn interest at market rates. Interest on the convertible debenture and demand loans is at fixed rates. Consequently, the Company is exposed to fair value changes on long-term debt when the market interest rate changes. Accounts receivable, accounts payable and accrued liabilities bear no interest.

The Company manages its interest rate risk by maximizing the interest income earned on excess funds while maintaining the liquidity necessary to conduct operations on a day-to-day basis. The Company's policy limits the investing of excess funds to liquid government guaranteed deposits or guaranteed investment certificates.

14. COMPENSATION OF KEY MANAGEMENT

Key management includes directors and executives of the Company. The compensation paid or payable (including stock based compensation) to key management for services is shown below:

	Three months ended July 31		Six months ended July 31	
	2012	**2011**	**2012**	**2011**
	$	$	$	$
Salaries and short term employee benefits	**113,600**	137,803	**207,600**	217,931
Director compensation	**18,000**	18,000	**18,000**	18,000
	131,600	155,803	**225,600**	235,931

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

For the six months ended July 31, 2012

15. GOVERNMENT ASSISTANCE

During the three and six month periods ended July 31, 2012 and 2011, the Company recognized amounts from Alberta Finance related to scientific research and development claims made for research and development expenditures incurred in fiscal 2012 and 2011. This funding was treated as a reduction of research and development expenses.

	Three months ended July 31		Six months ended July 31	
	2012	**2011**	**2012**	**2011**
	$	$	$	$
Gross R & D expenditures	**221,157**	142,775	**385,782**	275,018
Less government assistance	**(23,049)**	(39,839)	**(23,049)**	(39,839)
R & D expenditures, net	**198,108**	102,936	**362,733**	235,179

16. SUBSEQUENT EVENTS

On September 1, 2012, the Company signed an agreement granting 200,000 stock options to a consultant of the Company. The stock options are exercisable at a price of $0.10 per common share, vest immediately and carry an expiry date of September 1, 2022.

Subsequent to period end, the Company received $500,000 under the $8,000,000 investment financing arrangement.