

# WELICHEM BIOTECH INC.

## FORM 51 – 102F2

### MANAGEMENT DISCUSSION AND ANALYSIS

Period Ended August 31, 2009

The following discussion and analysis, prepared as of October 27, 2009, should be read together with the Company's audited financial statements for year ended May 31, 2009 and unaudited financial statements for period ended August 31, 2009 and related notes attached thereto, which are prepared in accordance with Canadian generally accepted accounting principles ("GAAP"). All amounts are stated in Canadian dollars unless otherwise indicated.

This Management Discussion & Analysis summarizes the activities of the Company to-date, and provides financial information for the 3-month period ended August 31, 2009. The discussion contains forward-looking statements made by management that involve risks and uncertainties. Such information is considered reasonable by the Company's management at the time of preparation. The actual results may differ materially from those contained in any forward-looking statements.

#### OVERVIEW

Welichem Biotech Inc. ("Welichem" or "the "Company") is dedicated to the discovery, research and development of pharmaceutical drugs for the treatment of unmet medical needs. The Company's prime focus continues to be the development of drugs for the treatment of inflammatory diseases and cancerous tumors.

The Company is building on its latest successes and has now placed a high priority on completing the development of its anti-inflammatory drug candidate, WBI-1001, for the treatment of atopic dermatitis (AD), a major unmet medical condition that currently has no cure. AD represents a significant global market that is expected to exceed US \$1 billion by 2010.

#### Q1 2010 business highlights

- Announced a non-brokered private placement of \$3.75 million that was closed in September 2009.
- Completed major GLP safety evaluations in the US
- Completed GMP manufacture of API and drug products for the planned clinical trials.
- Completed MOA studies of WBI-2100.

During this reporting period, significant Company time and resources have been invested in preparing for the next round of clinical trials which are scheduled to commence this fall, subject to regulatory approval. The Company allocated substantial resources to manufacturing the trial creams, including the drug substance (API) and drug product. Kilogram-scale API manufacture was successfully completed at GMP facilities in Switzerland in July and, subsequent, GMP manufacture of the drug product (0.5% & 1.0% WBI-1001 & placebo creams) was undertaken in the US. The successful completion of these GMP manufacturing activities has provided sufficient API and drug product for the planned Phase II clinical trials.

At the two meetings with regulatory authorities in Canada and the US, it was suggested that additional safety evaluations be conducted prior to the planned Phase II clinical trials. The company acted on these regulatory suggestions and invested substantial resources in further safety studies. In this quarter four, major GLP safety studies on WBI-1001 were successfully completed in the US to support the planned multicentre clinical trials.

Welichem's other priority is completion of the necessary studies to secure proof of principle of its anti-cancer/neutrophil boosting drug candidate, WBI-2100. The company has invested substantial resources to identify the molecular mode of action (MOA) associated with the unique activities of WBI-2100. The National Research Council of Canada also awarded this project a total of \$500,000. through its IRAP program. This quarter the MOA study identified a gene responsible for some of the functional pathways mediated by this drug candidate in cancerous cells and this is now being confirmed..

Given the prevailing national and international economic and financial difficulties, significant management time has been involved in raising funds for the planned clinical trials and the Company's operations. As part of the endeavor, shareholders approved a ten-to-one share consolidation plan to facilitate the financing effort. In July 2009, the Company announced a non-brokered private placement of \$3.75 million dollars which will be sufficient for the Company's operations for the next fiscal year.

The Company's long-term strategy includes the continual discovery and development of new drugs from the pipeline that are focused on the treatment of cancer and inflammatory diseases. The Company may seek future partnering opportunities for its drug candidates provided that reasonable terms can be negotiated for the shareholders and for the advancement of the Company's technology and business.

## CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The Company prepared its financial statements in accordance with Canadian generally accepted accounting principles (“GAAP”) and the reporting currency is the Canadian dollar. These accounting principles require the Company to make certain estimates and assumptions. Management believes that the estimates and assumptions upon which it relies are reasonable based on information available at the time that these estimates and assumptions are made. Actual results could differ from these estimates. Areas of significant estimates include: amortization of property and equipment, and stock-based compensation. The significant accounting policies that the Company believes are the most critical in fully understanding and evaluating the reported financial results include the following:

### **Cash and cash equivalents**

The Company considers unrestricted cash on hand and in banks, term deposits and guaranteed financial instruments with an original maturity of 90 days or less as cash and cash equivalents. Cash equivalents are classified as held-for-trading investments and measured at fair value.

### **Short-term investments**

The Company considers fixed income investments, marketable securities and other highly liquid financial instruments purchased with a maturity greater than 90 days but less than one year at the date of purchase as short term investments. Short-term investments with a stated maturity date that are not cash equivalents are classified as held-to-maturity investments, except where the Company does not intend to hold to maturity and, therefore, the investment is designated as held-for-trading. Held-to-maturity investments are measured at amortized cost using the effective interest rate method, while held-for-trading investments are recorded at fair value and the resulting gain or loss is recognized in earnings.

### **Accounts payable and accrued liabilities**

Accounts payable and accrued liabilities are typically short-term in nature and classified as other financial liabilities. These liabilities are carried at amortized costs.

## **Property and equipment**

Property and equipment are recorded at cost less accumulated amortization, and are amortized over their expected useful lives on the following basis:

Lab equipment	30% declining balance
Office equipment	30% declining balance
Leasehold improvements	Term of the lease

The Company uses the half year rule in the year of acquisition.

## **Impairment of long-lived assets**

The Company reviews the carrying value of its long-lived assets for existence of facts or changes in circumstances that might indicate a condition of impairment. An impairment loss would be recognized when the estimated undiscounted future projected cash flows expected to result from the use of the asset and its eventual disposition is less than the carrying amount. The amount of the impairment loss to be recorded is calculated by the excess of the carrying value over its fair value, with fair value being determined using a discounted cash flow analysis.

## **Stock-based compensation**

The Company uses the fair value method for stock-based compensation granted to employees and non-employees of the Company, and all direct awards of stock, in accordance with the CICA Handbook Section 3870 “Stock-Based Compensation and Other Stock-Based Payments”. The fair value of stock options is determined by the Black-Scholes Option Pricing Model with assumptions for risk-free interest rates, dividend yields, volatility factors of the expected market price of the Company’s common shares and an expected life of the options. The fair value of direct awards of stocks is determined by the quoted market price of the Company’s stock.

## **Foreign currency translation**

The Company maintains its accounting records in Canadian dollars. At the transaction date, transactions completed in foreign currencies are translated into Canadian dollars by the use of the exchange rate in effect at that date. Revenues and expenses are translated at the average exchange rate for the year. At the year end, monetary assets and liabilities denominated in foreign currencies are translated into Canadian dollars at the year-end exchange rates. Non-monetary assets and liabilities are translated using historical exchange rates. Exchange gains and losses on translation are included in operations.

## **Research and development expenses**

Research costs are expensed as incurred. Development costs are expensed as incurred unless such development costs meet the criteria under Canadian GAAP for deferral and amortization. Development costs which meet generally accepted criteria for deferral are capitalized and amortized against earnings over the estimated period of benefit. As of August 31, 2009, the Company has not deferred any development costs.

## **Government assistance and other subsidies**

Government assistance and other subsidies are recorded as either a reduction of the cost of the applicable assets or credited in the statement of operations as determined by the terms and conditions of the agreement under which the assistance is provided to the Company when there is reasonable assurance that the Company has complied with all conditions necessary to receive the grants and collectibility is reasonably assured.

## **Earnings (loss) per share**

Basic earnings (loss) per share are computed using the weighted average number of common shares outstanding during the year. Diluted earnings (loss) per share is calculated giving effect to the potential dilution that would occur if securities or other contracts to issue common shares were exercised or converted to common shares using the treasury method. The treasury method assumes that proceeds received from the exercise of stock options and warrants are used to repurchase common shares at the prevailing market rate. Diluted loss per share is equal to the basic loss per share as inclusion of common share equivalents securities are anti-dilutives in the three-month period ended August 31, 2009 and 2008.

## **Income taxes**

Future income taxes are recorded using the liability method. Future tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Future tax assets and liabilities are measured using substantively enacted tax rates expected to apply when the asset is realized or the liability settled. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the period that substantive enactment or enactment occurs. To the extent that the Company does not consider it more likely than not that a future tax asset will be recovered, it provides a valuation allowance against the excess.

## ADOPTION OF NEW ACCOUNTING PRONOUCEMENTS

### **Early adoption of an accounting standard – Goodwill and Intangible Assets:**

In fiscal year 2009, the Company chose to early adopt early the CICA issued Section 3064, Goodwill and Intangible Assets, which replace Section 3062, Goodwill and Other Intangible Assets, and Section 3450, Research and Development Costs. The standard provides guidance on the recognition of intangible assets in accordance with the definition of an intangible asset and the criteria for asset recognition as well as classifying the application of the concept of matching revenues and expenses, whether these assets are separately acquired or internally developed. The change as result of early adoption of accounting standard in respect of patent costs has been applied retroactively. The impact of adopting this standard had been to increase the opening deficit and to reduce patent rights and applications at the beginning of 2008 and 2009 by \$289,940 and \$273,708 respectively, which is the net book value of patent costs related to periods prior to the date. Furthermore, following the adoption of this standard, additions to patents and trademarks in the amount of \$310 previously added to patent rights and applications were expensed and amortization of patent rights and applications were reduced by \$10,483 for the three-month period ended August 31, 2008.

### **Capital Disclosure**

Effective June 1, 2008, the Company adopted the new recommendations of the CICA Handbook Section 1535, “Capital Disclosure”. This new accounting standard establishes the requirement for disclosing information about an entity’s capital and how it is managed. Section 1535 requires the disclosure of (i) an entity’s objectives, policies, and processes for managing capital; (ii) quantitative data about what the entity regards as capital; (iii) whether the entity has complied with any capital requirement; and if it has not complied, the consequences of such non-compliance. The disclosure required by the standard is provided in Note 6 of the financial statements.

### **Financial instruments**

Effective June 1, 2008, the Company also adopted the new recommendations of the CICA Handbook Section 3862, “Financial Instruments – Disclosure”, and Section 3863, “Financial Instruments – Presentation”. Section 3862 requires entities to provide disclosures in their financial statements that enable users to evaluate the significance of financial instruments on the entity’s financial position and its performance and the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the balance sheet date, and how the entity manages those risks. Section 3863 establishes standards for presentation of financial instruments and non-financial derivatives. It deals with the classification of financial instruments, from the perspective of the

issuers, between liabilities and equities, the classification of related interest, dividends, losses and gains, and circumstances in which financial assets and financial liabilities are offset. The Company has included disclosures recommended by these new Handbook sections in Note 7 to the financial statements.

### **General Standards of Financial Statement Presentation**

Effective June 1, 2008, the Company adopted the new recommendation of the CICA Handbook Section 1400, "General Standards of Financial Statement Presentation". The new accounting standard provides guidance related to management's responsibility to assess and disclose the ability of an entity to continue as a going concern. The disclosure required by this standard is provided in Note 1 of the financial statements.

## NEW ACCOUNTING PRONOUCEMENTS

### **Section 1582, Business Combinations**

This Section establishes the standards for the accounting of business combinations, and stated that all assets and liabilities of an acquired business will be recorded at fair value. Obligations for contingent considerations and contingencies will also be recorded at acquisition date fair value. The standard also states that acquisition-related costs will be expensed as incurred and that restructuring charges will be expensed in the periods after the acquisition date. This standard is equivalent to the International Financial Reporting Standard on business combinations. The Company will be required to adopt this standard prospectively for business combinations with acquisition dates no later than April 1, 2011. The Company is currently assessing the impact of adopting this standard on financial statements.

### **Section 1601, Consolidated Financial Statements**

In January 2009, CICA issued Handbook Section 1601, "*Consolidated Financial Statements*" which replaced the existing standard. This Section establishes the standards for preparing consolidated financial statements and its effective for the Company on April 1, 2011. The Company is assessing the impact of adopting this standard on financial statements.

## **Section 1602, Non-Controlling Interests**

In January 2009, CICA issued Handbook Section 1602, “*Non-Controlling Interests*”. This Section establishes the standards for accounting of non-controlling interests of a subsidiary in the preparation of consolidated financial statements subsequent to a business combination, and effective for the Company on April 1, 2011. The Company is assessing the impact of adopting this standard on financial statements.

## **Transition to International Financial Reporting Standards**

In January 2006, CICA Accounting Standards Board (“AcSB”) adopted a strategic plan for the direction of accounting standards in Canada. As part of that plan, accounting standards in Canada for public companies are expected to converge with International Financial Reporting Standards (“IFRS”) for accounting periods commencing on or after January 1, 2011. The Company is currently in the diagnostic phase of the conversion of our financial statements to IFRS. This phase includes identifying the difference between existing Canadian GAAP and IFRS standards and evaluating their impact on business processes and information systems, as well as assessing resource requirements for the conversion. The Company expects to complete our analysis over the next three quarters.

By November 30, 2009, when the diagnostic phase is complete, we will prepare a detailed conversion plan in the forth quarter of fiscal 2010 and thereafter begin execution to this plan. It is currently not possible to fully determine the impact of conversion to IFRS on the financial statements and any potential business impacts, as our diagnostic phase is not complete and as accounting standards and related interpretations continues to change.

## RESULTS OF OPERATIONS

Presently, Welichem has no revenues and it is unlikely to be in a position to generate sufficient revenues to meet its ongoing operating and capital expenses for the foreseeable future. Thus the Company has incurred operating losses since inception.

### **3-Month Period Ended August 31, 2009 compared to the 3-Month Period Ended August 31, 2008**

The net loss for the 3-month period ended August 31, 2009 was \$514,022 (2008 - restated \$431,362) and 3 cent per share (2008 - 5 cent per share). The loss per share and weighted average number of common shares outstanding were recalculated retroactively to reflect the ten-to-one share consolidation implemented on September 3, 2009.

The Research & Development Expenses for this period were \$362,980 (2008 - restated \$295,758). Major expenses included \$246,741 (2008 – \$205,358) in subcontractors, supplies and materials, \$105,140 (2008 – \$121,250) in wages and benefits and \$14,731 (2008 – restated \$310) in patent costs. The Company recorded \$3,632 (2008 – \$31,160) in government assistance and other subsidies.

Administrative expenses, including stock-based compensation, for this period were \$13,388 (2008 - \$nil). Major expenses included \$21,216 (2008 - \$28,827) in rent, \$43,343 (2008 - \$37,472) in wages and benefits, \$24,719 (2008 - \$28,268) in regulatory expenses, \$16,073 (2008 - \$25,091) in legal and accounting fees, \$15,343 (2008 - \$8,253) in travel expenses and \$9,900 (2007 - \$10,552) in insurance.

Factors that contributed to changes for certain administrative expense items for the three-month period ended August 31, 2009 included:

- i) \$7K increase in travel expenses to monitor cream manufacturing, and animal tests visiting this quarter.
- ii) \$6K increase in wages and benefits mainly because stock-based compensation accrued this quarter was \$13K compared to no stock-based compensation accrued in the same quarter last year.
- iii) \$8K decrease in rental costs as our office space was reduced by one-third, starting from January 2009.
- iv) \$6K decrease in legal fee for less legal consulting activities and \$3K decrease in accounting fee in this quarter.
- v) \$5K decrease in office expenses due to tightened expense control this quarter.

- vi) \$4K decrease in regulatory fees in respect of private placement and share consolidation this quarter.

## FINANCING

From its incorporation in 1995, the Company has financed its operations through private sales of equity securities, and through interest income, refundable tax credits and government grants.

On July 8, 2009 the Company announced a private placement by issuing 25,000,000 units comprising post-consolidation common shares at a price of \$0.15 per share and 12,500,000 post-consolidation warrants exercisable at \$0.15 up to July 7, 2011 in gross proceeds of \$3,750,000 less issuing costs of \$375,000. The gross subscription money was received by the Company on September 15, 2009.

In addition, the Company may seek future partnering opportunities for its product candidates provided that reasonable terms can be negotiated for the shareholders and for the advancement of the Company's technology.

## LIQUIDITY AND CAPITAL RESOURCES

During the three-month period ended August 31, 2009, the Company used up its operational funds and over drafted bank account at the end of this quarter.

As of August 31, 2009, the Company had a net negative working capital of \$159,763 (May 31 2009 - \$333,208) with negative \$34,827 (May 31 2009 - \$141,559) in cash and cash equivalents and negative \$18 (May 31 2009 - \$619,335) in short-term investments.

As stated in the Financing Section above, the Company closed a private placement for total gross proceeds of \$3,750,000 on September 15, 2009. The Company has financed its operations to date primarily through the sales of equity securities. The Company will continue to fund its operations from a combination of the sales and issuance of equity securities until the Company achieves the licensing or drug commercialization stages.

With this private placement fund, together with interest income and the funding from the NRC-IRAP, the Company anticipates that it has sufficient funds for operations, research and development up to the end of fiscal year 2010.

## MATERIAL COMMITMENTS AND CONTRACTUAL OBLIGATIONS

The Company leases lab and office space and is committed to future minimum lease payments as follows:

September 2009 to May 2010	61,223
June 2010 to September 2010	<u>27,907</u>
	<b><u>\$89,130</u></b>

The Company is also committed to paying its share of operating costs in connection with its lab and office space. In addition, the Company has signed agreements and contracts with various contract research organizations (CROs) related to its different research and development projects, and will be obliged to pay a total of \$781,739 to the CROs in the fiscal year of 2010 as the work is completed. The Company has not yet signed any agreement or contract with its CROs to provide services beyond fiscal year ending May 31, 2010. Thus there is no CRO obligation shown beyond the fiscal year ending May 31, 2010.

#### RISKS AND UNCERTAINTIES

The Company's business is in the development stage and does not generate cash flow from operations to adequately fund its activities and has thus relied principally on the issuance of securities for financing. There is no assurance that such financing will be available on a timely basis under terms acceptable to the Company.

It should be noted that the Company's funding needs may vary depending upon several factors, including the progress and nature of research and development initiatives, the ability to attract and maintain strategic alliances, the Company's decision to in-license technology, acquisition and unforeseen costs associated with undertaking pre-clinical/clinical studies.

If adequate funding is not available, the Company may be required to delay, reduce or eliminate one or more of its research and development programs or obtain funds through arrangements with corporate partners or others that may require the Company to relinquish some or all rights to product candidates at an earlier stage of development or on less favorable terms than the Company would otherwise seek. Insufficient funding may also require the Company to relinquish rights to certain of its technologies that the Company would otherwise develop itself.

SUMMARY OF ANNUAL INFORMATION

	Year Ended May 31, 2009	Year Ended May 31, 2008 <sup>(1)</sup> (restated)	Year Ended May 31, 2007 <sup>(1)</sup> (restated)
Loss for the year	(2,701,954)	(2,503,756)	(3,211,552)
Loss per Common Share -basic and fully diluted <sup>(2)</sup>	(0.16)	(0.34)	(0.52)
Total Assets	881,709	5,115,790	1,473,655
Total Current Liabilities	512,697	1,626,499	463,591
Total Long-term Liabilities	0	0	0
Shareholders' Equity	369,012	3,489,291	1,010,064

SUMMARY OF UNAUDITED QUARTERLY INFORMATION

	1 <sup>st</sup> Quarter Ended August 31, 2009	4 <sup>th</sup> Quarter Ended May 31, 2009	3 <sup>rd</sup> Quarter Ended February 28, 2009 <sup>(1)</sup> - restated	2 <sup>nd</sup> Quarter Ended November 30, 2008 <sup>(1)</sup> - restated	1 <sup>st</sup> Quarter Ended August 31, 2008 <sup>(1)</sup> - restated	4 <sup>th</sup> Quarter Ended May 31, 2008 <sup>(1)</sup> - restated	3 <sup>rd</sup> Quarter Ended February 29, 2008 <sup>(1)</sup> - restated	2 <sup>nd</sup> Quarter Ended November 30, 2007 <sup>(1)</sup> - restated
Loss for the period	(514,022)	(1,306,450)	(503,173)	(460,969)	(431,362)	(811,046)	(610,650)	(487,297)
Loss per Common Share – basic and fully diluted <sup>(2)</sup>	(0.03)	(0.08)	(0.03)	(0.03)	(0.05)	(0.11)	(0.09)	(0.07)
Total Assets	19,620	881,709	1,975,409	2,241,809	2,750,942	5,115,790	216,105	501,429
Total Liabilities	151,242	512,697	342,422	141,850	190,014	1,626,499	915,767	590,442
Shareholders' Equity	(131,623)	369,012	1,632,987	2,099,959	2,560,928	3,489,291	(699,662)	(91,592)

- (1) Restated due to a change in accounting policy for patent. See note 4 to the financial statements.
- (2) Weighted average numbers of common share outstanding and earnings per share (EPS) are recalculated retroactively for all periods presented to reflect 10-to-1 share consolidation implemented by the Company on September 3, 2009.

## OFF BALANCE SHEET ARRANGEMENTS

The Company does not have any off balance sheet arrangements requiring disclosure.

## RELATED PARTY TRANSACTIONS

All related party transactions are recorded at the exchange amount established and agreed by the related parties. No related party transactions occurred in Q1 2010.

## SUBSEQUENT EVENTS

On September 3, 2009 the TSX Venture Exchange approved the Company to consolidate all of the issued and outstanding common shares on the basis of one post-consolidation common share for every ten pre-consolidation common share. Each option, warrant, or other securities of the Company convertible into pre-consolidation common shares that have not been exercised or cancelled prior to the implementation of the share consolidation are adjusted pursuant to the terms thereof on the basis of one post-consolidation common share for every ten pre-consolidation common shares (i.e. the number of common shares issuable decreases while the exercise price increases). The weighted average numbers of common share outstanding and loss per share are recalculated retroactively for all periods presented to reflect the change.

On July 8, 2009 the Company announced a private placement by issuing 25,000,000 units comprising post-consolidation common shares at a price of \$0.15 per share and 12,500,000 post-consolidation warrants exercisable at \$0.15 up to July 7, 2011 in gross proceeds of \$3,750,000 less issuing costs of \$375,000. The gross subscription money was received by the Company on September 15, 2009.

## OUTSTANDING SHARE DATA

As of October 27, 2009, the Company had the following outstanding securities at post-consolidation basis:

(1) Common shares issued:	42,336,299
(Shares in escrow:	none)
(2) Stock options:	585,960
(3) Warrants:	17,500,000

## DISCLOSURE CONTROLS

The Company's Chief Financial Officer and Chief Executive Officer (the "Certifying Officers" are responsible for establishing and maintaining disclosure controls and procedures ("the procedures") which provide reasonable assurance that information required to be disclosed by the Company under provincial securities legislation (the "Required Filings") is reported within the time periods specified. Without limitation, the procedures are designed to ensure that material information relating to the Company is accumulated and communicated to management, including its Certifying Officers, as appropriate to allow for timely decisions regarding the Required Filings.

The Certifying Officers evaluate the effectiveness of the Company's procedures on a regular basis throughout the year and have concluded that the procedures in place as of the end of the period covered by the Required Filings are effective in providing reasonable assurance that material information relating to the Company is accumulated and communicated to management and reported within the time periods specified.

## ADDITIONAL INFORMATION

Additional Information relating to the Company is available by accessing the SEDAR website at [www.sedar.com](http://www.sedar.com).