LORUS THERAPEUTICS INC.

Q1 Financial Report

Three months ended August 31, 2006 and 2005

LETTER TO SHAREHOLDERS

Dear Shareholder:

We are pleased to review with you the operating highlights of the first quarter of our 2007 fiscal year.

In June, Lorus announced the initiation of a plan for a new clinical investigation of GTI-2040 as a single-agent in patients with high-grade myelodysplastic syndrome (MDS) and acute myeloid leukemia (AML). The clinical study will be sponsored by the US National Cancer Institute. These two disease conditions may represent a continuum in malignant progression of the abnormal production of blood cells in the bone marrow that results in a rapidly progressing form of leukemia. Patients that have MDS which progresses to AML have been identified as an especially high-risk group for poor survival.

We were pleased to complete a financing transaction with HighTech Beteiligungen GmbH & Co. KG (HighTech) issuing 28.8 million common shares at $0.36 per share for gross proceeds of $10.4 million. The subscription price represented a premium of 7.5 % over the closing price of the common shares on the Toronto Stock Exchange on July 13, 2006. HighTech is a leading European venture capital fund focused exclusively on providing financial support for the development of innovative products based upon applied technologies and life sciences.

We also completed a transaction with Technifund Inc. to issue on a private placement basis, 5 million common shares at $0.36 per share for gross proceeds of $1.8 million.

We announced in September that Dr. Jim A. Wright would step down as the President and Chief Executive Officer of Lorus on September 21, 2006 and that Dr. Aiping H. Young would succeed him in that position on September 21, 2006, the occasion of our Annual General Meeting.

“The first quarter of 2007 concluded with the completion of two financing transactions providing $12.2 million in gross proceeds to be used towards advancing our product pipeline,” said Dr. Aiping Young, president and CEO of Lorus. “I am pleased to be leading the Lorus team as we further develop GTI-2040 in the clinic, our lead small molecule LT-253 toward the clinic and work towards enhancing shareholder value.”

MANAGEMENT’S DISCUSSION AND ANALYSIS

The following information prepared as at **October 6, 2006** should be read in conjunction with the unaudited consolidated financial statements and notes prepared in accordance with Canadian generally accepted accounting principles (GAAP) in this quarterly report and should also be read in conjunction with the audited consolidated financial statements and notes and management’s discussion and analysis contained in the Company’s annual report for the year ended May 31, 2006. All amounts are expressed in Canadian dollars unless otherwise noted.

Overview of the Business

Lorus is a Canadian biotechnology company, traded on both the TSX (LOR) and AMEX (LRP), focused on the discovery, research and development of well-tolerated therapies that manage cancer and promote improved quality of life. We are currently operating several research and pre-clinical programs in-house and have two products in clinical development with a Phase II clinical trial program underway. We continue to focus on partnership activities for all our drug candidates.

The lead drugs in our antisense portfolio, GTI-2040 and GTI-2501, continue to advance in the clinic. There are currently six clinical trials with GTI-2040 sponsored by the US National Cancer Institute (NCI) in six different indications underway, as well as a Phase I/II clinical trial with GTI-2501 for the treatment of prostate cancer. We announced during the first quarter that an additional trial, to be sponsored by the US NCI, using GTI-2040 for the treatment of myelodysplastic syndrome would be initiated in the calendar year 2006.

We have continued the development of our small molecule program by advancing our lead molecule, LT-253 into toxicity studies. We anticipate that upon successful results of these toxicity studies that we will be in the position to initiate a Phase I clinical trial during calendar 2007.

In addition, Lorus has other novel, proprietary drug candidates in its product development pipeline including tumor suppressor/gene therapy approach and other low molecular weight compounds.

Results of Operations

Cash used in Operating Activities
Cash used in operating activities decreased 62% to $1.8 million for the three-month period ended August 31, 2006 compared with $4.8 million in the same period last year. The significant decrease in cash used in operating activities is due primarily to lower research and development expenditures during the quarter resulting from the close of the Virulizin® Phase III clinical trial in fiscal 2006 as well as headcount reductions in November 2005.

Research and Development
Research and development expenses for the three-month period ended August 31, 2006 decreased 66.4% to $1.3 million compared to $4.0 million for the same period last year. The decrease in costs is primarily due the reduction in clinical trial costs for the Phase III clinical trial of Virulizin® for which we no longer continue to incur costs. In addition, due to headcount reductions implemented in November 2005, we have fewer employees engaged in research and development activities.

General and Administrative
General and administrative expenses for the three-month period ended August 31, 2006 decreased 26.7% to $788,000 compared with $1.1 million for the same period last year. The decrease in general and administrative costs is the result of lower levels of staff following the November 2005 headcount reductions as well as lower corporate communication costs.

Stock-Based Compensation
Stock-based compensation expense decreased to $113,000 for the three-month period ended August 31, 2006 compared with $291,000 in the same period last year. The decrease in expense is attributable to; fewer options issued due to fewer employees and executive officers, a lower fair value assigned to the options issued resulting from a lower stock price, as well as the reversal of stock option expense previously recorded due to the forfeiture of unvested options.

Interest and Accretion Expense
We recognized non-cash interest expense of $265,000 for the three-month period ended August 31, 2006 compared with $198,000 in the same period last year representing interest at a rate of prime +1% on our $15.0 million convertible debentures (the 'debentures'). The increase in expense over the prior period is the result of increases in the prime rate of interest in comparison with the prior periods. The interest accrued on the debenture during the quarter was paid in common shares of the Company, a non-cash expense.

Accretion in the carrying value of the debentures amounted to $219,000 for the three-month period ended August 31, 2006 compared with $186,000 for the three-month period ended August 31, 2006. This accretion charge arises as under Canadian GAAP, the Company has allocated the proceeds from each tranche of the debentures to the debt and equity instruments issued on a relative fair value basis resulting in the $15.0 million debentures having an initial cumulative carrying value of $9.8 million as of their dates of issuance.

Depreciation and Amortization
Depreciation and amortization expense for the three-month period ended August 31, 2006 was $100,000 compared to $130,000 for the same period in the prior year. The decrease is the result of fewer asset acquisitions during fiscal 2006 compared with the prior year and no asset acquisitions during the quarter.

Amortization of Deferred Financing Charges
Amortization of deferred financing charges for the three-month period ended August 31, 2006 was $25,000 compared to $20,000 for the same period in the prior year.

Interest Income
Interest income for the three months ended August 31, 2006 was $67,000, compared with $115,000 for the same period last year. The decrease is attributable to a lower cash and short-term investment balance during the quarter, as the proceeds from the equity financing were not received until August 30 and August 31, 2006.

Net Loss
Net loss for the three-month period ended August 31, 2006 totaled $2.8 million ($0.01 per share) compared to a loss of $5.7 million ($0.03 per share) for the same period last year. The decrease in net loss is due to a reduction of $2.6 million in research and development expenses and a decrease in general and administrative expenses of $300,000.

Financing
On August 30, 2006, Lorus raised gross proceeds of $10,368,000 by way of a subscription agreement for 28,800,000 common shares at a price of $0.36 per common share. The 28,800,000 common shares have been qualified for distribution in Canada under a short form prospectus filed on August 25, 2006 with the Ontario Securities Commission. In connection with the transaction, the investor received demand registration rights that will enable the investor to request the registration or qualification of the common shares for resale in the United States and Canada, subject to certain restrictions. These demand registration rights will expire on June 30, 2012.

On August 31, 2006, Lorus raised gross proceeds of $1,800,000 by way of a private placement for 5,000,000 common shares at a price of $0.36 per common share.

We incurred expenses of $527,000 related to these issuances, which have been recorded as a reduction to share capital.

During the quarter ended August 31, 2006, 46,000 stock options were exercised for cash proceeds of $14,000 (August 31, 2005 – nil)

Quarterly Financial Information (unaudited)
The selected financial information provided below is derived from the Company's unaudited quarterly financial statements for each of the last eight quarters, all of which cover periods of three months.

(Amounts in 000's except for per common share data)	**Aug. 31, 2006**	**May 31, 2006**	**Feb. 28, 2006**	**Nov. 30, 2005**	**Aug. 31, 2005**	**May 31, 2005**	**Feb. 28, 2005**	**Nov. 30, 2004**	**Aug. 31, 2004**
Revenue	$ 7	$ 14	$ 5	$ 6	$ 1	$ -	$ 3	$ 1	$ 2
Research and development	1,331	1,353	2,296	2,631	3,957	2,332	3,175	3,838	5,049
General and administrative	788	730	909	1,619	1,076	1,506	1,484	1,333	1,025
Net loss	(2,770)	(2,720)	(4,095)	(5,102)	(5,742)	(4,598)	(5,274)	(5,945)	(6,245)
Basic and diluted net loss per share	**$ (0.01)**	**$ (0.02)**	**$ (0.02)**	**$ (0.03)**	**$ (0.03)**	**$ (0.03)**	**$ (0.03)**	**$ (0.03)**	**$ (0.04)**
Cash used in operating activities	$(1,815)	$ (1,940)	$(3,956)	$(2,360)	$(4,809)	$(3,789)	$(4,106)	$(4,966)	$(5,860)

Liquidity and Capital Resources
Since its inception, Lorus has financed its operations and technology acquisitions primarily from equity and debt financing, the exercise of warrants and stock options, and interest income on funds held for future investment. We expect to continue to finance the GTI-2501 Phase I/II clinical trial and the development of our small molecule program from internal resources until their anticipated completion. The ongoing costs of the GTI-2040 Phase II clinical program will continue to be borne by the US NCI with Lorus continuing to be responsible for any additional GTI-2040 manufacturing costs.

We have not earned substantial revenues from our drug candidates and are therefore considered to be in the development stage. The continuation of our research and development activities and the commercialization of the targeted therapeutic products are dependent upon our ability to successfully finance and complete our research and development programs through a combination of equity financing and payments from strategic partners. We have no current sources of payments from strategic partners. In addition, we will need to repay or refinance the secured convertible debentures on their maturity should the holder not choose to convert the debentures into common shares. There can be no assurance that

additional funding will be available at all or on acceptable terms to permit further clinical development of our products or to repay the convertible debentures on maturity. If we are not able to raise additional funds, we may not be able to continue as a going concern and realize our assets and pay our liabilities as they fall due. The financial statements do not reflect adjustments that would be necessary if the going concern assumption were not appropriate. If the going concern basis were not appropriate for our financial statements, then adjustments would be necessary in the carrying value of the assets and liabilities, the reported revenues and expenses and the balance sheet classifications used.

Our current level of cash and short-term investments are sufficient to execute our current planned expenditures for the next twelve months.

Cash Position
At August 31, 2006 Lorus had cash and cash equivalents and short-term investments totaling $18.2 million compared to $8.3 million at May 31, 2006. Working capital was $15.8 million at August 31, 2006 compared to $5.8 million at May 31, 2006.

Contractual Obligations and Off-Balance Sheet Financing
At August 31, 2006, we had contractual obligations requiring annual payments as follows:
(Amounts in 000's)

	Less than** 1 year	1-3 years	4-5 years	5+ years	Total
Operating leases	139	86	—	—	225
Convertible Debenture[1]	—	—	15,000	—	15,000
Total	*139*	*86*	*15,000*	—	*15,225*

[1] The convertible debentures as described above may be converted into common shares of Lorus at a conversion price of $1.00. In the event that the holder does not convert the debentures, Lorus has an obligation to repay the $15.0 million in cash.

** On September 19, 2006 the Company announced that Dr. Jim A Wright would step down as the President and Chief Executive Officer effective September 21, 2006. The departure of Dr. Wright resulted in a liability based on a mutual separation agreement executed subsequent to the quarter end of approximately $500 thousand. The amount will be paid by the end of the third quarter 2007.

Outlook
Until one of our drug candidates receives regulatory approval and is successfully commercialized, Lorus will continue to incur operating losses. The magnitude of these operating losses will be largely affected by the timing and scope of future research and development, clinical trials and other development activities related to the Company's lead products, as well as any new initiatives. Finally, the duration of the operating losses will depend on the scientific results of such clinical trials.

Risks and Uncertainties
Please refer to the MD&A included in our 2006 Annual Report for a complete discussion of risks and uncertainties.

Some of the most immediate risks and uncertainties facing us in the next fiscal year include:

- We have a history of operating losses. We expect to incur additional losses and we may never achieve or maintain profitability.
- We may be unable to obtain partnerships for one or more of our product candidates which could curtail future development and negatively impact our share price.
- We may never develop any commercial drugs or other products that generate revenues.
- We may be unable to obtain patents to protect our technologies from other companies with competitive products, and patents of other companies could prevent us from manufacturing, developing or marketing our products.
- We may violate one or more of the operational covenants related to our convertible debentures that could result in an event of default and the requirement for early payment of our convertible debentures.
- Our cash flow may not be sufficient to cover interest payments on the secured convertible debentures or to repay the debentures upon maturity or in the event of default.

- Our share price has been and may continue to be volatile and an investment in our common shares could suffer a decline in value.
- We will need to raise additional funds to conduct research and development, preclinical studies, and clinical trials necessary to bring our potential products to market. We intend to raise additional financing, as required, through strategic alliance arrangements, the exercise of options and warrants, and the issuance of new share capital, as well as through other financing opportunities. There can be no assurance that these financing efforts will be successful or that we will continue to be able to meet our ongoing cash requirements.
- Future sales of our common shares by us or by our existing shareholders could cause our share price to fall.

Critical Accounting Policies and Estimates

Our accounting policies are in accordance with Canadian GAAP including some that require management to make assumptions and estimates that could significantly affect the results of operations and financial position. The significant accounting policies that we believe are the most critical in fully understanding and evaluating the reported financial results are disclosed in the MD&A section of our 2006 Annual Report. As well, our significant accounting policies are disclosed in Note 2, *Significant Accounting Policies,* of the notes to our audited consolidated financial statements for the fiscal year ended May 31, 2006.

Disclosure Controls and Procedures

Lorus announced subsequent to quarter end that Dr. Jim Wright would be resigning as the Company's President and CEO effective September 21, 2006. Lorus also announced that Dr. Aiping Young, the Company's COO, would be appointed President and CEO effective the same day as Dr. Wright's resignation. As Lorus will not be without a President and CEO for any period of time, and given Dr. Young's knowledge of the Company and its internal and disclosure controls, we do not anticipate that our current internal and disclosure control structure will be compromised from this change in management.

Updated Share Information

As at September 30, 2006, the number of issued and outstanding common shares of the Company was 209,625,949. In addition, there were 3,000,000 warrants to purchase 3,000,000 common shares of the Company and 12,665,000 stock options outstanding that can be exercised into an equal number of common shares. The convertible debentures are convertible into 15,000,000 common shares of the Company.

Forward Looking Statements

This management discussion and analysis may contain forward-looking statements within the meaning of Canadian and U.S. securities laws. Such statements include, but are not limited to, statements relating to: our expectations regarding future financings, our plans to conduct clinical trials, the successful and timely completion of clinical studies and the regulatory approval process, our plans to obtain partners to assist in the further development of our product candidates, the establishment of corporate alliances, the Company's plans, objectives, expectations and intentions and other statements including words such as "continue", "believe", "plan", "expect", "intend", "will", "should", "may", and other similar expressions. Such statements reflect our current views with respect to future events and are subject to risks and uncertainties and are necessarily based upon a number of estimates and assumptions that, while considered reasonable by us are inherently subject to significant business, economic, competitive, political and social uncertainties and contingencies. Many factors could cause our actual results, performance or achievements to be materially different from any future results, performance, or achievements that may be expressed or implied by such forward-looking statements, including, among others:

- our ability to obtain the capital required for research and operations
- the regulatory approval process;
- the progress of our clinical trials;
- our ability to find and enter into agreements with potential partners;
- our ability to attract and retain key personnel;
- changing market conditions; and

- other risks detailed from time-to-time in our ongoing quarterly filings, annual information forms, annual reports and annual filings with Canadian securities regulators and the United States Securities and Exchange Commission

Should one or more of these risks or uncertainties materialize, or should the assumptions set out in the section entitled “Risk Factors” in our Annual Report underlying those forward-looking statements prove incorrect, actual results may vary materially from those described herein. These forward-looking statements are made as of the date of this press release and we do not intend, and do not assume any obligation, to update these forward-looking statements, except as required by law. We cannot assure you that such statements will prove to be accurate as actual results and future events could differ materially from those anticipated in such statements. Investors are cautioned that forward-looking statements are not guarantees of future performance and accordingly investors are cautioned not to put undue reliance on forward-looking statements due to the inherent uncertainty therein.

Lorus Therapeutics Inc.

Consolidated Balance Sheets

(amounts in Canadian 000's)		**As at August 31, 2006 (Unaudited)**		As at May 31, 2006 (Audited)
ASSETS				
Current				
Cash and cash equivalents	**$**	**13,286**	$	2,692
Short-term investments (note 4)		**4,873**		5,627
Prepaid expenses and other assets		**703**		515
		18,862		8,834
Long-term				
Fixed assets		**785**		885
Deferred financing charges		**456**		481
Goodwill		**606**		606
Acquired patents and licenses		**262**		655
		2,109		2,627
	$	**20,971**	$	11,461
LIABILITIES				
Current				
Accounts payable	**$**	**596**	$	555
Accrued liabilities		**2,448**		2,460
		3,044		3,015
Long-term				
Secured convertible debentures		**11,221**		11,002
SHAREHOLDERS' EQUITY (DEFICIT)				
Share capital (note 2)				
Common shares		**156,928**		145,001
Equity portion of secured convertible debentures		**3,814**		3,814
Stock options (note 3)		**4,614**		4,525
Contributed surplus		**7,681**		7,665
Warrants		**991**		991
Deficit accumulated during development stage		**(167,322)**		(164,552)
		6,706		(2,556)
	$	**20,971**	$	11,461

See accompanying notes to the unaudited consolidated financial statements

Lorus Therapeutics Inc.
Consolidated Statements of Loss and Deficit (unaudited)

(amounts in Canadian 000's except for per common share data)	**Three months ended Aug 31, 2006**	Three months ended Aug 31, 2005	Period from inception Sept. 5, 1986 to Aug 31, 2006
REVENUE	**$ 7**	$ 1	$ 713
EXPENSES			
Cost of sales	**3**	-	90
Research and development	**1,331**	3,957	111,806
General and administrative	**788**	1,076	48,263
Stock-based compensation (note 3)	**113**	291	6,863
Depreciation and amortization	**100**	130	8,923
Operating expenses	**2,335**	5,454	175,945
Interest expense on convertible debentures	**265**	198	1,447
Accretion in carrying value of convertible debentures	**219**	186	1,435
Amortization of deferred financing charges	**25**	20	196
Interest income	**(67)**	(115)	(10,988)
Loss for the period	**2,770**	5,742	167,322
Deficit, beginning of period	**164,552**	146,643	-
Deficit, end of period	**$ 167,322**	$ 152,385	$ 167,322
Basic and diluted loss per common share	**$ 0.01**	$ 0.03	
Weighted average number of common shares outstanding used in the calculation of basic and diluted loss per share	**186,529**	172,713	

See accompanying notes to the unaudited consolidated financial statements

Lorus Therapeutics Inc.
Consolidated Statements of Cash Flows (unaudited)

(amounts in Canadian 000's)	**Three months ended Aug 31, 2006**	Three months ended Aug 31, 2005	Period from inception Sept. 5, 1986 to Aug 31, 2006
OPERATING ACTIVITIES			
Loss for the period	**$ (2,770)**	$ (5,742)	$ (167,322)
Add items not requiring a current outlay of cash:			
Stock-based compensation	**113**	291	6,863
Interest expense on convertible debentures	**265**	198	1,447
Accretion in carrying value of convertible debentures	**219**	186	1,435
Amortization of deferred financing charges	**25**	20	196
Depreciation, amortization and write-down of fixed assets	**493**	523	21,222
Other	**-**	**-**	707
Net change in non-cash working capital balances related to operations	**(159)**	(285)	1,433
Cash used in operating activities	**(1,814)**	(4,809)	(134,019)
INVESTING ACTIVITIES			
Maturity (purchase) of short-term investments, net	**754**	8,229	(4,873)
Business acquisition, net of cash received	**-**	**-**	(539)
Acquired patents and licenses	**-**	**-**	(715)
Additions to fixed assets	**-**	(70)	(6,049)
Cash proceeds on sale of fixed assets	**-**	**-**	348
Cash provided by (used in) investing activities	**754**	8,159	(11,828)
FINANCING ACTIVITIES			
Issuance of debentures, net proceeds	**-**	**-**	12,948
Issuance of warrants	**-**	**-**	37,405
Issuance of common shares, net of issuance costs	**11,654**	-	109,025
Additions to deferred financing charges	**-**	**-**	(245)
Cash provided by financing activities	**11,654**	-	159,133
Increase in cash and cash equivalents during the period	**10,594**	3,350	13,286
Cash and cash equivalents, beginning of period	**2,692**	2,776	-
Cash and cash equivalents, end of period	**$ 13,286**	$ 6,126	$ 13,286

See accompanying notes to the unaudited consolidated financial statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

Three months ended August 31, 2006 and 2005

1. *Basis of presentation*

These unaudited consolidated interim financial statements of Lorus Therapeutics Inc. ("the Company") have been prepared by the Company in accordance with Canadian generally accepted accounting principles for interim financial statements and do not include all the information required for complete financial statements. The unaudited interim financial statements follow the same accounting policies and methods of application as the audited annual financial statements for the year ended May 31, 2006 and as set out in *Note 2*. These statements should be read in conjunction with the audited consolidated financial statements for the year ended May 31, 2006.

The information presented as at and for the three months ended August 31, 2006 and August 31, 2005 reflect, in the opinion of management, all adjustments consisting only of normal recurring adjustments, necessary for a fair presentation of the results of the interim periods presented. Interim results are not necessarily indicative of results for a full year.

The Company has not earned substantial revenues from its drug candidates and is therefore considered to be in the development stage. The continuation of the Company's research and development activities is dependent upon the Company's ability to successfully finance its cash requirements through a combination of equity financing and payments from strategic partners. The Company has no current sources of payments from strategic partners. In addition, the Company will need to repay or refinance the secured convertible debentures on their maturity should the holder not chose to convert the debentures into common shares. There can be no assurance that additional funding will be available at all or on acceptable terms to permit further clinical development of the Company's product candidates or to repay the convertible debentures on maturity.

Management believes that the Company's current level of cash and short-term investments will be sufficient to execute the Company's current planned expenditures for the next twelve months. If the Company is not able to raise additional funds, it may not be able to continue as a going concern and realize its assets and pay its liabilities as they fall due. The financial statements do not reflect adjustments that would be necessary if the going concern assumption were not appropriate. If the going concern basis were not appropriate for these financial statements, then adjustments would be necessary in the carrying value of the assets and liabilities, the reported revenues and expenses and the balance sheet classifications used.

2. *Share capital*

(a) Continuity of common shares and warrants

(amounts and units in 000's)	Common Shares		Warrants	
	Number	Amount	Number	Amount
Balance at May 31, 2005	172,541	$144,119	3,000	$ 991
Interest payments (b)	265	198	—	—
Balance at August 31, 2005	172,806	$144,317	3,000	$ 991
Interest payments (b)	537	209	—	—
Balance at November 30, 2005	173,343	$144,526	3,000	$ 991
Interest payments (b)	672	224	—	—
Balance at February 28, 2006	174,015	$144,750	3,000	$ 991
Interest payments (b)	679	251	—	—
Balance at May 31, 2006	**174,694**	**$145,001**	3,000	$ 991
Equity issuance (c)	**33,800**	**11,640**	—	—
Interest payments (b)	**792**	**265**	—	—
Stock option exercises	**46**	**22**	—	—
Balance at August 31, 2006	**209,332**	**$156,928**	3,000	$ 991

(b) Interest payments

Interest payments relate to interest payable on the $15.0 million convertible debentures payable at a rate of prime +1% until such time as the Company's share price reaches $1.75 for 60 consecutive trading days, at which time, interest will no longer be charged. Common shares issued in payment of interest were issued at a price equal to the weighted average trading price of such shares for the ten trading days immediately preceding their issue in respect of each interest payment.

(c) Equity issuances

On August 30, 2006, the Company raised gross proceeds of $10,368,000 by way of a subscription agreement for 28,800,000 common shares at a price of $0.36 per common share. The 28,800,000 common shares have been qualified for distribution in Canada under a short form prospectus filed on August 25, 2006 with the Ontario Securities Commission. In connection with the transaction, the investor received demand registration rights that will enable the investor to request the registration or qualification of the common shares for resale in the United States and Canada, subject to certain restrictions. These demand registration rights will expire on June 30, 2012.

On August 31, 2006, the Company raised gross proceeds of $1,800,000 by way of a private placement for 5,000,000 common shares at a price of $0.36 per common share.

The Company incurred expenses of $527,000 related to these issuances, which have been recorded as a reduction to share capital.

During the quarter ended August 31, 2006, 46,000 stock options were exercised for cash proceeds of $14,000 (August 31, 2005 – nil)

(d) Loss per share

The Company has excluded from the calculation of diluted loss per share all common shares potentially issuable upon the exercise of stock options, warrants and the convertible debenture that could dilute basic loss per share, because to do so would be anti-dilutive.

(e) Continuity of contributed surplus

(amounts in 000's)	**2007**	2006
Balance at beginning of the year	**$ 7,665**	$ 6,733
Forfeiture of vested options	**16**	—
Balance at end of the period	**$ 7,681**	$ 6,733

3. Stock-Based Compensation

(a) Continuity of stock options

	Three months ended Aug 31, 2006 (000's)	**Weighted average exercise price**	**Three months ended Aug 31, 2005 (000's)**	Weighted average exercise price
Outstanding at beginning of period	**10,300**	**$ 0.70**	8,035	$ 0.96
Granted	**2,417**	**$ 0.33**	3,713	$ 0.78
Exercised	**(46)**	**$ 0.30**	**—**	**—**
Forfeited	**(389)**	**$ 0.58**	(227)	$ 0.86
Outstanding at end of period	**12,282**	**$ 0.63**	11,521	$ 0.90

In the first quarter of 2007, stock compensation expense of $113,000 (August 31, 2005 - $291,000) was recognized, representing the amortization applicable to the current period of the estimated fair value of options granted since June 1, 2002.

(b) Fair value assumptions

The following assumptions were used in the Black-Scholes option-pricing model to determine the fair value of stock options granted during the period:

	Three months ended August 31, 2006	Three months ended August 31, 2005	Year ended May 31, 2006
Risk free interest rate	**4.5%**	2.25%	2.25-4.00 %
Expected dividend yield	**0%**	0%	0%
Expected volatility	**80%**	70%	70-81%
Expected life of options	**5 years**	5 years	2.5-5 years
Weighted average fair value of options granted or modified in the period	**$0.22**	$0.46	$0.33

The amounts estimated according to the Black-Scholes option pricing model may not be indicative of the actual values realized upon the exercise of these options by the holders.

(c) Continuity of stock options

(amounts in 000's)	**2007**	2006
Balance at beginning of the year	**$ 4,525**	$ 4,252
Forfeiture of stock options	**(16)**	—
Stock option exercise	**(8)**	
Stock option expense	**113**	291
Balance at August 31	**$ 4,614**	$ 4,543

4. Short term investments

As at August 31, 2006 *(amounts in 000's)*

	Less than one year maturities	**Greater than one year maturities**	**Total**	**Yield to maturity**
Fixed income government investments	**$ 2,823**	**$ —**	**$ 2,823**	**3.55-3.64%**
Corporate instruments	**2,050**	**—**	**2,050**	**3.84-3.87%**
Balance	**$ 4,873**	**$ —**	**$ 4,873**	

The Company received proceeds of $12.2 million just prior to the end of the quarter from the equity issuances disclosed in note 2 above. This amount is reported in cash and cash equivalents at the end of the quarter.

As at May 31, 2006 *(amounts in 000's)*

	Less than one year maturities	**Greater than one year maturities**	**Total**	**Yield to maturity**
Fixed income government investments	**$ 2,838**	**$ —**	**$ 2,838**	**3.55-3.64%**
Corporate instruments	**2,789**	**—**	**2,789**	**3.46-3.87%**
Balance	**$ 5,627**	**$ —**	**$ 5,627**	

At August 31, 2006 and May 31, 2006, the carrying values of short term investments approximate their quoted market values. Short term investments held at August 31, 2006 have varying maturities from one to four months (May 2006 – one to six months).

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

Three months ended August 31, 2006 and 2005

5. Corporate changes

In November 2005, as a means to conserve cash and refocus operations, the Company scaled back some activities related to the Virulizin® technology and implemented a workforce reduction of approximately 39% or 22 employees.

In accordance with EIC 134 – *Accounting for Severance and Termination Benefits*, during the period ended November 30, 2005 the Company recorded severance compensation expense for former employees of $557,000 in the prior year. Of this expense, $468,000 was presented in the income statement as general and administrative expense and $89,000 as research and development expense. Accounts payable and accrued liabilities at August 31, 2006 include severance and compensation expense liabilities relating to the Company's November 2005 corporate changes of $64,000 that are expected to be paid by December 2006.

6. Secured convertible debentures

The terms of the secured convertible debentures are described in note 13 to the Company's annual consolidated financial for the year ended May 31, 2006. The debentures are due on October 6, 2009 and may be convertible at the holder's option at any time in to common shares of the Company at a conversion price of $1.00 per share. The lender has the option to demand repayment in the event of default, including the failure to maintain certain subjective covenants, representations and warranties.

Management assesses on a quarterly basis whether or not events during the quarter could be considered an event of default. This assessment was performed and management believes that there has not been an event of default and that, at August 31, 2006; the term of the debt remains unchanged.

7. Subsequent Event

On September 19, 2006 the Company announced that Dr. Jim A Wright would step down as the President and Chief Executive Officer effective September 21, 2006. The departure of Dr. Wright resulted in a liability based on a mutual separation agreement executed subsequent to the quarter end of approximately $500 thousand. The amount will be paid by the end of the third quarter 2007.