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Allon Therapeutics Inc.

2ND QUARTER REPORT JUNE 30 2010



# FINANCIAL INFORMATION

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## MANAGEMENT'S DISCUSSION & ANALYSIS

*The following information should be read in conjunction with the unaudited interim financial statements as at and for the three and six months ended June 30, 2010 and the audited consolidated financial statements and their accompanying notes for the year ended December 31, 2009. The financial statements listed have been prepared in accordance with Canadian generally accepted accounting principles. All dollar amounts are expressed in Canadian dollars unless otherwise specified. Additional information relating to Allon Therapeutics Inc. ("Allon" or the "Company"), including Allon's Annual Information Form (AIF) can be obtained from SEDAR at [www.sedar.com](http://www.sedar.com).*

August 11, 2010

## FORWARD LOOKING STATEMENTS

This Management's Discussion & Analysis (MD&A) contains forward-looking statements that reflect the current view of the Company with respect to future events and financial performance. The forward-looking statements in this MD&A include, but are not limited to, statements regarding: the status of the Company's research and development programs; the Company's expectation regarding the progress of its clinical and pre-clinical programs; the sufficiency of the Company's financial resources to fund operations into 2011; and the Company's future funding requirements. Forward-looking statements include, but are not limited to, those statements set out in this MD&A under "Overview", "Results of Operations", "Liquidity and Capital Resources", "Critical Accounting Policies and Estimates" and "Risks and Uncertainties". The forward-looking statements in this MD&A are based on the Company's current expectations, estimates, projections and assumptions made in light of its experience and its perception of historical trends. Any such forward-looking statements are subject to a number of risks and uncertainties that could cause actual results to differ materially from current expectations. The Company cautions readers that should certain risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary significantly from those expected. The risks that could cause actual results to differ from current expectations include inherent risks in the biopharmaceutical industry, general economic conditions, government regulations, status of healthcare reimbursements, competition, failure of third parties and subcontractors, failure to recruit or retain required management and employees, reliance on collaborative partners, potential for clinical trial liability, inadequate protection of intellectual property rights, uncertainty in the Company's future financial condition and the impact of foreign currency exchange rates. For additional information with respect to certain of these risk factors, reference should be made to the "Risks and Uncertainties" section of this MD&A, to the notes to the unaudited interim consolidated financial statements as at and for the six months ended June 30, 2010, to the "Risk Factors" section in the Company's most recent Annual Information Form, and continuous disclosure materials filed from time to time with Canadian securities regulatory authorities, which are available online at [www.sedar.com](http://www.sedar.com).

The forward-looking information contained in this MD&A is expressly qualified by this cautionary statement. The Company disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, other than as required by law, rule or regulation. You should not place undue reliance on forward-looking statements.

## OVERVIEW

Allon Therapeutics Inc. is a clinical-stage biotechnology company developing treatments for major neurodegenerative conditions. Allon's drug, davunetide, has demonstrated human efficacy in amnesic mild cognitive impairment (aMCI), a precursor to Alzheimer's disease (AD), and in cognitive impairment associated with schizophrenia (CIAS). Allon has advanced clinical development programs pursuing large underserved markets, such as Alzheimer's disease and CIAS, and in orphan markets, such as frontotemporal dementias. The Company's compounds are derived from two proprietary technology platforms, activity-dependent neuroprotective protein (ADNP) and activity-dependent neurotrophic factor (ADNF), both of which are important for normal brain function. Because the two platforms are based on different proteins, the drugs from each are different molecules with different therapeutic mechanisms and distinct commercial opportunities. Clinical-stage drugs based on davunetide are derived from ADNP, while preclinical stage drug AL-309 is derived from ADNF. Davunetide is targeted at Alzheimer's disease, CIAS and frontotemporal dementia and is administered intranasally. ADNF drug candidate AL-309 is targeted for the treatment of peripheral neuropathies and has characteristics that allow it to be developed for multiple routes of administration based on bioavailability studies using oral, intranasal, or subcutaneous administration.

### **Status of research and development programs**

The following table summarizes the development status of each of our research and development programs:

| <b>Platform</b> | <b>Compound</b> | <b>Stage Development</b>  | <b>Status</b>   |
|-----------------|-----------------|---|---|
| ADNP            | Davunetide      | <p>Phase 2 clinical trial in frontotemporal dementia</p> <p>Phase 2 clinical trial in CIAS</p> <p>Phase 1 human cerebrospinal fluid (CSF) pharmacokinetic clinical trial</p> <p>Phase 2a clinical trial in amnesic mild cognitive impairment</p> <p>Phase 2a clinical trial in MCI-CABG</p> | <p>Pilot study commenced in Q1 2010</p> <p>Study completed. Data released in Q4 2009</p> <p>Study completed. Data released in Q3 2008</p> <p>Study completed. Data released in Q1 2008</p> <p>Study completed, data released in Q3 2008</p> |
| ADNF            | AL-309          | Preclinical stage   | Preclinical pharmacology and toxicology ongoing   |

## SECOND QUARTER 2010 ACHIEVEMENTS

- Davunetide was granted Fast Track status by the United States Food and Drug Administration (FDA) for the treatment of Progressive Supranuclear Palsy (PSP), a rapidly-progressing and fatal degenerative brain disease. Fast Track status is designed to facilitate development and expedite review of a drug candidate that treats a serious or life-threatening condition and addresses an unmet medical need.
- Publication of data from preclinical studies that demonstrated that davunetide improved cognitive performance in a model of schizophrenia. The research found that treatment with davunetide improved schizophrenia-like symptoms, such as hyperactivity and memory deficits, in a model where the condition is dependent on reduced expression of the microtubule-associated protein, stable tubule-only polypeptide or STOP. These results suggest that davunetide may alter the course of neurological disease through effects on microtubules, critical structures for neurotransmission.
- Allon was chosen as the “Most Innovative Development Company” in the New Economy 2010 Pharmaceutical & Healthcare Awards sponsored by New Economy Magazine. Editors of London-based New Economy Magazine said Allon was chosen as “the company that has most distinguished itself from its global peers with demonstrated technology innovation – in Allon’s case, the neurodegenerative drug davunetide.”

## RESULTS OF OPERATIONS

Allon reported a net loss of \$2,711,569 (\$0.03 per share) for the three months ended June 30, 2010, compared to a net loss of \$1,204,940 (\$0.02 per share) for the three months ended June 30, 2009, representing an increase in net loss of \$1,506,629. For the six months ended June 30, 2010, the Company reported a net loss of \$5,898,162 (\$0.08 per share), compared to a net loss of \$3,214,529 (\$0.04 per share) for the six months ended June 30, 2009. The following is a description of the significant variances from the comparable period in 2009.

### RESEARCH AND DEVELOPMENT

For the three and six months ended June 30, 2010, research and development expenses were \$1,778,674 and \$3,946,585 compared to \$541,645 and \$1,740,581 for the three and six months ended June 30, 2009. The increase in research and development expenses resulted from an increase in clinical trial activity related to the Company’s neuroprotective drug candidate, davunetide. Details of the Company’s clinical programs are provided below.

#### **Davunetide**

Davunetide is an eight amino acid neuroprotective peptide from the ADNP platform. The Company completed a Phase 2a clinical trial in 2008 evaluating davunetide as a treatment for aMCI, a precursor to AD, and completed a Phase 2a clinical trial in 2009 evaluating davunetide as a treatment for CIAS.

During the six months ended June 30, 2010, the Company commenced a pilot clinical trial in its program to develop davunetide as the first approved treatment for FTD and initiated certain startup

activities related to its Phase 2 clinical trial in PSP, a subtype of FTD. The study is expected to start in the second half of 2010. The Company also initiated and completed within the first quarter of 2010 a Phase 1 clinical trial of davunetide to broaden its demonstrated safety range and pharmacokinetic profile. As a result of these clinical activities, for the three and six months ended June 30, 2010, development costs for davunetide increased to \$1.3 million and \$3.0 million compared to \$0.1 million and \$0.7 million for the three and six months ended June 30, 2009.

### ***Frontotemporal dementia (FTD)***

On January 26, 2010, the Company announced the commencement of a pilot clinical trial in its program to develop davunetide as a treatment for FTD, a group of rapidly progressive and fatal degenerative brain diseases. The study is sponsored by the Memory and Aging Center of the University of California, San Francisco (UCSF). This pilot clinical study, enrolling approximately 12 patients, will help Allon and its clinical collaborators validate the trial design and prepare for a larger Phase 2 clinical trial in progressive supranuclear palsy (PSP) scheduled to begin in 2010. PSP is one of several types of FTD in which the pathology is known to involve impairment of the brain protein tau. The United States Food and Drug Administration (FDA) and the European Union have granted Orphan Drug Designation to davunetide for the treatment of PSP, and in April, 2010, the FDA also granted Fast Track status to davunetide for the treatment of PSP. Fast Track status is designed to facilitate development and expedite review of a drug candidate that treats a serious or life-threatening condition and addresses an unmet medical need.

### ***Alzheimer's disease (AD)***

On February 26, 2008, the Company released results of a Phase 2a clinical trial showing that davunetide intranasal has a positive impact on memory function in patients with aMCI, a precursor to AD. Statistically significant efficacy was achieved on key endpoints that measured short-term recall and working memory, two types of memory that are clinically relevant in AD. The trial also demonstrated that davunetide intranasal was safe and well tolerated by patients.

The Company is currently in the process of seeking a pharmaceutical partnership for the AD program and will initiate a Phase 2b study in AD upon the completion of a partnership arrangement.

### ***Cognitive impairment associated with schizophrenia (CIAS)***

On March 30, 2010, the Company released top-line results from an imaging study of schizophrenia patients showing that 12 weeks of treatment with davunetide resulted in a statistically significant increase in levels of a biomarker that is an important indicator of brain cell health. Statistically significant ( $p=0.0170$ ) increase in levels of N-acetyl aspartate (NAA) were measured in the brains of the schizophrenia patients treated with davunetide using magnetic resonance spectroscopy (MRS). NAA is an informative biomarker because decreased levels of NAA occur in schizophrenia, and in numerous other neurodegenerative conditions such as brain injury, stroke, and Alzheimer's disease.

On December 7, 2009, the Company released results of a Phase 2a clinical trial showing that davunetide intranasal has a positive impact on the ability of schizophrenia patients to carry out important activities in their daily lives. Statistically significant efficacy ( $p=0.015$ ) was achieved on the UCSD (University of California at San Diego) Performance-based Skills Assessment (UPSA). The UPSA scale assesses the functional capacity of skills for daily living. In total, six domains were tested

in staged tasks: medication management, comprehension/planning, financial, communication, transportation, and household skills. The drug was also evaluated with the MATRICS (Measurement and Treatment Research to Improve Cognition in Schizophrenia) composite battery of tests which was the primary outcome. Davunetide intranasal did not show significance on this measure. The trial was largely funded and managed by the Treatment Units for Research on Neurocognition and Schizophrenia (TURNS).

### **Second generation davunetide**

The Company has begun work to develop a second generation davunetide product, administered by another route as a complement to the intranasal formulation of davunetide. The Company has not incurred any significant expenses related to this project in 2010.

### **AL-309**

AL-309 is a D-amino acid derivative of AL-209 from the ADNF platform. In February 2010, the Company presented pre-clinical data that demonstrates the potential of AL-309 as a treatment for peripheral neuropathy. The preclinical data has shown AL-309 to be effective at reducing nerve damage and pain in animal models for peripheral neuropathy caused by diabetes and cancer chemotherapy, two of the most common causes of the disease. Further pre-clinical development is ongoing.

## **GENERAL AND ADMINISTRATIVE**

For the three and six months ended June 30, 2010, general and administrative expenses were \$883,388 and \$1,735,795 compared to \$548,180 and \$1,298,865 for the three and six months ended June 30, 2009. The increase of \$335,208 and \$436,930 compared to 2009 resulted primarily from expenses related to the standby equity distribution agreement, commercial research activities, and increase in investor relations activities.

## **AMORTIZATION**

Amortization expense for the three and six months ended June 30, 2010 were \$135,904 and \$272,684 compared to \$136,848 and \$273,460 for the three and six months ended June 30, 2009. Allon amortizes tangible assets and intellectual property on a straight-line basis.

## **OTHER (INCOME)/EXPENSES**

The Company's other income and expenses are comprised of interest income, foreign exchange gains and losses, and gain on disposal of investments. The Company earned interest revenue of \$6,256 and \$15,009 during the three and six months ended June 30, 2010 compared to \$48,394 and \$111,417 for the same period in 2009. Reduced interest earnings resulted primarily from lower cash balances and lower interest rates in 2010 compared to the same period in 2009.

Foreign exchange translation gain was \$42,509 and \$4,260 for the three and six months ended June 30, 2010. This compared to a loss of \$10,335 and gain of \$22,773 for the three and six months ended June 30, 2009. The Company's foreign exchange exposure is primarily limited to the translation of U.S. dollar balances in cash and short-term investment accounts to Canadian dollars. During the second quarter of 2010, the U.S. dollar appreciated against the Canadian dollar resulting in foreign

exchange gains that more than offset the losses incurred in the first quarter when the U.S. dollar depreciated against the Canadian dollar. This compared to 2009 when the U.S. dollar declined against the Canadian dollar in the second quarter of 2009 offsetting gains from the first quarter of 2009 when the U.S. dollar appreciated against the Canadian dollar.

During the second quarter of 2010, the Company disposed of investments previously written-off, resulting in a gain of \$37,633.

## QUARTERLY INFORMATION

The following is selected quarterly financial information for the Company's eight most recently completed quarters:

(in thousands, except per share data)

|                                    | Jun 30, 2010 | Mar 31, 2010 | Dec 31, 2009 | Sep 30, 2009 |
|------------------------------------|--------------|--------------|--------------|--------------|
| Interest income and other income   | \$ 86        | \$ 9         | \$ 20        | \$ 16        |
| Research and development expenses  | \$ 1,779     | \$ 2,168     | \$ 1,435     | \$ 716       |
| Net loss for the quarter           | \$ (2,712)   | \$ (3,186)   | \$ (2,576)   | \$ (1,551)   |
| Loss per share – basic and diluted | \$ (0.03)    | \$ (0.04)    | \$ (0.03)    | \$ (0.02)    |

|                                    | Jun 30, 2009 | Mar 31, 2009 | Dec 31, 2008 | Sep 30, 2008 |
|------------------------------------|--------------|--------------|--------------|--------------|
| Interest income and other income   | \$ 32        | \$ 44        | \$ 130       | \$ 133       |
| Research and development expenses  | \$ 542       | \$ 1,199     | \$ 1,505     | \$ 1,674     |
| Net loss for the quarter           | \$ (1,205)   | \$ (2,010)   | \$ (1,938)   | \$ (2,310)   |
| Loss per share – basic and diluted | \$ (0.02)    | \$ (0.03)    | \$ (0.02)    | \$ (0.03)    |

## LIQUIDITY AND CAPITAL RESOURCES

The Company's objective is to maintain a sufficient capital base so as to sustain future research and development and business initiatives and to maintain investor, creditor and market confidence. The Company considers the items included in consolidated shareholders' equity as capital and may issue new shares or raise debt in order to maintain its capital structure. However, at this time, the Company has not utilized debt facilities as part of its capital management program. The Company is a research and development stage company and as such funds are primarily invested in research and development initiatives and no dividends are issued to shareholders. The Company does not foresee implementing a dividend program in the near future. Neither Allon nor its subsidiary are subject to any externally imposed capital requirements and the Company does not use financial ratios to manage capital.

Revenue is currently derived from interest earned on cash balances. At June 30, 2010, the Company had accumulated a deficit of \$58,689,049. Losses are expected to continue in the near future as the Company invests in research and development, pre-clinical studies and clinical trials. Since inception, the Company has been financed primarily from public and private sales of equity and interest earned on cash balances and short-term investments.

For the three and six months ended June 30, 2010, operating activities used cash of \$2,166,469 and \$6,709,910 compared to \$1,517,755 and \$4,564,106 used in operations for the three and six months ended June 30, 2009. Cash used in operating activities reflects the net loss of \$2,711,569 and \$5,898,162 for the three and six months ended June 30, 2010, adjusted for non-cash items including amortization of tangible and intangible assets, stock-based compensation and changes in non-cash working capital.

For the three and six months ended June 30, 2010, investing activities generated cash of \$29,721 and \$29,539 compared to nil and use of cash of \$5,563 in the three and six months ended June 30, 2009. The amounts for 2010 represented proceeds from disposal of investments net of cash used in purchase of fixed assets. The 2009 amount represented purchase of small amounts of fixed assets.

On March 3, 2010, the Company announced that it has entered into a standby equity distribution agreement with YA Global Master SPV Ltd., a fund managed by Yorkville Advisors, LLC (Yorkville). Under the terms of the agreement, Yorkville has committed to provide up to \$10 million of equity capital over the next three years, if and when drawn by the Company at the Company's discretion. The Company can terminate the agreement at any time without the payment of any additional fees. Newly issued common shares will be priced at a 5% discount to the 5-day weighted average share price of the Company's shares at the time of draw down, and are subject to a minimum price set by the Company in advance. As of June 30, 2010, the Company has not drawn on this standby equity distribution agreement.

At June 30, 2010, the Company had cash and cash equivalents of \$4,322,488 compared to \$11,002,859 of cash and cash equivalents at December 31, 2009. The Company's cash equivalents are held in high-grade, liquid and low risk investments which may include commercial paper, government bonds and money market funds and are recorded at fair value. The Company invests its cash reserve within the guidelines of the Company's investment policy, which mandates preservation of capital and maintaining liquidity while seeking the best available return.

At June 30, 2010, the Company has 3,834,096 exercisable stock options at exercise prices ranging from \$.001 to \$1.72 per share and 571,500 warrants outstanding and exercisable at a price of \$1.05 per share. If all outstanding and exercisable stock options were exercised, proceeds of \$2,862,954 would be generated. All the warrants expired on July 15, 2010.

Management expects cash on hand to be sufficient to fund operations into 2011. The Company also has access to additional funding under the standby equity distribution agreement described above subject to certain limitations including a minimum share price. Future funding requirements in 2011 and beyond will largely depend on research and development initiatives undertaken by the Company. Such funding may be obtained from the issuance of shares or convertible instruments in association with an external financing, or through a drug development partnership with a biotechnology or pharmaceutical company. There can be no assurance that the Company will be successful in raising any capital through any type of offerings or partnership. Funding may also be obtained, subject to share price, from the issuance of shares from the exercise of outstanding stock options.

While advancing its clinical and pre-clinical programs, the Company has entered into contracts that will remain in effect over several reporting periods. The total current and future commitments account for \$1,391,515 of the \$4,322,488 cash on hand. The Company has no off-balance sheet arrangements.

## Schedule of contractual and planned commitments as of June 30, 2010

(in thousands)

|                           | 2010   | 2011   | 2012   | 2013-2014 | Total    |
|---------------------------|--------|--------|--------|-----------|----------|
| Clinical Initiatives      | \$ 568 | \$ 392 | \$ 192 | \$ 15     | \$ 1,168 |
| Pre-clinical Initiatives  | \$ 68  | \$ -   | \$ -   | \$ -      | \$ 68    |
| Licensing                 | \$ -   | \$ 16  | \$ 16  | \$ 32     | \$ 64    |
| Other                     | \$ 56  | \$ 36  | \$ -   | \$ -      | \$ 92    |
| Total Company Commitments | \$ 692 | \$ 444 | \$ 208 | \$ 47     | \$ 1,392 |

## OUTSTANDING SHARE CAPITAL

At June 30, 2010, the Company had 78,066,666 common shares outstanding. Each common share entitles the holder to one vote per share. At June 30, 2010, there were 6,798,766 options outstanding, of which 3,834,096 were exercisable into an equivalent number of the Company's common shares at exercise prices ranging from \$0.001 to \$1.72. The Company also had 571,500 warrants outstanding on June 30, 2010, entitling holders to purchase one common share of the Company for each warrant held at an exercise price of \$1.05. The warrants expired on July 15, 2010.

The Company's shares are listed on the Toronto Stock Exchange and held by a broad base of investors, none of whom exercise significant influence. See Note 4 of the Company's financial statements for more detail regarding outstanding share capital.

## RELATED PARTY TRANSACTIONS

During the three and six month periods ended June 30, 2010, the Company paid one of its Board members \$25,000 and \$75,000 respectively, for consulting services provided to the Company in relation to general research and advancement of the Company's drug development programs. The Company plans to retain these services throughout 2010.

During the first quarter of 2009, the Company received US\$113,378 from a Senior Officer of the Company as full repayment of principal and interest on a loan granted during the fourth quarter of 2008. The loan carried an annual interest rate of 5.00%, consistent with market rates at the time of the loan and was related to the 2004 acquisition of Allon Therapeutics, Inc.

## INTERNAL CONTROLS OVER FINANCIAL REPORTING

Management has designed internal controls over financial reporting (ICFR) to provide reasonable assurance regarding the reliability of the Company's financial reporting and the preparation of financial statements in accordance with Canadian generally accepted accounting principles. During the three and six months ended June 30, 2010, there were no significant changes in the Company's internal controls over financial reporting that have materially affected or are reasonably likely to affect the Company's internal controls over financial reporting.

The Company is committed to full compliance with the listing standards and rules related to corporate governance of the Toronto Stock Exchange as well as applicable securities legislations. The Company has adopted a Code of Business Conduct that includes Criteria for Ethical Decision Making and Guidelines for Ethical Business Practices. A copy of the Code of Business Conduct may be obtained upon request without charge from the Company at the following address and contact

number of the Company: 506 – 1168 Hamilton Street, Vancouver, B.C. V6B 2S2; telephone number 604-736-0634. Additionally, the Code of Business Conduct can also be viewed on the Company website at [www.allontherapeutics.com](http://www.allontherapeutics.com).

## **CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

The preparation of consolidated financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements as well as the reported amount of revenues and expenses during the reporting periods. The reported amounts and note disclosures are determined using management's best estimates based on assumptions that reflect the most probable set of economic conditions and planned course of action. Significant areas requiring the use of management estimates relate to the assessment for impairment and useful lives of intangible assets, clinical trial accounting including the determination of useful lives of clinical drug supplies, accrued liabilities, research and development costs and determination of the fair value of stock-based compensation. Management believes that the estimates and assumptions are reasonable based upon information available at the time that these estimates and assumptions were made. Actual results could differ from those estimates used in the preparation of the financial statements. For a full description of the Company's Critical Accounting Policies and Estimates, reference should be made to the "Critical Accounting Policies and Estimates" section of the Company's annual MD&A for the year ended December 31, 2009 filed with Canadian securities regulatory authorities, which is available online at [www.sedar.com](http://www.sedar.com).

The Company's financial statements have been prepared under the assumption that the Company will continue as a going concern. The eventual profitability of the Company and its ability to continue as a going concern is dependent upon many factors, including its ability to obtain sufficient financing, the successful development of its products, and receiving regulatory approvals. In addition, the biotechnology industry is subject to rapid and substantial technological change which could reduce the marketability of the Company's technology. The Company's existing cash resources are sufficient, in management's opinion, to fund its business into 2011 in accordance with the Company's current business plan. The Company will be required to obtain additional sources of financing in the future to continue its research activities, realize returns on its assets and discharge its liabilities in the normal course of business. There is no guarantee that the Company will be able to raise any capital through any type of offerings.

## **FUTURE CHANGES IN ACCOUNTING POLICIES**

In January 2009, the CICA issued Section 1601, *Consolidated Financial Statements*, and Section 1602, *Non-Controlling Interests*. These Sections replaces Section 1600, *Consolidated Financial Statements*. Section 1601 establishes standards for the preparation of consolidated financial statements. Section 1602 establishes standards for the accounting of non-controlling interests in a subsidiary in the consolidated financial statements subsequent to a business combination. These Sections will apply to the Company's financial statements beginning on January 1, 2011. The Company is currently evaluating the implications of these new Sections on the consolidated financial statements.

In January 2009, the CICA issued Section 1582, *Business Combinations*. This Section replaces Section 1581, *Business Combinations*. Section 1582 establishes standards for the recognition of business combination. This Section will apply to financial statements relating to the Company beginning on January 1, 2011. The Company is currently evaluating the implications of this new Section on the consolidated financial statement.

#### *IFRS Conversion*

In February 2008, the Accounting Standards Board (“AcSB”) of the CICA confirmed that Canadian GAAP for publically accountable enterprises will be converged with International Financial Reporting Standards (“IFRS”) effective in the calendar year 2011. The conversion to IFRS will be required, for the Company, for interim and annual financial statements beginning on January 1, 2011. IFRS uses a conceptual framework similar to Canadian GAAP, but there are significant differences on recognition, measurement and disclosures.

The Company has identified various IFRS standards below that differ from current accounting practices and that management expects may have a financial impact on its financial statements upon initial conversion. While the financial impact has not been quantified at this time, the following narrative discussion provides insight into the key elements of the Company’s financial statements that are expected to be impacted by the changeover to IFRS.

IFRS 1, *First-time Adoption of International Financial Reporting Standards*, is the standard that provides guidance for creating the Company’s first IFRS financial statements. The standard provides elective options in the opening balance sheet to allow financial information to be produced at a cost that does not exceed the benefits to users, and it provides mandatory exceptions to retrospective application of IFRS in certain circumstances to ensure the benefit of hindsight does not impact the integrity of historical information. At this time, the Company expects to apply the following IFRS 1 elections and exemptions in its opening balance sheet:

- Business combinations – IFRS 3, *Business Combinations*, may be applied retrospectively or prospectively. The Company will elect to prospectively apply the standard such that all business combinations prior to January 1, 2010 will not be restated to comply with IFRS 3.
- Share-based payments – IFRS 2, *Share-based payments*, encourages entities to apply the standard to all equity instruments issued, however under IFRS 1 the Company may elect not to apply IFRS 2 to equity instruments issued prior to November 7, 2002, and to equity instruments issued after November 7, 2002 that were vested prior to the date of transition. The Company will make this election and apply IFRS 2 only to equity instruments that were issued after November 7, 2002 that had not vested prior to January 1, 2010. IFRS 2 will apply to the Company’s share options that were granted after November 7, 2002, but have not vested prior to January 1, 2010, as noted above. The Company currently uses a straight-line approach to amortization of share-based compensation expense. Under IFRS 2, share options that vest in installments are amortized accordingly in an accelerated format. In addition, the Company had adjusted for forfeitures as they occurred, whereas IFRS 2 will require an estimate of forfeitures on initial recognition.
- Pursuant to IAS 1, *Presentation of Financial Statements*, the Company will be required to group its expenses on the income statement using a classification system based solely on function. The Company currently presents its expenses by function, with the exception of amortization of

property, plant and equipment and intangibles. The Company's IFRS consolidated statement of profit or loss will allocate amortization to the relevant functional areas of research and development and SG&A expenses.

- Under IAS 1, an entity may present comprehensive income in either a single statement of comprehensive income, or an income statement (displaying components of profit and loss) and a separate statement of comprehensive income. The Company currently presents comprehensive income and loss in the Changes in Shareholders' Equity statement. Upon adoption of IFRS, the Company will present its comprehensive income and loss in a single statement of comprehensive income.
- Under IAS 7, *Statement of Cash Flows*, an entity has the choice of presenting interest revenue as either an operating activity or investing activity. The Company currently presents interest revenue under operating activity and will elect to continue presenting interest revenue under operating activity.
- Under IAS 24, *Related Party Disclosures*, key management personnel compensation is disclosed in total and is analyzed by component. Comprehensive disclosures of related party transactions are required for each category of related party relationship. The Company currently does not consider management compensation as related party transactions. Upon the adoption of IFRS, the Company will disclose management compensation as part of related party disclosures.
- Cumulative translation differences – a first-time adopter may be exempt from complying with the requirements of IAS 21, *Foreign Exchange*, for cumulative translation differences that existed at the date of transition to IFRS. The first-time adopter may deem cumulative translation differences for all foreign operations to be zero at the date of transition to IFRS, and the gain or loss on a subsequent disposal of any foreign operation shall exclude translation differences that arose before the date of transition to IFRS. IAS 21 explicitly requires an entity to first determine its functional currency using explicitly prescribed tests that differ from Canadian GAAP prior to translating its financial results into the reporting currency of the consolidated entity. Under Canadian GAAP, the Company's foreign subsidiary is considered an integrated operation and therefore requires the use of temporal based accounting when translating its financial statements into Canadian dollars, the Company's reporting currency. IAS 21 does not distinguish between integrated foreign operations and self-sustaining foreign operations and requires the financial results of all foreign operations to be translated to the Company's reporting currency using an approach commonly known as the current rate method. Under the temporal method of translation only monetary assets and liabilities are translated to the reporting currency at current rates of exchange and the effect of the translation is reported as a foreign exchange gain or loss. Under the current rate method all assets and liabilities are translated to the reporting currency at current rates of exchange and the effect of the translation is reported as other comprehensive income or loss. The Company is currently evaluating the impact of IAS 21 on the consolidated financial statements.

## **RISKS AND UNCERTAINTIES**

As previously described, cash and cash equivalents on hand, along with the funds available under the standby equity distribution agreement, are expected to be sufficient to fund operations into 2011. Funding needs may, however, vary depending on a number of factors including progress in research

and development, the cost associated with completing clinical trials and the regulatory approval process, and the costs of enforcing and prosecuting patent claims and other intellectual property rights. The Company will need to raise additional funds to continue research and development and clinical trials necessary for market approval. The Company cannot guarantee that financing will be available or that terms for additional financing will be favourable.

The Company's primary market risk is the exposure to foreign currency exchange rate fluctuations. This risk arises from the Company's holdings of foreign currency denominated cash, accounts payable, cash equivalents, and short-term investments. Changes in foreign currency exchange rates can create significant foreign exchange gains or losses to the Company. The Company's current foreign currency risk is primarily with the U.S. dollar. The Company has minimal exposure to interest rate risks as it does not have long-term financial liabilities.

In general, prospects for companies in the biopharmaceutical industry may be regarded as uncertain given the nature of the industry; therefore, investments in such companies should be regarded as highly speculative. Additional information with respect to these and other risks affecting the Company is described in the section "Risk Factors" in the Company's most recent Annual Information Form filed with Canadian securities regulatory authorities. Reference should also be made to the notes to the unaudited consolidated financial statements for the three and six months ended June 30, 2010 and to the Company's other continuous disclosure materials filed from time to time with Canadian securities regulatory authorities, which are available online at [www.sedar.com](http://www.sedar.com).

Interim Consolidated Financial Statements of

**ALLON THERAPEUTICS INC.**

Three and six months ended June 30, 2010 and 2009

(Unaudited)

# ALLON THERAPEUTICS INC.

Consolidated Balance Sheets  
(Unaudited)

|                               | June 30,<br>2010     | December 31,<br>2009 |
|-------------------------------|----------------------|----------------------|
| <b>Assets</b>                 |                      |                      |
| Current assets:               |                      |                      |
| Cash and cash equivalents     | \$ 4,322,488         | \$11,002,859         |
| Accounts receivable           | 34,130               | 22,438               |
| Prepaid expenses and deposits | 376,813              | 430,878              |
| Drug supplies (note 3)        | 4,321,159            | 3,922,156            |
|                               | <u>9,054,590</u>     | <u>15,378,331</u>    |
| Non-current assets:           |                      |                      |
| Property and equipment        | 37,172               | 42,567               |
| Intangible assets             | 4,855,234            | 5,114,430            |
| Drug supplies (note 3)        | 327,938              | 327,938              |
|                               | <u>5,220,344</u>     | <u>5,484,935</u>     |
|                               | <u>\$ 14,274,934</u> | <u>\$ 20,863,266</u> |

## Liabilities and Shareholders' Equity

|  |                      |                      |
|--|----------------------|----------------------|
| Current liabilities:                     |                      |                      |
| Accounts payable and accrued liabilities | \$ 1,484,517         | \$ 2,290,906         |
| Shareholders' equity:                    |                      |                      |
| Share capital (note 4)                   | 69,110,562           | 69,110,562           |
| Contributed Surplus                      | 2,367,133            | 2,252,684            |
| Deficit                                  | (58,687,278)         | (52,790,886)         |
|  | <u>12,790,417</u>    | <u>18,572,360</u>    |
|  | <u>\$ 14,274,934</u> | <u>\$ 20,863,266</u> |

Basis of presentation and going concern (note 1)

See accompanying notes to consolidated financial statements.

Approved on behalf of the Board:

*"Frank A. Holler"*

Frank A. Holler, Director

*"C. Michael O'Brian"*

C. Michael O'Brian, Director

# ALLON THERAPEUTICS INC.

Consolidated Statements of Operations, Comprehensive Loss and Deficit  
(Unaudited)

Three and six months ended June 30, 2010 and 2009

|  | Three months<br>ended<br>June 30,<br>2010 | Three months<br>ended<br>June 30,<br>2009 | Six months<br>ended<br>June 30,<br>2010 | Six months<br>ended<br>June 30,<br>2009 |
|--|---|---|---|---|
| <b>Expenses:</b>                                     |   |   |   |   |
| Research and development                             | \$ 1,778,674                              | \$ 541,645                                | \$ 3,946,585                            | \$ 1,740,581                            |
| General and administrative                           | 881,617                                   | 548,180                                   | 1,734,024                               | 1,298,865                               |
| Amortization   | 135,904                                   | 136,848                                   | 272,684                                 | 273,460                                 |
|  | <u>2,796,195</u>                          | <u>1,226,673</u>                          | <u>5,953,293</u>                        | <u>3,312,906</u>                        |
| <b>Other expense (income):</b>                       |   |   |   |   |
| Interest and other income                            | (43,888)                                  | (32,068)                                  | (52,642)                                | (75,604)                                |
| Foreign exchange loss/(gain)                         | (42,509)                                  | 10,335                                    | (4,260)                                 | (22,773)                                |
|  | <u>(86,397)</u>                           | <u>(21,733)</u>                           | <u>(56,902)</u>                         | <u>(98,377)</u>                         |
| <b>Net and comprehensive loss<br/>for the period</b> | <b>(2,709,798)</b>                        | <b>(1,204,940)</b>                        | <b>(5,896,391)</b>                      | <b>(3,214,529)</b>                      |
| <b>Deficit, beginning of period</b>                  | <b>(55,977,479)</b>                       | <b>(47,458,490)</b>                       | <b>(52,790,886)</b>                     | <b>(45,448,901)</b>                     |
| <b>Deficit, end of period</b>                        | <b><u>\$(58,687,277)</u></b>              | <b><u>\$(48,663,430)</u></b>              | <b><u>\$(58,687,277)</u></b>            | <b><u>\$(48,663,430)</u></b>            |
| <b>Net loss per share:</b>                           |   |   |   |   |
| Basic and diluted (note 6)                           | <u>\$ (0.03)</u>                          | <u>\$ (0.02)</u>                          | <u>\$ (0.08)</u>                        | <u>\$ (0.04)</u>                        |

See accompanying notes to consolidated financial statements.

# ALLON THERAPEUTICS INC.

Consolidated Statements of Cash Flows  
(Unaudited)

Three and six months ended June 30, 2010 and 2009

|   | Three months<br>ended<br>June 30,<br>2010 | Three months<br>ended<br>June 30,<br>2009 | Six months<br>ended<br>June 30,<br>2010 | Six months<br>ended<br>June 30,<br>2009 |
|---|---|---|---|---|
| Cash provided by (used in):                             |   |   |   |   |
| Operations:   |   |   |   |   |
| Net loss for the period                                 | \$(2,709,798)                             | \$(1,204,940)                             | \$(5,896,391)                           | \$(3,214,529)                           |
| Items not involving cash:                               |   |   |   |   |
| Amortization  | 135,904                                   | 136,848                                   | 272,684                                 | 273,460                                 |
| Stock-based compensation                                | 63,502                                    | 90,146                                    | 114,449                                 | 190,507                                 |
| Change in non-cash operating<br>working capital         | 381,556                                   | (539,809)                                 | (1,163,019)                             | (1,813,544)                             |
|   | (2,128,836)                               | (1,517,755)                               | (6,672,277)                             | (4,564,106)                             |
| Investments:  |   |   |   |   |
| Purchase of property and equipment                      | (7,912)                                   | -   | (8,094)                                 | (5,563)                                 |
| Decrease in cash and cash<br>equivalents for the period | (2,136,748)                               | (1,517,755)                               | (6,680,371)                             | (4,569,669)                             |
| Cash and cash equivalents,<br>beginning of period       | 6,459,236                                 | 16,041,585                                | 11,002,859                              | 19,093,499                              |
| Cash and cash equivalents,<br>end of period             | \$ 4,322,488                              | \$14,523,830                              | \$ 4,322,488                            | \$14,523,830                            |
| Supplementary information:                              |   |   |   |   |
| Interest received                                       | \$ 6,256                                  | \$ 48,394                                 | \$ 15,009                               | \$ 111,417                              |

See accompanying notes to consolidated financial statements.

## 1. Basis of presentation and going concern:

Allon Therapeutics Inc. ("Allon" or the "Company") is a public company incorporated under the Canada Business Corporations Act. Allon is a biopharmaceutical company engaged in the development of drugs to treat neurodegenerative diseases and disorders.

The accompanying financial statements have been prepared under the assumption that the Company will continue as a going concern. The eventual profitability of the Company and its ability to continue as a going concern is dependent upon many factors, including its ability to obtain sufficient financing, the successful development of its products, and receiving regulatory approvals. In addition, the biotechnology industry is subject to rapid and substantial technological change which could reduce the marketability of the Company's technology. The Company's existing cash resources are sufficient, in management's opinion, to fund its business into 2011. The Company also has access to additional funding under a \$10 million standby equity distribution agreement to be drawn at the Company's discretion over the next three years subject to certain limitations including a minimum share price (see Note 4). The Company will continue to require additional sources of financing in the future to continue its research activities, realize returns on its assets and discharge its liabilities in the normal course of business. There is no guarantee that the Company will be able to raise any capital through any type of offerings.

## 2. Significant accounting policies:

These unaudited interim consolidated financial statements are prepared following accounting policies and methods of their application consistent with the Company's audited annual financial statements for the year ended December 31, 2009. These unaudited interim consolidated financial statements do not include all note disclosures required by Canadian generally accepted accounting principles ("Canadian GAAP") for annual financial statements, and therefore should be read in conjunction with the annual audited consolidated financial statements for the year ended December 31, 2009 included in the Company's 2009 Annual Report. The results of operations for the three and six months ended June 30, 2010 are not necessarily indicative of the results for the full year.

### (a) Future changes in accounting policies:

In January 2009, the CICA issued Section 1601, *Consolidated Financial Statements*, and Section 1602, *Non-Controlling Interests*. These Sections replaces Section 1600, *Consolidated Financial Statements*. Section 1601 establishes standards for the preparation of consolidated financial statements. Section 1602 establishes standards for the accounting of non-controlling interests in a subsidiary in the consolidated financial statements subsequent to a business combination. These Sections will apply to the Company's financial statements beginning on January 1, 2011. The Company is currently evaluating the implications of these new Sections on the consolidated financial statements.

In January 2009, the CICA issued Section 1582, *Business Combinations*. This Section replaces Section 1581, *Business Combinations*. Section 1582 establishes standards for the recognition of business combination. This Section will apply to financial statements relating to the Company beginning on January 1, 2011. The Company is currently evaluating the implications of this new Section on the consolidated financial statement.

### *IFRS Conversion*

In February 2008, the Accounting Standards Board (“AcSB”) of the CICA confirmed that Canadian GAAP for publically accountable enterprises will be converged with International Financial Reporting Standards (“IFRS”) effective in the calendar year 2011. The conversion to IFRS will be required, for the Company, for interim and annual financial statements beginning on January 1, 2011. IFRS uses a conceptual framework similar to Canadian GAAP, but there are significant differences on recognition, measurement and disclosures. The Company is in the process of implementing its changeover plan and has identified various IFRS standards that differ from current accounting practices and that management expects may have a financial impact on its financial statements upon initial conversion. The major identified differences include business combination, share-based payments, allocation of amortization in the income statement, presentation of comprehensive income and related party disclosure.

### **3. Drug supplies:**

As of June 30, 2010, the Company held \$4,321,159 of drug supplies to be used within the next twelve months and as a result, they are recorded as current assets in the Company's consolidated balance sheet.

The Company also held drug supplies of \$327,938 to be used in future clinical trials beyond the next twelve months. These drug supplies are recorded as non-current assets.

### **4. Share capital:**

#### (a) Authorized:

Unlimited voting common shares without par value

Unlimited preferred shares, issuable in series

#### (b) Structured equity financing:

On March 2, 2010, the Company entered into a standby equity distribution agreement with YA Global Master SPV Ltd., a fund managed by Yorkville Advisors, LLC (Yorkville). Under the terms of the agreement, Yorkville has committed to provide up to \$10 million of equity capital over three years, if and when drawn by the Company at the Company's discretion. The Company can terminate the agreement at any time without payment of any additional fees. Newly issued common shares will be priced at a 5% discount to the 5-day weighted average share price of the Company's shares at the time of draw down, and are subject to a minimum price set by the Company in advance. The Company incurred \$178,065 in expenses associated with this financing which is included in general and administrative expenses.

#### (c) Warrants:

At June 30, 2010, the Company has 571,500 share purchase warrants outstanding. Each whole warrant will entitle the holder thereof to purchase one common share at an exercise price of \$1.05. The warrants expired on July 15, 2010.

## 5. Stock-based compensation:

The Company recognized \$63,502 and \$114,449 in stock-based compensation expense for the three and six months ended June 30, 2010 compared to \$90,146 and \$190,507 for the three and six months ended June 30, 2009. Stock-based compensation expenses comprised awards granted to employees and non-employees under the Company's stock option plan.

The Company's Stock Option Plan ("the Plan"), provides for the granting of options for the purchase of common shares of the Company at a purchase price not less than the fair market value of the Company's stock at the grant date. Stock options are granted to both employees and non-employees. The Company's Board of Directors has discretion as to the number, vesting period, and expiry dates of stock options granted.

The Plan is based on a rolling percentage of options issuable of up to 10% of the Company's outstanding common shares. As of June 30, 2010, the Company had 78,066,666 common shares issued and outstanding resulting in current authorization to issue a maximum of 7,806,667 options under the Plan.

Stock option activity from December 31, 2008 to June 30, 2010 is as follows:

|                                | Common shares<br>under option | Weighted average<br>exercise price |
|--------------------------------|-------------------------------|------------------------------------|
| Outstanding, December 31, 2008 | 6,421,600\$                   | 0.83                               |
| Granted                        | 805,500                       | \$ 0.28                            |
| Exercised                      | -                             | -                                  |
| Cancelled                      | (75,000)                      | 0.96                               |
| Outstanding, December 31, 2009 | 7,152,100                     | \$ 0.76                            |
| Granted                        | -                             | -                                  |
| Exercised                      | -                             | -                                  |
| Cancelled                      | (353,334)                     | 0.85                               |
| Outstanding, June 30, 2010     | 6,798,766`                    | \$ 0.76                            |

At June 30, 2010, the Company has 3,834,096 stock options exercisable at weighted average exercise price of \$0.75. At December 31, 2009, the Company has 3,957,430 stock options exercisable at weighted average exercise price of \$0.75.

The following table summarizes stock options outstanding at June 30, 2010:

| Exercise price  | Options outstanding     |   |                                 | Options exercisable |                                 |
|-----------------|-------------------------|---|---------------------------------|---------------------|---------------------------------|
|                 | Number of common shares | Weighted average remaining contractual life | Weighted average exercise price | Number exercisable  | Weighted average exercise price |
| \$ 0.001 – 0.40 | 2,917,933               | 6.36  | \$ 0.23                         | 1,684,098           | \$ 0.16                         |
| \$ 1.00 – 1.72  | 3,880,833               | 6.01  | 1.16                            | 2,149,998           | 1.21                            |
|                 | 6,798,766               | 6.16  | 0.76                            | 3,834,096           | 0.75                            |

The fair value of share based awards is determined using the Black-Scholes option pricing model. Like other accepted option valuation models, the Black-Scholes model was developed to estimate fair value of freely tradable, fully transferable options without vesting restrictions, which significantly differs from the Company's stock option awards. The Black-Scholes option pricing model is also based on several subjective assumptions including the expected life of the option and expected future stock price volatility. Changes in these assumptions can materially affect the estimated fair value of the Company's stock options.

The estimated fair value of options granted to the Company's employees and directors is calculated at the grant date and amortized on a straight line basis over the vesting period of the options. The fair value of non-employee awards are estimated each reporting period until the final measurement date. There was no stock option award to employees or directors during the six month periods ending June 30, 2010 and June 31, 2009.

The following table summarizes assumptions used in the Black-Scholes option pricing model for non-employees as of June 30, 2010 and June 30, 2009:

|                         | Non-Employees |        |
|-------------------------|---------------|--------|
|                         | 2010          | 2009   |
| Dividend yield          | 0%            | 0%     |
| Expected volatility     | 79%           | 73%    |
| Risk free interest rate | 1.77%         | 1.29%  |
| Expected life in years  | 2.79          | 2.64   |
| Fair value per share    | \$0.16        | \$0.10 |

#### 6. Net loss per common share:

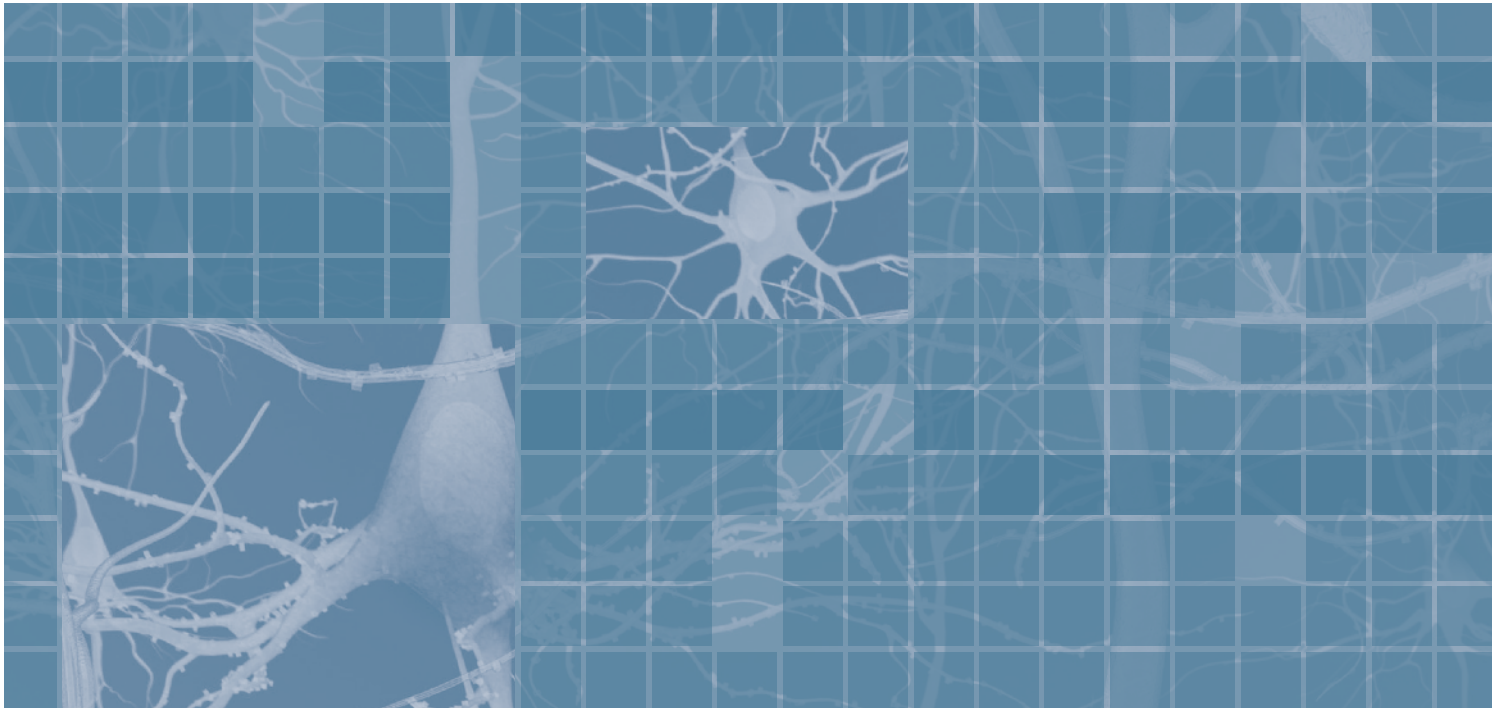
The following table sets forth the computation of loss per common share:

|   | Three months<br>ended June<br>30, 2010 | Three months<br>ended June<br>30, 2009 | Six months<br>ended June<br>30, 2010 | Six months<br>ended June<br>30, 2009 |
|---|--|--|--------------------------------------|--------------------------------------|
| Net loss for the period                                 | (2,709,798)                            | (1,204,940)                            | (5,896,391)                          | (3,214,529)                          |
| Weighted average number of<br>common shares outstanding | 78,066,666                             | 78,066,666                             | 78,066,666                           | 78,066,666                           |
| Net loss per common share                               | (0.03)                                 | (0.02)                                 | (0.08)                               | (0.04)                               |

#### **7. Related party transactions:**

During the three and six month periods ended June 30, 2010, the Company paid one of its Board members \$25,000 and \$75,000 respectively, for consulting services provided to the Company in relation to general research and advancement of the Company's drug development programs. The Company plans to retain these services throughout 2010.

During the first quarter of 2009, the Company received US\$113,378 from a Senior Officer of the Company as full repayment of principal and interest on a loan granted during the fourth quarter of 2008. The loan carried an annual interest rate of 5.00%, consistent with market rates at the time of the loan and was related to the 2004 acquisition of Allon Therapeutics, Inc.



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