



Allon Therapeutics Inc.

## 2010 ANNUAL REPORT



Bringing to market innovative  
central nervous system therapies

## Corporate Profile

Allon Therapeutics Inc. is a clinical-stage biotechnology company focused on bringing to market innovative central nervous system therapies. Allon's lead drug, davunetide, is proceeding in a pivotal Phase 2/3 clinical trial in an orphan indication, progressive supranuclear palsy (PSP), under a Special Protocol Assessment (SPA) with the Food and Drug Administration (FDA). This pivotal trial is based upon statistically significant human efficacy

demonstrated in amnesic mild cognitive impairment, cognitive impairment associated with schizophrenia, and positive biomarker data. The Company is listed on the Toronto Stock Exchange under the trading symbol "NPC" and based in Vancouver.

For additional information please visit the company's website:

[www.allontherapeutics.com](http://www.allontherapeutics.com)

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### Clinical development

	INDICATION	PRECLINICAL	PHASE 1	PHASE 2	PHASE 3
Davunetide	PSP	Completed	Completed	Underway	
	Alzheimer's	Completed	Completed	Completed	
	Schizophrenia	Completed	Completed	Completed	
	Parkinson's	Completed	Completed	Completed	
2nd generation	Dementias	Completed			
AL 309	Neuropathy	Completed			
AL 408	Neuroprotection	Completed			
AL 508	Neuroprotection	Completed			

Completed
  Underway

Phase 2a data from aMCI study provides human proof of concept for frontotemporal dementias and Alzheimer's disease.

## → Corporate Highlights

### 2010 Achievements

- > **January 12**  
FDA grants Orphan Drug Status for *davunetide* for the treatment of progressive supranuclear palsy
- > **March 3**  
Allon enters into \$10-mm standby equity distribution agreement
- > **March 17**  
Received EU Orphan Drug Status for *davunetide* for the treatment of PSP
- > **March 30**  
*Davunetide* shows statistically significant improvement in schizophrenia imaging study
- > **April 6**  
*Davunetide* receives FDA Fast Track Status for the treatment of PSP
- > **July 19**  
Allon wins New Economy 2010 Pharmaceutical & Healthcare Award for drug development innovation
- > **November 1**  
Completed U.S. \$10 million financing
- > **November 4**  
Received Qualifying Therapeutic Discovery Project grants for drug development from U.S. government
- > **November 30**  
Received Michael J. Fox Foundation grant for Parkinson's disease research

### 2011 Q1 Achievements

- > **January 4**  
Announced FDA and Allon agree on Special Protocol Assessment for pivotal trial in PSP in Q4 2010
- > **January 6**  
Announced enrolment of a Phase 2/3 trial for PSP began in Q4 2010
- > **February 2**  
*Davunetide* improves motor function and brain pathology in a Parkinson's disease model
- > **February 10**  
Allon Granted Key Japanese Patent for *Davunetide*
- > **February 23**  
Dr. Michael Gold appointed Chief Medical Officer

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## → Letter to Shareholders

Dear Shareholders:

We have made major progress in 2010 and the early months of 2011 toward our goal of bringing to market high potential central nervous system products.

Our most significant achievement in 2010 was the launch of a pivotal clinical trial, that we believe can generate data that will be the basis for a New Drug Application (NDA) to the U.S. Food and Drug Administration (FDA), for marketing approval for our lead drug *davunetide* as a treatment for progressive supranuclear palsy (PSP).

We are running this trial because of the statistically significant human data we have already shown. More importantly, the courage and dignity of patients facing an awful disease inspire us every day. Similarly, we're deeply grateful for the support and commitment of caregivers and clinicians whose dedication to their loved ones and patients inspires us as well.

Our focus in 2011 will be to complete patient enrolment in the pivotal trial, as well as to continue development of a second-generation *davunetide* product that we are targeting at large neurodegenerative diseases such as Alzheimer's disease (AD), Parkinson's disease (PD), and schizophrenia.

### **Pivotal trial**

This trial targeted at PSP is the Company's fastest path to bring this product to patients. Our optimism going forward is based on:

- 1) our existing data in which *davunetide* has shown statistically significant efficacy in human trials and animal studies for neurodegenerative diseases;
- 2) the significant commercial opportunity that is supported by *davunetide's* Orphan Drug Designation in the U.S. and the EU as a treatment for PSP;
- 3) the design of our pivotal trial which follows a Special Protocol Assessment (SPA) from the FDA and thus ensures that the clinical study design can be used for marketing approval; and
- 4) our capability to complete the trial with our existing financial resources.

This pivotal trial is the most advanced clinical trial we have undertaken and reaffirms that *davunetide* is the most advanced tau-based therapy in the world. PSP and other neurodegenerative diseases, such as Alzheimer's, have pathologies that include impairment of the tau protein in brain cells. Our preclinical studies have shown that *davunetide* reduced tau impairment and preserved memory in mice bred to replicate Alzheimer's or PSP tau pathology. Similarly, our human studies, where we have shown statistically significant efficacy, are also in diseases where the tau and microtubule interaction appears key to the disease process.

This trial will enroll approximately 300 patients at leading medical institutions in the United States, Canada, Europe and Australia. We are on track to complete patient enrolment by the end of 2011 and to report final data approximately a year later.

Two other key achievements in 2010 preceded launch of our pivotal trial:

- > Granting of Fast Track status in the U.S. for *davunetide* in the treatment of PSP; and
- > Completion of a Phase 1 clinical trial that expanded the demonstrated safety range and pharmacokinetic profile of *davunetide* at dosage levels higher than previously investigated in the Company's clinical trials.

**Second Generation *davunetide***

Our objective for second-generation *davunetide*, which is administered by subcutaneous depot, is to have it ready for efficacy clinical trials by the time we have data from the pivotal trial in PSP with 1<sup>st</sup> generation *davunetide* intranasal.

We believe second-generation *davunetide* will provide effective market segmentation, generate incremental intellectual property, and exploit the data we have already generated in some of these target diseases such as AD, PD and schizophrenia.

A listing of our 2010 and Q1 2011 achievements precedes this Letter and offers a snapshot of our progress. I want to emphasize two recent developments:

On February 2 we announced that a research project we undertook with funding from the Michael J. Fox Foundation (MJFF) for Parkinson's Research found that intranasal *davunetide* treatment significantly improved motor function and brain pathology in a mouse model which replicates certain characteristics of Parkinson's disease (PD), a progressive neurodegenerative disease. Treatment with *davunetide* caused a 38% improvement in motor performance and coordination relative to controls.

These results have encouraged the MJFF to provide us a second grant to further our PD research.

An estimated 1.5 million people in North America suffer from PD and its incidence is expected to increase significantly over the next 25 years as the population ages. While there are therapies available to help patients manage many of the symptoms, there are currently no known treatments to stop the progression of PD. We are eager to determine whether the potential of *davunetide* as a treatment to stop progression of PD can be confirmed with further study.

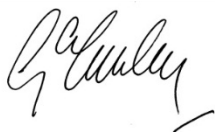
On February 23, we reported Dr. Michael Gold's appointment as Vice-President Clinical Development and Chief Medical Officer. Mike is a board certified specialist in neurology and psychiatry who demonstrated an outstanding drug development track record for companies such as GlaxoSmithKline Inc., Johnson & Johnson and Bristol-Myers Squibb.

Mike has precisely the knowledge and track record to guide our pivotal clinical trial and to help build and diversify our product pipeline with Gen2 *davunetide* and other products. We are gratified that Mike shares our view of the potential of *davunetide* and he complements effectively the tremendous team already in place.

Going forward, we remain focused on our simple goal developing *davunetide* and other drugs that can make a critical difference in the lives of millions of people who suffer with neurodegenerative disease -- or are touched by the suffering of family and friends. Our progress year to year has been constant and I expect we will end 2011 ever closer to the goal line.

I am grateful for the dedication of our employees, the wisdom of our directors and the perseverance and support of our shareholders -- and I look forward to reporting our further progress as it occurs in the coming months.

Respectfully,



Gordon C. McCauley  
President & CEO



# FINANCIAL INFORMATION

## MANAGEMENT'S DISCUSSION & ANALYSIS

*The following information should be read in conjunction with the 2010 audited consolidated financial statements and their accompanying notes for the year ended December 31, 2010. 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).*

March 10, 2011

### 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 2012; 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 audited consolidated financial statements for the year ended December 31, 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. Similarly, nothing in this report is meant to promote a pharmaceutical product or make a regulated claim of efficacy.

## OVERVIEW

Allon Therapeutics Inc. is a clinical-stage biotechnology company developing treatments for major neurodegenerative conditions. Allon's drug, *davunetide*, is proceeding in a Phase 2/3 clinical trial in an orphan indication, progressive supranuclear palsy (PSP), under a Special Protocol Assessment (SPA) with the United States Food and Drug Administration (FDA). This pivotal trial is based upon statistically significant human efficacy demonstrated in amnesic mild cognitive impairment (aMCI), a precursor to Alzheimer's disease (AD), and in cognitive impairment associated with schizophrenia (CIAS) as well as positive biomarker data.

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. Our clinical-stage drug, *davunetide*, is derived from ADNP, while the preclinical stage drug AL-309 is derived from ADNF. *Davunetide* is targeted at PSP (a type of frontotemporal dementia), Alzheimer's disease, CIAS and Parkinson's disease. 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.

### **Mechanism of Action: The Tangles Pathway**

Neuroprotection is needed in chronic degenerative conditions such as frontotemporal dementia, CIAS and Alzheimer's disease. Preventing the loss of neurons from these and other neurodegenerative conditions is the critical goal of neuroprotection.

Neurofibrillary tangles are a result of hyperphosphorylation of the tau protein which is associated with microtubular networks in neurons. Patients with Alzheimer's disease and a number of other forms of dementia have large numbers of tangles and high levels of hyperphosphorylated tau. The Company's compounds have been shown to reduce tau hyperphosphorylation in animals. Studies have also shown that animals treated with its compounds have improved cognitive performance compared to untreated groups. Neurofibrillary tangles are one of the two classic pathology hallmarks of Alzheimer's disease, while the other classic hallmark is beta amyloid plaques. Of these two hallmarks, tangles are most closely associated with cognition. *Davunetide* has been shown in animal studies to reduce both tangles and plaques, with the greater reduction occurring with tangles.

### Status of research and development programs

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

Platform	Compound	Stage Development	Status
ADNP	<i>Davunetide</i>	Phase 2/3 clinical trial in progressive supranuclear palsy (PSP)	Study commenced in Q4 2010 under SPA
		Pilot clinical trial in PSP and other types of FTD	Study completed in Q4 2010. Met primary endpoint
		Phase 2 clinical trial in CIAS	Study completed. Data released in Q4 2009
		Phase 1 human cerebrospinal fluid (CSF) pharmacokinetic clinical trial	Study completed. Data released in Q3 2008
		Phase 2a clinical trial in amnesic mild cognitive impairment	Study completed. Data released in Q1 2008
		Phase 2a clinical trial in MCI-CABG	Study completed. Data released in Q3 2008
ADNF	AL-309	Preclinical stage	Preclinical pharmacology and toxicology ongoing

### KEY 2010 ACHIEVEMENTS

- The Company initiated a pivotal Phase 2/3 clinical trial to evaluate the Company's lead neuroprotective drug candidate, *davunetide*, as a potential treatment for PSP, a rapidly-progressing and fatal degenerative brain disease. The study will be conducted under a Special Protocol Assessment granted by the FDA. Enrollment in the study began in the fourth quarter of 2010.
- The Company received a major grant totaling \$625,000 from the Michael J. Fox Foundation (MJFF) for Parkinson's Research to conduct pre-clinical research that will help determine the potential of *davunetide* as a treatment for Parkinson's disease, a progressive neurodegenerative disease. On February 2, 2011, the Company announced that the research project sponsored by MJFF found that intranasal *davunetide* treatment significantly improved motor function and brain pathology in a mouse model which replicates certain characteristics of Parkinson's disease. Treatment with *davunetide* resulted in 38% better motor performance and coordination relative to controls

- The Company was awarded two non-taxable grants totaling approximately \$500,000 from the United States government under the Qualifying Therapeutic Discovery Project (QTDP) program. Therapeutic discovery projects that show reasonable potential to result in new therapies to treat areas of unmet medical need; prevent, detect, or treat chronic or acute disease and conditions; and reduce long-term health care costs in the United States are eligible for the QTDP program. The grants awarded to the Company will help fund development of *davunetide* as a treatment for PSP and preclinical-stage drug candidate AL-309 as a treatment for peripheral neuropathy.
- The Company entered into a Convertible Revenue and Royalty Interest agreement with Isar Pharma K/S (Isar), a wholly owned limited partnership of Nordic Biotech Venture Fund II K/S. Under the terms of the agreement, Isar paid the Company U.S. \$10.0 million (Cdn \$10.2 million) in return for a convertible royalty and revenue obligation on *davunetide*. Isar can elect to convert its interest into common shares of Allon at any time at a conversion price of \$0.45. (See Liquidity and Capital Resources.)
- Investigators at the University of California, San Francisco (UCSF) led by Dr. Adam Boxer,, completed a pilot clinical trial with *davunetide* in patients with PSP and other types of Frontotemporal dementia (FTD) like corticobasal syndrome and progressive non-fluent aphasia. The pilot clinical trial successfully met its primary endpoint of safety and tolerability. The trial was a 12-week randomized, double-blind, placebo-controlled study of *davunetide* in 12 patients. Completion of this pilot study at UCSF has helped validate the trial design for the Phase 2/3 clinical trial.
- 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*.”
- *Davunetide* was granted Fast Track status by the FDA 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.
- 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.
- 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 ( $p=0.017$ ) 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.
- *Davunetide*, was granted Orphan Drug Status in the European Union (EU) for the treatment of PSP.
- Completed a Phase 1 clinical trial of *davunetide*. The results demonstrated that the intranasal dose range can be broadened and provided additional information on the pharmacokinetic profile of

*davunetide*. The results confirmed *davunetide's* safety and expands the doses that can be used in future clinical trials

- The Company entered into a standby equity distribution agreement (SEDA) with YA Global Master SPV Ltd., a fund managed by Yorkville Advisors, LLC. 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.
- Released preclinical data demonstrating the potential of AL-309, the Company's pre-clinical drug candidate, as a treatment for peripheral neuropathy, a debilitating and painful disorder of the peripheral nervous system. The data 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.
- The FDA granted Orphan Drug Designation to *davunetide* for the treatment of PSP.
- Received Japanese allowance for a patent covering its two neuroprotection technology platforms. This patent provides protection for the treatment and prevention of a large number of disorders involving learning and memory deficits, such as those in AD, Down syndrome and normal aging. The Japanese patent covers the combination use of various derivatives of compounds from the Company's ADNP and ADNF platforms.

## RESULTS OF OPERATIONS

Allon reported a net loss of \$16,591,113 (\$0.21 per share) for the year ended December 31, 2010, compared to a net loss of \$7,341,985 (\$0.09 per share) for the year ended December 31, 2009, representing a year over year increase in net loss of \$9,249,128. The following is a description of the significant variances as compared to 2009.

### RESEARCH AND DEVELOPMENT

For the fiscal year ended December 31, 2010, research and development expenses were \$12,140,132 compared to \$3,891,750 for the fiscal year ended December 31, 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. During 2009, the Company completed a Phase 2a clinical trial evaluating *davunetide* as a treatment for CIAS. During 2010, clinical trial activity related to *davunetide* increased as Investigators at UCSF led by Dr. Adam Boxer, completed a pilot clinical trial with *davunetide* in patients with PSP and other types of FTD like corticobasal syndrome and progressive non-fluent aphasia and in the fourth quarter of 2010, the Company began enrollment for its Phase 2/3 clinical trial in PSP. 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, development costs for *davunetide* increased to \$10.0 million in 2010 compared to \$1.8 million in 2009.

### **Progressive Supranuclear Palsy (PSP)**

During the fourth quarter of 2010, the Company initiated a pivotal Phase 2/3 clinical trial to evaluate *davunetide* as a potential treatment for PSP under a Special Protocol Assessment granted by the FDA. PSP is one of several types of FTD in which the pathology is known to involve impairment of the brain protein tau. The 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. Enrollment in the study began in the fourth quarter of 2010. Investigators at the UCSF led by Dr. Adam Boxer, completed a pilot clinical. The pilot clinical trial successfully met its primary endpoint of safety and tolerability. This trial, a 12-week randomized, double-blind, placebo-controlled study of *davunetide* in 12 patients, helped the Company and its clinical collaborators validate trial design and prepare for the larger Phase 2/3 clinical trial in PSP.

### **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.

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

In May 2010, data from preclinical studies that demonstrated that *davunetide* improved cognitive performance in a model of schizophrenia was published. 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. These results suggest that *davunetide* may alter the course of neurological disease through effects on microtubules, critical structures for neurotransmission. The animal study results correspond to data from human trials in schizophrenia patients, which demonstrated that both the daily functioning of these patients and the chemistry of their brain cells were positively impacted by *davunetide*.

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 ( $p=0.017$ ) 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 (TURNIS).

### **Parkinson's disease (PD)**

On February 2, 2011, the Company announced that a research project funded by the Michael J. Fox Foundation for Parkinson's Research found that intranasal *davunetide* treatment significantly improved motor function and brain pathology in a mouse model which replicates certain characteristics of PD, a progressive neurodegenerative disease. In the study, performed at the University of California, Los Angeles (UCLA),  $\alpha$ -synuclein mice were treated with *davunetide* daily for two months. At the end of the treatment period, these mice and various control groups were tested for motor function, coordination and activity. The *davunetide* treated  $\alpha$ -synuclein mice showed a 38% decrease in the number of errors per step in the beam traversal test, a measure of motor function. Further pre-clinical development is ongoing.

### **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 year ended December 31, 2010, general and administrative expenses were \$3,766,596 compared to \$2,840,193 for the year ended December 31, 2009. The increase of \$926,403 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 year ended December 31, 2010 was \$545,108 compared to \$546,766 for the year ended December 31, 2009. Allon amortizes tangible assets and intellectual property on a straight-line basis. The small decline compared to the previous year was primarily the result of certain assets being fully amortized.

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

The Company's other income and expenses are primarily comprised of interest income and foreign exchange gains and losses and gain on disposal of investments. The Company earned interest revenue of \$23,750 in 2010 compared to \$103,058 in 2009. Reduced interest earnings resulted from lower interest rates and lower cash balances during 2010 compared to 2009.

Foreign exchange translation loss was \$200,660 in 2010. This compared to loss of \$175,309 in 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. The foreign exchange translation losses for both 2010 and 2009 resulted from the decline of the U.S. dollar 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.

**SELECTED FINANCIAL INFORMATION**

The following is selected financial information for Allon's three most recently completed fiscal years:

(in thousands, except per share data)

	Dec 31, 2010	Dec 31, 2009	Dec 31, 2008
Loss	\$ (16,591)	\$ (7,342)	\$ (11,312)
Loss per share – basic and diluted	\$ (0.21)	\$ (0.09)	\$ (0.17)
Total assets	\$ 14,031	\$ 20,863	\$ 27,467
Total long-term financial liabilities	\$ 181	\$ -	\$ -

**QUARTERLY INFORMATION**

The following is selected quarterly financial information for Allon, for the eight most recently completed quarters:

(in thousands, except per share data)

	Dec 31, 2010	Sep 30, 2010	Jun 30, 2010	Mar 31, 2010
Interest income and other income	\$ 3	\$ 5	\$ 43	\$ 9
Research and development expenses	\$ 6,444	\$ 1,750	\$ 1,779	\$ 2,168
Net loss for the quarter	\$ (7,956)	\$ (2,737)	\$ (2,712)	\$ (3,186)
Loss per share – basic and diluted	\$ (0.10)	\$ (0.04)	\$ (0.03)	\$ (0.04)

	Dec 31, 2009	Sep 30, 2009	Jun 30, 2009	Mar 31, 2009
Interest income and other income	\$ 20	\$ 16	\$ 32	\$ 44
Research and development expenses	\$ 1,435	\$ 716	\$ 542	\$ 1,199
Net loss for the quarter	\$ (2,576)	\$ (1,551)	\$ (1,205)	\$ (2,010)
Loss per share – basic and diluted	\$ (0.03)	\$ (0.02)	\$ (0.02)	\$ (0.03)

During the quarter ended March 31, 2009, the Company presented, at an international Alzheimer's conference in Prague, Czech Republic, new preclinical data confirming the potential of the Company's drug, *davunetide*, as a treatment for FTD. The Company was also issued a United States patent covering the chemical composition of two component peptides under the ADNF technology platform and covering their use in drugs to protect brain cells from degenerative diseases.

During the quarter ended June 30, 2009, the Company formed a special Steering Committee consisting of leading neurologists and psychiatrists to help the Company design and conduct a Phase 2 human clinical trial that will evaluate the Company's drug, *davunetide*, as a potential treatment for FTD. Also during the quarter, the European Patent Office issued a notice of allowance for a patent covering the composition and method of use of the Company's neuroprotective compound, *davunetide*, as a treatment for Alzheimer's disease.

During the quarter ended September 30, 2009, the Company released top-line results from a Phase 2a clinical trial showing that the Company's drug, *davunetide*, 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 University of California at San Diego Performance-based Skills Assessment. The drug was also

evaluated with the Measurement and Treatment Research to Improve Cognition in Schizophrenia composite battery of tests which was the primary outcome. *Davunetide* did not show significance on this measure.

During the quarter ended December 31, 2009, the Company was issued a Canadian patent covering the chemical composition of the Company's preclinical-stage peptide AL-209 and its use in protecting against Alzheimer's disease and other degenerative diseases. The Company also presented the Phase 2a clinical data evaluating *davunetide* in schizophrenia-related cognitive impairment at the American College of Neuropsychopharmacology annual meeting.

During the quarter ended March 31, 2010, the Company's drug, *davunetide*, was granted Orphan Drug Status in the U.S. and the European Union for the treatment of PSP. The Company also completed a number of clinical activities including: a Phase 1 clinical trial of *davunetide* which demonstrated that the intranasal dose range can be broadened and confirmed *davunetide's* safety profile; released positive results from an imaging study of schizophrenia patients; and released preclinical data demonstrating the potential of AL-309 as a treatment for peripheral neuropathy. Furthermore, the Company entered into a standby equity distribution agreement with YA Global Master SPV Ltd., which will provide up to \$10 million of equity capital over the next three years.

During the quarter ended June 30, 2010, the Company's drug, *davunetide*, was granted Fast Track status by the FDA for the treatment of PSP. Furthermore, data from preclinical studies were published demonstrating that *davunetide* improved cognitive performance in a model of schizophrenia.

During the quarter ended September 30, 2010, the Company was chosen as the "Most Innovative Development Company" in the New Economy 2010 Pharmaceutical & Healthcare Awards sponsored by New Economy Magazine.

During the quarter ended December 31, 2010, Investigators at the UCSF led by Dr. Adam Boxer, completed a pilot clinical initiated a pivotal Phase 2/3 clinical trial with *davunetide* in patients with PSP under an SPA granted by the FDA. The Company also entered into a \$10.2 million Convertible Revenue and Royalty Interest agreement with Isar. The Company was awarded two non-taxable grants totaling approximately \$500,000 from the United States government under the Qualifying Therapeutic Discovery Project program and was given a major grant totaling \$625,000 from the Michael J. Fox Foundation for Parkinson's Research. The Company also successfully completed a pilot clinical trial in PSP and other types of FTD and validated the trial design for the pivotal Phase 2/3 clinical trial.

## **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 and long-term debt as capital and may issue new shares or raise debt in order to maintain its capital structure. 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 December 31, 2010, the Company had accumulated a deficit of \$69,381,999. 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 related instruments.

For the year ended December 31, 2010, operating activities used cash of \$13,078,930 compared to \$8,068,107 used in operations for the year ended December 31, 2009. Cash used in operating activities reflects the net loss of \$16,591,113 for the year ended December 31, 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 year ended December 31, 2010, investing activities earned cash of \$24,438 compared to cash used by investing activities of \$22,533 for the year ended December 31, 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.

For the year ended December 31, 2010, financing activities generated cash of \$9,911,917 compared to nil in 2009. The financing activity in 2010 relates to the Convertible Revenue and Royalty Interest agreement with Isar. Under the terms of the agreement, Isar paid the Company U.S. \$10.0 million (Cdn \$10.2 million) in return for a convertible royalty and revenue obligation on *davunetide*. Isar can elect to convert its interest into common shares of Allon at any time at a conversion price of U.S. \$0.44 (Cdn \$0.45) which represents a 10 percent premium to the 10-day volume weighted average price of Allon prior to closing. The Company can generally force conversion at the conversion price over the next three years when the share price is two times the conversion price, or during the following 4 years when the share price is three times the conversion price. Until conversion, the Company has agreed to pay to Isar the greater of an 8 percent royalty from sales of *davunetide* or 20 percent of what it receives for commercializing the product. The Company will also pay 20 percent of all non-royalty revenue received in a partnership. The payment obligations decrease proportionately as the investment is converted. The number of shares issuable on conversion is limited to a maximum of 19.99 percent of the Company's outstanding shares at any time unless and until the Company's shareholders resolve both to allow conversions beyond 19.99 percent and to terminate the shareholder rights.

In March 2010, the Company entered into a standby equity distribution agreement (SEDA) 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 this agreement at any time without payment of 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. In January 2011, the Company initiated its first draw down under the SEDA of \$200,000. According to the SEDA provisions, Yorkville will subscribe for common shares at a 5% discount to the five-day weighted average price of Allon shares for the period ending on or about January 12, 2011.

As a result of the above financing arrangements, management expects to have sufficient cash to fund operations into 2012. Future funding requirements 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.

**CONTRACTUAL OBLIGATIONS**

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 \$1,508,105 of the \$7,860,284 million cash on hand. The Company has no off-balance sheet arrangements.

Schedule of contractual and planned commitments as of December 31, 2010

(in thousands)

	2011	2012	2013	2014-2015	Total
Pre-clinical Initiatives	\$ 107	\$ 87	\$ -	\$ -	\$ 194
Clinical Initiatives	\$ 931	\$ 110	\$ 109	\$ 23	\$ 1,173
Capital and Licensing	\$ 15	\$ 15	\$ 15	\$ 30	\$ 75
Other	\$ 42	\$ 6	\$ 6	\$ 13	\$ 67
Total Company Commitments	\$ 1,095	\$ 218	\$ 130	\$ 65	\$ 1,508

**OUTSTANDING SHARE CAPITAL**

At December 31, 2010, the Company had 78,066,666 common shares outstanding. Each common share entitles the holder to one vote per share. At December 31, 2010, there were 7,032,100 options outstanding, of which 4,471,770 options were exercisable into an equivalent number of the Company's common shares at exercise prices ranging from \$0.001 to \$1.72. All previous outstanding 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 7 of the Company's financial statements for more detail regarding outstanding share capital.

**RELATED PARTY TRANSACTIONS**

During the year ended December 31, 2010, the Company paid one of its Board members \$100,000 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 on a continuing basis.

**DISCLOSURE CONTROLS AND PROCEDURES**

Disclosure controls and procedures are designed to provide reasonable assurance that material information required to be disclosed in the prescribed filings and reports filed with the Canadian securities regulatory authorities is recorded, processed, summarized and reported on a timely basis. Controls are also designed to provide reasonable assurance that information required to be disclosed is assimilated and communicated to senior management in a timely manner so that appropriate decisions can be made regarding public disclosure. The Company's Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of the Company's disclosure controls and procedures and concluded that they provide reasonable assurance that material information relating to the Company was made known to them and reported as required.

**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. Management, including the Company's Chief Executive Officer and Chief Financial Officer, is responsible of establishing and maintaining adequate ICFR, which has been developed based on the framework established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Management, under the supervision and with the participation of the Company's Chief Executive Officer and Chief Financial Officer, conducted an evaluation of the effectiveness of the Company's internal control over financial reporting based on the COSO framework and concluded that the Company's internal control over financial reporting was effective as of December 31, 2010.

Regardless of how well an internal control system is designed and operated, it can provide only reasonable, not absolute, assurance that all misstatements due to error or fraud will be detected or prevented from occurring in the financial statements due to the inherent limitations of any internal control system.

During 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 except the following. During the third quarter of 2010, the Company completed the implementation of a new online system to value stock-based compensation.

## **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, determination of fair value in relation to the convertible royalty and revenue financing agreement, 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.

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 2012 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.

### **Intangible Assets**

The Company's intangible assets are comprised of purchased technology, patents and licenses. The cost of the Company's intangible assets is amortized on a straight-line basis over the estimated useful life ranging

from 15 to 17 years. Factors considered in estimating the useful life of intangible assets include the expected use of the asset by the Company, legal, regulatory and contractual provisions that may limit the useful life, and the effects of competition. Costs incurred to establish and maintain patents for intellectual property developed internally are expensed in the period incurred.

The Company reviews the carrying value of long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by comparing the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, the carrying value will be written down to its fair value and an impairment charge equal to the amount by which the carrying amount of the asset exceeds the fair value of the asset will be recognized. As of December 31, 2010, the Company has not recorded any such impairment losses.

### **Research and Development Costs**

Research and development costs consist of direct and indirect expenditures related to the Company's clinical and pre-clinical drug development programs. Research and development costs are expensed as incurred unless they meet generally accepted accounting criteria for deferral and amortization. Costs are assessed to determine if they have met the relevant criteria for deferral and amortization at each reporting date. To date, no development costs have been deferred.

Clinical trial expenses relating to service agreements with contract research organizations, investigators, contractors and other service providers who conduct certain product development activities for the Company are recorded based on the estimated amount of work completed for each trial. During internal reviews, contractual terms and obligations, patient enrolment, correspondence and discussions with service providers are considered in order to estimate the amount of clinical trial expense for an accounting period.

### **Stock Based Compensation**

Stock based compensation is accounted for in accordance with section 3870 of the CICA handbook. When equity based instruments such as stock options are issued, an estimate of fair value is derived using the Black-Scholes pricing model. The application of this pricing model requires management to estimate several variables, including the period for which the instrument is expected to be outstanding, price volatility of the Company's stock over the relevant timeframe, the determination of a relevant risk free interest rate and an assumption regarding the Company's future dividend rate policy. Changes in one or more assumptions could materially impact the value derived for these equity instruments.

During 2010, the Company revised its estimate of the expected exercise dates from five years to eight years for options granted to employees. The impact of this revision increased the fair value of options granted and overall stock based compensation expense to be booked during the vesting period, for each option granted.

### **Financial Instruments**

Financial instruments are classified into one of five categories: held-for-trading, held-to-maturity, loans and receivables, available-for-sale financial assets, or other financial liabilities. All financial instruments, including derivatives, are measured on the balance sheet at fair value except for loans and receivables, held-to-maturity investments and other financial liabilities which are measured at amortized cost.

Compound instruments are bifurcated and presented in the financial statements in their component parts. The equity component is assigned the residual amount after deducting from the fair value of the instrument as

a whole the amount separately determined for the liability component. The liability component is considered floating rate with no accretion recorded.

For each financial instrument, subsequent measurement and accounting for changes in fair value are dependent on the initial classification. Held-for-trading financial assets are measured at fair value and changes in fair value are recognized in net income. Available-for-sale financial instruments are measured at fair value with changes in fair value recorded in other comprehensive income until the investment is derecognized or impaired at which time the amounts would be recorded in net income. For other financial liability, subsequent adjustments to expected cash flows are recorded if and when they occur through adjustments to the related expense.

The Company designated its cash and cash equivalents as held-for-trading which are measured at fair value. Accounts receivable are classified as loans and receivables, which are measured at amortized cost. Accounts payable, accrued liabilities and the financial liability associated with the Company's convertible royalty and revenue obligations are classified as other financial liabilities.

## **FUTURE CHANGES IN ACCOUNTING POLICIES**

### **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.

### ***Major identified differences***

The Company has identified various IFRS standards below that differ from current accounting practices and that management expects may have an impact on its financial statements upon initial conversion. While the adoption of IFRS will not have a material impact on the Company's reported cash flow, it will have a material impact on the consolidated balance sheets and consolidated statement of operations. In particular, the opening balance sheet will reflect the revaluation of nonmonetary assets and liabilities of the Company's U.S. subsidiary and adjustments related to share-based payments. Estimate of the impact of these differences on the Company's shareholders' equity as of January 1, 2010 is an increase of \$414,218 with a corresponding increase to total assets.

The following discussion highlights the initial adjustments required to be made on adoption of IFRS in order to provide an opening balance sheet and the significant accounting policies that differ from the Company's current accounting practices. This discussion had been prepared using the standards and interpretations currently issued and expected to be effective at the end of the first annual IFRS reporting period.

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. 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 requires an estimate of forfeitures on initial recognition and then adjust estimate to actual forfeitures over the vesting period of the options. The impact of these adjustments on the Company's opening balance sheet as of January 1, 2010 is an increase in contributed surplus of \$123,119 and a corresponding decrease in retained earnings.
- 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 transitional impact of changing to the current rate method on the Company's opening balance sheet as at January 1, 2010 is an increase of \$414,218 to total assets and a corresponding increase to shareholders' equity. Subsequent to this date all changes will be recorded as other comprehensive income and their cumulative impact will be included in equity as accumulated other comprehensive income.

### **Presentation**

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 (R&D) and general and administrative (G&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.

## **RISKS AND UNCERTAINTIES**

As previously described, cash and cash equivalents on hand, including the funds available under the standby equity distribution agreement, are expected to be sufficient to fund operations into 2012. 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 liabilities requiring interest payments.

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 audited consolidated financial statements for the year ended December 31, 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)

## **SIGNIFICANT EQUITY INVESTEEES**

As of December 31, 2010, Allon had one shareholder with more than 10% of the Company's issued and outstanding shares. NDI Capital Inc., as manager for the Neuro Discovery Limited Partnership, controls 11,490,952 shares or approximately 14.7% of the Company's issued and outstanding shares.

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Consolidated Financial Statements of

**ALLON THERAPEUTICS INC.**

Years ended December 31, 2010 and 2009

## MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING

The consolidated financial statements contained in this annual report have been prepared by management in accordance with generally accepted accounting principles and have been approved by the Board of Directors. The integrity and objectivity of these financial statements are the responsibility of management. In addition, management is responsible for all other information in the annual report and for ensuring that this information is consistent, where appropriate, with the information in the financial statements.

In support of this responsibility, management maintains a system of internal controls to provide reasonable assurance as to the reliability of financial information and the safe-guarding of assets. The financial statements include the amounts of which are based on the best estimates and judgments of management.

The Board of Directors is responsible for ensuring that management fulfills its responsibility for financial reporting and internal control and exercises this responsibility principally through the Audit Committee. The Audit Committee consists of three directors not involved in the daily operations of the Company. The Audit Committee meets with management and meets independently with the external auditors to satisfy itself that management's responsibilities are properly discharged and to review the financial statements prior to their presentation to the Board of Directors for approval.

The external auditors, KPMG LLP, conduct an independent examination, in accordance with generally accepted auditing standards, and express their opinion on the consolidated financial statements. Their examination includes a review of the Company's system of internal controls and appropriate tests and procedures to provide reasonable assurance that the financial statements are, in all material respects, presented fairly and in accordance with accounting principles generally accepted in Canada. The external auditors have free and full access to the Audit committee with respect to their findings concerning the fairness of financial reporting and the adequacy of internal controls.

Allon Therapeutics Inc.



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Frank A. Holler  
Director



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C. Michael O'Brian  
Director



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**Chartered Accountants**  
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Canada

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Internet [www.kpmg.ca](http://www.kpmg.ca)

## **INDEPENDENT AUDITORS' REPORT TO THE SHAREHOLDERS**

We have audited the accompanying consolidated financial statements of Allon Therapeutics Inc., which comprise the consolidated balance sheets as at December 31, 2010 and 2009, and the consolidated statements of operations and comprehensive loss, the consolidated statement of changes in shareholders' equity and the consolidated statement of cash flows for the year ended, and a significant accounting policies and other explanatory information.

### *Management's Responsibility for the Financial Statements*

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with Canadian generally accepted accounting principles, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

### *Auditor's Responsibility*

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform an audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Fund's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Fund's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinions.

### *Opinion*

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Allon Therapeutics Inc. as at December 31, 2010 and 2009, and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

A handwritten signature in black ink that reads 'KPMG LLP'. The signature is written in a cursive, slightly slanted style. Below the signature is a horizontal line that starts under the 'K' and ends under the 'P'.

KPMG LLP  
March 9, 2011  
Vancouver, Canada

**ALLON THERAPEUTICS INC.**

## Consolidated Balance Sheets

December 31, 2010 and 2009

	2010	2009
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 7,860,284	\$ 11,002,859
Accounts receivable	143,846	22,438
Prepaid expenses and deposits	855,680	430,878
Drug supplies (note 3)	218,560	3,922,156
	<u>9,078,370</u>	<u>15,378,331</u>
Non-current assets:		
Property and equipment (note 4)	29,044	42,567
Intangible assets (note 5)	4,596,040	5,114,430
Drug supplies (note 3)	327,938	327,938
	<u>\$ 14,031,392</u>	<u>\$ 20,863,266</u>

**Liabilities and Shareholders' Equity**

Current liabilities:		
Accounts payable and accrued liabilities	\$ 1,731,018	\$ 2,290,906
Deferred revenue (note 6)	159,543	-
	<u>1,890,561</u>	<u>2,290,906</u>
Long-term liabilities (note 7)	180,628	-
Shareholders' equity:		
Share capital (note 7)	69,110,562	69,110,562
Contributed surplus	12,231,640	2,252,684
Deficit	(69,381,999)	(52,790,886)
	<u>11,960,203</u>	<u>18,572,360</u>
	<u>\$ 14,031,392</u>	<u>\$ 20,863,266</u>

Basis of presentation and going concern (note 1)  
Commitments (note 11)

See accompanying notes to consolidated financial statements.

Approved on behalf of the Board:



Frank A. Holler, Director



C. Michael O'Brian, Director

**ALLON THERAPEUTICS INC.**

## Consolidated Statements of Operations and Comprehensive Loss

Years ended December 31, 2010 and 2009

	2010	2009
<b>Expenses:</b>		
Research and development	\$ 12,140,132	\$ 3,891,750
General and administrative	3,766,596	2,840,193
Amortization	545,108	546,766
	<u>16,451,836</u>	<u>7,278,709</u>
<b>Other expense (income):</b>		
Interest and other income	(61,383)	(112,033)
Foreign exchange loss	200,660	175,309
	<u>139,277</u>	<u>63,276</u>
<b>Net and comprehensive loss</b>	<u>(16,591,113)</u>	<u>(7,341,985)</u>
<b>Net loss per share:</b>		
Basic and diluted (note 9)	\$ (0.21)	\$ (0.09)

See accompanying notes to consolidated financial statements.

**ALLON THERAPEUTICS INC.**

## Consolidated Statements of Changes in Shareholders' Equity

Years ended December 31, 2010 and 2009

	Share capital		Contributed Surplus	Deficit	Total Shareholders' Equity
	Number	Value			
Balance, December 31, 2008	78,066,066	\$ 69,110,562	\$ 1,894,894	\$ (45,448,901)	\$ 25,556,555
Stock based compensation	-	-	357,790	-	357,790
Net and comprehensive loss	-	-	-	(7,341,985)	(7,341,985)
Balance, December 31, 2009	78,066,666	\$ 69,110,562	\$ 2,252,684	\$ (52,790,886)	\$ 18,572,360
Stock based compensation	-	-	247,667	-	247,667
Convertible royalty & revenue financing (net) (note 7)	-	-	9,731,289	-	9,731,289
Net and comprehensive loss	-	-	-	(16,591,113)	(16,591,113)
Balance, December 31, 2010	78,066,666	\$ 69,110,562	\$12,231,640	\$ (69,381,999)	\$ 11,960,203

See accompanying notes to consolidated financial statements.

**ALLON THERAPEUTICS INC.**

## Consolidated Statements of Cash Flows

Years ended December 31, 2010 and 2009

	2010	2009
Cash provided by (used in):		
Operations:		
Net loss for the year	\$ (16,591,113)	\$ (7,341,985)
Items not involving cash:		
Amortization	545,108	546,766
Stock-based compensation	247,667	357,790
Change in non-cash operating items	2,719,408	(1,630,678)
	<u>(13,078,930)</u>	<u>(8,068,107)</u>
Investment:		
Purchase of property and equipment	(13,195)	(22,533)
Proceeds from disposal of investments	37,633	-
	<u>24,438</u>	<u>(22,533)</u>
Financing:		
Proceeds from convertible royalty and revenue agreement, net (note 7)	9,911,917	-
	<u>9,911,917</u>	<u>-</u>
Decrease in cash and cash equivalents	(3,142,575)	(8,090,640)
Cash and cash equivalents, beginning of year	11,002,859	19,093,499
Cash and cash equivalents, end of year	<u>\$ 7,860,284</u>	<u>\$ 11,002,859</u>
Supplementary information:		
Interest received	\$ 23,750	\$ 138,871

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 2012. 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 limitation (see Note 7). The Company will continue to require additional sources of financing in the future to continue its research activity, 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:**

(a) Principles of consolidation:

The consolidated financial statements include the accounts of the Company and its wholly owned U.S. subsidiary. All material inter-company balances and transactions have been eliminated on consolidation. All amounts in these consolidated financial statements are expressed in Canadian dollars unless stated otherwise.

(b) Use of 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 amounts reported in the consolidated financial statement and notes thereto. 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, determination of fair value in relation to the convertible royalty and revenue financing agreement, determination of useful lives of clinical drug supplies, accrued liabilities, research and development costs and determination of the fair value of stock-based compensation. Actual results could differ from those estimates used in the preparation of the financial statements.

(c) Foreign currency translation:

The Company follows the temporal method of accounting for the translation of foreign currency amounts, including those of its integrated foreign subsidiary, into Canadian dollars. Under this method, monetary assets and liabilities denominated in foreign currencies are translated into Canadian dollars using exchange rates in effect at the balance sheet date. All other assets and liabilities are translated at the applicable historical rates in effect at the date the transaction occurred. Revenue and expense items are

translated at the monthly average exchange rate during the period. Foreign exchange gains and losses, both realized and unrealized, are included in the determination of the loss for the period.

(d) Cash and cash equivalents:

Cash and cash equivalents consist of highly liquid investments, with minimal interest rate risk and having an initial term to maturity of 90 days or less when acquired.

(e) Property and equipment:

Property and equipment are recorded at cost less accumulated amortization. The Company records amortization using the straight-line method over the estimated useful lives of the capital assets as follows:

Assets	Rate
Furniture and equipment	20%
Computer hardware	45%
Computer software	45%

(f) Intangible assets:

Intangible assets acquired as part of a group of other assets are initially recognized and measured at cost. The cost of a group of intangible assets acquired in a business combination that meet the specified criteria for recognition apart from goodwill, is allocated to the individual assets acquired based on their relative fair values. Costs incurred to establish and maintain patents for intellectual property developed internally are expensed in the period incurred.

Intangible assets with finite useful lives are amortized over their estimated useful lives. The amortization methods and estimated useful lives of intangible assets, which are reviewed annually, are as follows:

Assets	Basis	Rate
Licenses	Straight-line	15-17 years
Patents	Straight-line	15-17 years
Medical technology	Straight-line	15 years

(g) Impairment of long-lived assets:

The Company reviews the carrying value of long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by comparing the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. As of December 31, 2010, the Company has not recorded any such impairment losses.

(h) Research and development expenditures:

Research expenditures are expensed in the period incurred. Product development expenditures are expensed in the period incurred unless the product candidate meets Canadian generally accepted

accounting criteria for deferral and amortization. The Company's policy is to amortize deferred product development expenditures over the expected future life of the product once product revenues or royalties are recorded. No product development expenditures have been deferred to date.

(i) Revenue recognition:

Revenue arising from cash and investments yielding interest is recognized when reasonable assurance exists regarding measurement and collectability, resulting in interest being recognized on a time proportional basis.

Grant revenue is recognized when there is reasonable assurance of compliance with grant conditions and the grant is collectible. Grant amounts received prior to compliance with grant conditions are recorded as deferred revenue. The Company uses the income approach to account for grant revenue resulting from government assistance. Grants received to directly offset expenses incurred for a specific project are credited to expense to directly offset the expense incurred.

Revenue from service transactions is recognized as the service or contract activity is performed.

(j) Stock-based compensation:

The Company grants stock options to employees, directors and consultants pursuant to a compensation plan, which is described in note 8. Compensation expense is recorded for stock options issued to employees and non-employees using the fair value method with a corresponding increase in contributed surplus. Any consideration received on exercise of stock options or the purchase of stock is credited to share capital.

Under the fair value based method, stock-based payments to non-employees are measured at the fair value of the equity instrument issued, and the awards are periodically re-measured during the vesting period as the options are earned. Any changes in value are recognized over the vesting period and in the same manner as if the Company had paid cash instead of paying with or using equity instruments. The fair value of stock-based awards to employees is measured at the grant date and amortized over the vesting period.

(k) Net loss per share:

Net loss per common share is calculated by dividing the net loss for the period by the weighted average number of common shares outstanding during the period. Diluted per share amounts do not differ from basic share amounts as the effect of outstanding warrants and options is anti-dilutive for all periods presented.

(l) Income taxes:

The Company uses the asset and liability method of accounting for income taxes. Under the asset and liability method, future tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases ("temporary differences") and loss carryforwards. Future tax assets and liabilities are measured using enacted or substantively enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future tax assets and liabilities of a change in tax rates is generally recognized in income in the period that includes the date of enactment or substantive enactment.

(m) Financial instruments:

Financial instruments are classified into one of five categories: held-for-trading, held-to-maturity, loans and receivables, available-for-sale financial assets, or other financial liabilities. All financial instruments, including derivatives, are measured on the balance sheet at fair value except for loans and receivables, held-to-maturity investments and other financial liabilities which are measured at amortized cost.

Compound instruments are bifurcated and presented in the financial statements in their component parts. The equity component is assigned the residual amount after deducting from the fair value of the instrument as a whole the amount separately determined for the liability component. The liability component is considered floating rate with no accretion recorded.

For each financial instrument, subsequent measurement and accounting for changes in fair value are dependent on the initial classification. Held-for-trading financial assets are measured at fair value and changes in fair value are recognized in net income. Available-for-sale financial instruments are measured at fair value with changes in fair value recorded in other comprehensive income until the investment is derecognized or impaired at which time the amounts would be recorded in net income. For other financial liability, subsequent adjustments to expected cash flows are recorded if and when they occur through adjustments to the related expense.

The Company designated its cash and cash equivalents as held-for-trading which are measured at fair value. Accounts receivable are classified as loans and receivables, which are measured at amortized cost. Accounts payable, accrued liabilities and the financial liability associated with the Company's convertible royalty and revenue obligations are classified as other financial liabilities and are measured at amortized cost.

(n) Future changes in accounting policies:

*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.

**3. Drug supplies:**

As of December 31, 2010, the Company held \$218,560 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. Property and equipment:**

<b>2010</b>	Cost	Accumulated amortization	Net book value
Computer hardware	\$ 97,588	\$ 79,739	\$ 17,849
Furniture and equipment	46,208	37,630	8,578
Computer software	21,556	18,939	2,617
	<b>\$ 165,352</b>	<b>\$ 136,308</b>	<b>\$ 29,044</b>

<b>2009</b>	Cost	Accumulated amortization	Net book value
Computer hardware	\$ 93,130	\$ 68,717	\$ 24,413
Furniture and equipment	48,277	30,789	17,488
Computer software	21,350	20,684	666
	<b>\$ 162,757</b>	<b>\$ 120,190</b>	<b>\$ 42,567</b>

**5. Intangible assets:**

Intangible assets include acquired licenses, patents and medical technology acquired relating to the development of drugs to treat neurological diseases and disorders.

<b>2010</b>	Cost	Accumulated amortization	Net book value
Medical technology	\$ 6,643,362	\$ 2,768,098	\$ 3,875,264
Patents and licenses	1,174,037	453,261	720,776
	<b>\$ 7,817,399</b>	<b>\$ 3,221,359</b>	<b>\$ 4,596,040</b>

<b>2009</b>	Cost	Accumulated amortization	Net book value
Medical technology	\$ 6,643,362	\$ 2,325,202	\$ 4,318,160
Patents and licenses	1,174,037	377,767	796,270
	<b>\$ 7,817,399</b>	<b>\$ 2,702,969</b>	<b>\$ 5,114,430</b>

**6. Deferred revenue and government grants:**

The Company only recognizes grant revenue when there is reasonable assurance of compliance with grant conditions and the grant is collectible. Grant amounts received prior to compliance with grant conditions are recorded as deferred revenue. At December 31, 2010, the Company has \$159,543 of deferred revenue related to a grant received from the Michael J. Fox Foundation for Parkinson's Research to conduct pre-clinical research in Parkinson's disease. The Company expects to conduct this research in 2011.

The Company uses the income approach to account for grant revenue resulting from government assistance. Grants received to directly offset expenses incurred for a specific project are credited to expense to directly offset the expense incurred. For the year ended December 31, 2010, grant revenue of \$495,364 was netted against directly related expenses. The grants were awarded to the Company by the United States government under the Qualifying Therapeutic Discovery Project program. The Company did not receive any grant revenue during 2009.

## 7. Share capital:

### (a) Authorized:

Unlimited voting common shares without par value

Unlimited preferred shares, issuable in series

### (b) Convertible royalty and revenue financing:

During the fourth quarter of 2010, the Company entered into a financing agreement with Isar Pharma K/S (Isar), a wholly owned limited partnership of Nordic Biotech Venture Fund II K/S. Under the terms of the agreement, Isar paid the Company U.S. \$10.0 million (Cdn \$10.2 million) in return for a convertible royalty and revenue obligation on *davunetide*. Isar can elect to convert its interest into common shares of Allon at any time at a conversion price of U.S. \$0.44 (Cdn \$0.45) which represents a 10 percent premium to the 10-day volume weighted average price of Allon prior to closing. The Company can generally force conversion at the conversion price over the next three years when the share price is two times the conversion price, or during the following 4 years when the share price is three times the conversion price. Until conversion, the Company has agreed to pay to Isar the greater of an 8 percent royalty from sales of *davunetide* or 20 percent of what it receives for commercializing the product. The Company will also pay 20 percent of all non-royalty revenue received in a partnership. The payment obligations decrease proportionately as the investment is converted. The number of shares issuable on conversion is limited to a maximum of 19.99 percent of the Company's outstanding shares at any time unless and until the Company's shareholders resolve both to allow conversions beyond 19.99 percent and to terminate the shareholder rights plan.

This financing agreement was accounted for as a compound instrument and is presented in the financial statements in its component parts. The equity component was assigned the residual amount after deducting from the fair value of the instrument as a whole the amount separately determined for the liability component. An amount of \$0.2 million was included in long term liabilities as the liability component of the financing agreement and was calculated as the present value of the estimated future royalty payments discounted at a rate applicable to biotechnology companies at a similar stage of development. An amount of \$9.7 million, representing the value of the right of conversion, was included in shareholders' equity as the equity component of the financing agreement and was calculated as the difference between the liability component and the amount of the investment by Isar, net of transaction costs of \$0.3 million. The liability component is classified as other financial liabilities and is accounted for at amortized cost. The distribution payment stream related to the liability component is considered to be a non-financial variable specific to the Company and as a result, it does not meet the criteria for a derivative. The Company's accounting policy is to treat this instrument as a variable-rate debt. Any subsequent changes to the cash flows will only be reflected in income when the related change is realized.

To estimate the fair value of the liability component of the financing agreement, the Company used a probability weighted discounted cash flow model based on estimated timing and amount of future cash flows, discounted using a risk adjusted cost of capital of 47% determined by management after considering all available market and industry information including the Company's market capitalization. Future cash flows were estimated by utilizing external market research to estimate market size and pricing assumptions. If the discount rate were to increase by 1%, the liability component would decrease by approximately \$5,400. If estimated future revenues were to decrease by 10%, the liability component would decrease by approximately \$18,500.

(c) Standby equity distribution agreement:

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.

(d) Warrants:

On July 15, 2010, all of the Company's outstanding share purchase warrants expired. The warrants entitled holders to purchase 571,500 common shares at an exercise price of \$1.05. At December 31, 2010, the Company has nil share purchase warrants outstanding.

**8. Stock-based compensation:**

The Company recognized \$247,667 in stock-based compensation expense for the year ended December 31, 2010 compared to \$357,790 for the year ended December 31, 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 December 31, 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.

During the year ended December 31, 2010, the Company granted 312,500 (2009 – 805,500) options with terms of ten years and vesting over three years. The options entitle holders to purchase common shares of the Company at a price of \$0.40 per share.

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

	Common shares under option	Weighted average 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	312,500	0.40
Exercised	-	-
Cancelled	(432,500)	0.90
Outstanding, December 31, 2010	7,032,100	\$ 0.74

At December 31, 2010, the Company has 4,471,770 stock options exercisable at weighted average exercise price of \$0.71 (2009 – 3,957,430 options at \$0.75).

The following table summarizes stock options outstanding at December 31, 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	3,229,600	6.26	\$ 0.25	2,175,937	\$ 0.20
\$ 1.00 – 1.72	3,802,500	5.54	1.16	2,295,833	1.20
	7,032,100	5.87	0.74	4,471,770	0.71

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.

The following table summarizes assumptions used in the Black-Scholes option pricing model:

	Employees & Directors		Contractors	
	2010	2009	2010	2009
Dividend yield	0%	0%	0%	0%
Expected volatility	73%	71%	71%	76%
Risk free interest rate	2.82%	2.23%	2.69%	1.60%
Expected life in years	8.00	5.00	6.02	2.38
Fair value per share	\$0.28	\$0.17	\$0.22	\$0.07

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

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

	2010	2009
Net loss for the period	\$(16,591,113)	\$(7,341,985)
Weighted average number of common shares outstanding	78,066,666	78,066,666
Net loss per common share	\$ (0.21)	\$ (0.09)

#### 10. Income taxes:

Income taxes attributable to the loss for the year in these financial statements differ from amounts computed by applying the Canadian federal and provincial statutory rate of 28.5% (2009 – 30.0%) as follows:

	2010	2009
Loss before income taxes	\$ (16,591,113)	\$ (7,341,985)
Expected tax recovery	\$ 4,728,467	\$ 2,202,596
Tax effect of:		
Changes in enacted tax rates	(556,629)	(208,416)
Foreign tax rate difference	(588)	45,090
Permanent differences, foreign exchange and other	(479,001)	(1,161,179)
Change in valuation allowance	(3,692,249)	(878,091)
Income tax recovery	\$ -	\$ -

The tax effects of temporary differences that give rise to significant portions of the future tax assets and liabilities are:

	2010	2009
Future income tax assets and liabilities:		
Fixed assets	\$ 127,663	\$ 41,970
Intangible assets	(937,400)	(975,208)
Losses carried forward	14,853,356	12,366,415
Share issue costs	954,173	394,002
Scientific research and experimental development	2,707,081	2,185,445
Total gross future tax assets	17,704,873	14,012,624
Valuation allowance	(17,704,873)	(14,012,624)
	\$ -	\$ -

At December 31, 2010, the Company has non-capital losses carried forward for tax purposes which are available to reduce taxable income of future years in Canada of \$31,247,000 and in the U.S. of \$20,119,000. The losses expire as follows:

	Canada	US
2014	\$ 982,000	\$ -
2015	443,000	-
2022	-	1,000
2023	-	475,000
2024	-	1,404,000
2025	-	2,317,000
2026	3,985,000	4,474,000
2027	3,658,000	5,662,000
2028	2,596,000	4,656,000
2029	2,749,000	1,130,000
2030	16,834,000	-
	\$ 31,247,000	\$ 20,119,000

#### 11. Commitments:

The Company has entered into purchase, lease and licensing agreements that require minimum payments for the next five years, estimated as follows:

2011	\$ 1,095,073
2012	217,868
2013	129,854
2014	44,031
2015	21,279
	\$ 1,508,105

The majority of Allon's 2011 commitments relate to contractual obligations supporting clinical initiatives.

In addition to the above commitments, the Company has a Patent License Agreement and Research and License Agreement (the Licenses) with The National Institutes of Health (NIH) and RAMOT at Tel Aviv University Ltd. respectively. Under the terms of the Licenses, the Company has obtained a worldwide exclusive license, including the right to sublicense, to use the Licensed Information and the Patents for use in the development and commercialization of therapeutics for the treatment of neurodegenerative and neurological diseases and conditions. Future royalty and milestone payments to NIH are contingent on certain clinical and commercial development milestones being achieved and future royalty payments to RAMOT are contingent on commercial sales being achieved. The Company is responsible for the development of the compounds.

During the fourth quarter of 2010, the Company entered into a financing agreement with Isar, a wholly owned limited partnership of Nordic Biotech Venture Fund II K/S. Under the terms of the agreement, Isar paid the Company U.S. \$10.0 million (Cdn \$10.2 million) in return for a convertible royalty and revenue obligation on davunetide. (See Note 7.)

## **12. Segmented information:**

Management has determined that the Company operates in one industry segment, being the development of biopharmaceutical products. Substantially all of the Company's operations, assets and employees are located in Canada and the United States.

## **13. Financial Instruments:**

The Company's financial instruments consists of cash and cash equivalents, accounts receivable, deposits, accounts payable, accrued liabilities and other financial liability. The fair values of cash, accounts receivable, deposits, accounts payable and accrued liabilities approximate carrying value because of the short-term nature of these instruments. Cash equivalents are classified as held for trading and their fair value is determined directly by reference to quoted market prices. Other financial liability relates to the convertible royalty and revenue obligations and is carried at amortized cost. It is considered a floating rate liability with no accretion and the subsequent adjustments to the expected cash flows are recorded if and when they occur through adjustments to the related expense.

### **(a) Credit risk:**

Cash equivalents are held in high-grade, liquid and low risk investments with minimal exposure to liquidity risk or risk of fair value changes. These financial instruments are classified as held for trading as they may periodically be traded or redeemed before their maturity date. At December 31, 2010, the Company's cash equivalents are held in money market funds with a major Canadian financial institution. The Company's accounts receivable is consisted of a receivable from the U.S. government relating to a qualified therapeutic discovery project grant and a receivable from the Canadian Revenue Agency relating to goods and services tax. The Company does not consider its accounts receivable as presenting any significant credit risk.

### **(b) Liquidity risk:**

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they come due. The Company manages its liquidity risk by continuously monitoring forecasted and actual cash flows,

as well as anticipated investing and financing activities. The Company's current financial liabilities comprise accounts payables and accrued liabilities and are generally due within ninety days.

(c) Market risk:

Market risk is the risk that changes in market prices, such as foreign currency exchange rates, will affect the Company's income or the value of the financial instruments held.

(i) Foreign currency risk:

The Company's primary market risk is the exposure to foreign currency exchange rate fluctuation. This risk arises from the Company's holdings of foreign currency denominated cash, cash equivalents, accounts receivable and accounts payable. 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 limits its exposure to U.S. dollar foreign exchange risk by holding sufficient U.S. denominated cash and cash equivalents to satisfy near term U.S. dollar denominated liabilities and expenses.

Accounts exposed to foreign exchange risk as of December 31, 2010 are:

	US\$ Balance <sup>1</sup>
Cash and equivalents	\$ 6,680,617
Accounts receivable	106,733
Accounts payable	(531,751)
<b>Total</b>	<b>\$ 6,255,599</b>

(1) All US dollar balances are shown in Canadian dollar equivalents.

(ii) Foreign currency exchange risk sensitivity analysis:

The following table details the Company's sensitivity analysis to a 10% decline in the US Dollar on foreign currency denominated monetary items by adjusting their translation at the balance sheet date for a 10% change in foreign currency rates. For a 10% strengthening of the US Dollar against the Canadian Dollar, there would be an equal and opposite impact on net and comprehensive loss for the period.

Change in foreign exchange gain/(loss) resulting from currency fluctuations at December 31, 2010:

	10% Foreign Currency Decline
Cash and equivalents	\$ (668,062)
Accounts receivable	(10,673)
Accounts payable	53,175
<b>Total</b>	<b>\$ (625,560)</b>

**14. Management of capital:**

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 and long term liabilities 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 the Company nor its subsidiary are subject to any externally exposed capital requirements and the Company does not use financial ratios to manage capital.

**15. Related party transactions:**

During the year ended December 31, 2010, the Company paid one of its Board members \$100,000 (2009 - nil) 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 on a continuing basis.

## **CORPORATE GOVERNANCE**

The Board of Directors and management of Allon Therapeutics Inc. consider good governance to be an important factor in the effective operation of the Company.

The Board has overall responsibility for conduct of the business and affairs of the Company and discharges this responsibility both directly and through delegating certain authority to committees of the Board and to senior management of the Company.

The Board regularly reviews Allon's governance practices to ensure they have kept pace with changing regulatory environments in Canada.

Please refer to the Company's management proxy circular for more information on the overall structure of the Board, its Committees and its corporate governance practices.

## Board of Directors

**James Miller, Ph.D.** (Chair) <sup>2</sup>  
Managing Partner,  
NDI Capital Inc.

**Frank A. Holler** <sup>1,3</sup>  
Chief Executive Officer,  
Lions Capital Corp.

**Anthony G. Phillips, Ph.D.** <sup>1,2</sup>  
Scientific Director of the CIHR  
Institute of Neuroscience,  
Mental Health and Addictions

**Prof. Illana Gozes, Ph.D.**  
Vice President, Research  
Allon Therapeutics Inc.

**Gordon C. McCauley**  
President & CEO,  
Allon Therapeutics Inc.

**Dr. Martin Barkin, FRCSC** <sup>2,3</sup>  
Chairman of Centric Health  
Corporation and Director  
of Northwest Healthcare  
Properties REIT

**C. Michael O'Brian** <sup>1,3</sup>  
President, Nairbo Investments Inc.

<sup>1</sup> Member of Audit Committee

<sup>2</sup> Member of Governance and  
Nominations Committee

<sup>3</sup> Member of Compensation  
Committee

## Management

**Gordon C. McCauley**  
President & CEO

**Matthew J. Carlyle, CFA**  
Chief Financial Officer

**Dr. Michael Gold, M.S., M.D.**  
VP, Clinical Development  
& Chief Medical Officer

**Bruce H. Morimoto, Ph.D.**  
VP, Drug Development

**Alistair J. Stewart, Ph.D.**  
VP, Commercial Research

## Annual General Meeting

Thursday, June 2, 2011 at 1:00 pm  
Terminal City Club  
837 West Hastings Street  
Vancouver, BC V6C 1B6

## Contact Information

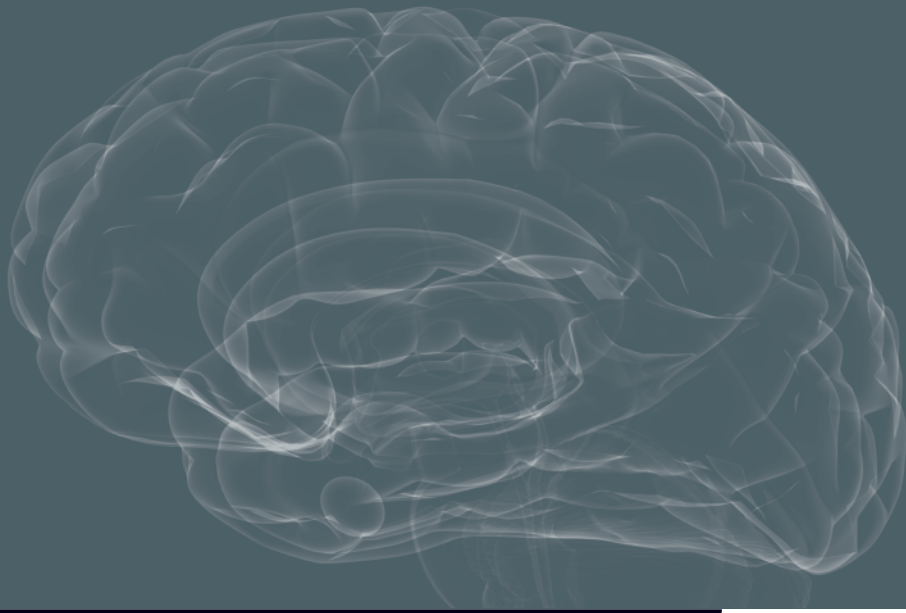
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Stock Exchange: TSX  
Stock Symbol: NPC





TSX:NPC



**Allon Therapeutics Inc.**

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