

## Management's Discussion and Analysis of Financial Condition and Results of Operations

### Highlights

- In February 2008, we reported that a first group of patients had been treated with AEZS-108 for a Phase 2 trial in advanced ovarian and endometrial cancers.
- In March 2008, we reported that dosing had commenced with cetorelix in the second efficacy study of our Phase 3 program in benign prostatic hyperplasia ("BPH").
- In March 2008, we completed the sale to Paladin Labs Inc. ("Paladin") of our marketed product, Impavido<sup>®</sup> (miltefosine), for approximately \$9.2 million.
- In April 2008, appointment of Juergen Ernst, the Company's Chairman of the Board at the time, as Interim President and Chief Executive Officer, following the departure of our former President and Chief Executive Officer.
- In April 2008, we reported the completion of patient recruitment with cetorelix, for the first efficacy study of our Phase 3 program in BPH.
- In May 2008, we reported that a first group of patients had been treated with cetorelix for the safety trial of our Phase 3 program in BPH.
- In June 2008, we completed the sale of our Quebec City property for a purchase price of \$7.1 million.
- In September 2008, Juergen Engel, Ph.D., was appointed as the Company's President and Chief Executive Officer, succeeding Juergen Ernst who, at the same time, was appointed as Executive Chairman of the Company.
- In October 2008, we reported the completion of patient recruitment for the second efficacy trial of our Phase 3 program with cetorelix in BPH.
- In October and November 2008, we reported that we had entered the second stage of patient recruitment for our AEZS-108 trials in advanced ovarian and endometrial cancers, respectively.

- In December 2008, we sold our rights to royalties on future sales of Cetrotide<sup>®</sup>, covered by our license agreement with Merck Serono, to Cowen Healthcare Royalty Partners L.P. (“Cowen”) for gross consideration of \$52.5 million.
- In December 2008, we reported the completion of patient recruitment for the safety trial of our Phase 3 program in BPH with cetrotirelix.
- In December 2008, Matthias Seeber, MBA, was nominated Company Senior Vice President, Administration and Legal Affairs.
- Subsequent to year-end, we entered into a development, commercialization and license agreement with sanofi-aventis for the development, registration and marketing of cetrotirelix in BPH for the United States market. The agreement includes an initial upfront payment of \$30.0 million and a total of \$135.0 million in payments upon achieving certain pre-established regulatory and commercial milestones, as well as escalating double-digit royalties on future net sales of cetrotirelix for BPH in the United States.

## Introduction

The following analysis provides a review of the consolidated results of operations, financial condition and cash flows of Aeterna Zentaris Inc. for the three-month period and full year ended December 31, 2008. In this Management’s Discussion and Analysis (“MD&A”), the “Company”, “we”, “us”, and “our” mean Aeterna Zentaris Inc. and its subsidiaries. This discussion should be read in conjunction with the information contained in the Company’s annual consolidated financial statements and related notes as at and for the years ended December 31, 2008, 2007 and 2006. Our consolidated financial statements, reported in United States dollars (“US dollars”), have been prepared in accordance with Canadian Generally Accepted Accounting Principles (“Canadian GAAP”), which differ in certain respects from United States Generally Accepted Accounting Principles (“US GAAP”), as discussed below.

All amounts presented in this MD&A are in US dollars, except where otherwise noted.

## About Forward-Looking Statements

This document contains forward-looking statements, which reflect our current expectations regarding future events. Forward-looking statements may include words such as anticipate, believe, could, expect, goal, guidance, intend, may, objective, outlook, plan, seek, should, strive, target and will.

Forward-looking statements involve risks and uncertainties, many of which are discussed in this MD&A. Results or performances may differ significantly from expectations. For example, the results of current clinical trials cannot be foreseen, nor can changes in policy or actions taken by such regulatory authorities as the US Food

and Drug Administration, the Therapeutic Products Directorate of Health Canada or any other organization responsible for enforcing regulations in the pharmaceutical industry.

Given these uncertainties and risk factors, readers are cautioned not to place undue reliance on such forward-looking statements. We disclaim any obligation to update any such factors or to publicly announce the result of any revisions to any of the forward-looking statements contained herein to reflect future results, events or developments, unless requested to do so by a governmental authority or applicable law.

### **About Material Information**

This MD&A includes the information we believe to be material to investors after considering all circumstances, including potential market sensitivity. We consider information and disclosures to be material if they result in, or would reasonably be expected to result in, a significant change in the market price or value of our shares, or where it is quite likely that a reasonable investor would consider the information and disclosures to be important in making an investment decision.

The Company is a reporting issuer under the securities legislation of all of the provinces of Canada and is registered in the United States and is, therefore, required to file continuous disclosure documents such as interim and annual financial statements, an MD&A, a Proxy Circular, an Annual Report on Form 20-F, material change reports and press releases with the appropriate securities regulatory authorities. Copies of these documents may be obtained free of charge on request from the office of the Secretary of the Company or on the Internet at the following addresses: [www.aezsinc.com](http://www.aezsinc.com), [www.sedar.com](http://www.sedar.com) and [www.sec.gov/edgar.shtml](http://www.sec.gov/edgar.shtml).

### **Company Overview**

Æterna Zentaris Inc. (TSX: AEZ, NASDAQ: AEZS) is a global biopharmaceutical company focused on endocrine therapy and oncology.

Our pipeline encompasses compounds at all stages of development, from drug discovery through marketed products. The two highest priorities in drug development are our Phase 3 program in BPH with our lead endocrinology compound, cetorelix, and our Phase 2 program in advanced endometrial and ovarian cancers with our lead oncology compound, AEZS-108.

## Key Developments for the Year Ended December 31, 2008

### Drug Development

Status of our Drug Pipeline as at December 31, 2008					
Discovery	Preclinical	Phase 1	Phase 2	Phase 3	Commercial
120,000 compound library	<p>AEZS-115 Non-peptide luteinizing hormone-releasing hormone (“LHRH”) antagonists (endometriosis &amp; urology)</p> <p>AEZS-120 (oncology vaccine)</p> <p>AEZS-126 Erk &amp; PI3K Inhibitors (oncology)</p> <p>AEZS-127 ErPC (oncology)</p> <p>Ghrelin receptor ligands (endocrinology)</p>	<p>AEZS-112 (oncology)</p> <p>AEZS-130 (endocrinology)</p>	<p>AEZS-108 (endometrial and ovarian cancers)</p> <p>Cetrorelix (endometriosis) (BPH in Japan)</p> <p>Ozarelix (BPH, prostate cancer)</p> <p>Perifosine (multiple cancers)</p>	Cetrorelix (BPH)	Cetrotide® ( <i>in vitro</i> fertilization)
Partners (as defined in subsequent sections of this MD&A)					
			<p>Cetrorelix: <b>Shionogi</b> in Japan</p> <p>Ozarelix: <b>Spectrum</b> in North-America and India, <b>Nippon Kayaku</b> in Japan</p> <p>Ozarelix (BPH): <b>Handok</b> in Korea, Indonesia, Malaysia, the Philippines and Singapore</p> <p>Perifosine: <b>Keryx</b> in North America</p>	<p>Cetrorelix (BPH): <b>Sanofi-aventis</b> in the U.S.A. (beginning on March 5,2009)</p> <p><b>Handok</b> in Korea</p>	<p>Cetrotide®: <b>Merck Serono</b> (World ex-Japan) <b>Shionogi and Nippon Kayaku</b> (Japan)</p>

**Cetrorelix**

In April 2008, we reported completion of patient recruitment for the first efficacy study of our Phase 3 program in BPH with cetrorelix. This one year placebo-controlled study, involving 667 patients located mainly in North America, is assessing an intermittent dosage regimen of cetrorelix as a potential safe and tolerable treatment providing prolonged improvement in BPH-related signs and symptoms. Results of this trial are expected in the third quarter of 2009.

In July 2008, we signed a license and cooperation agreement for the commercialization of cetrorelix in BPH with Handok Pharmaceuticals Co., Ltd., (“Handok”) for the Korean market.

In October 2008, we reported the completion of patient recruitment for the second efficacy trial of the Phase 3 program with cetrorelix in BPH. This trial, during which dosing had commenced in March 2008, has a similar design to the first efficacy trial and involves 420 patients located in Europe. Results of this trial are expected in the fourth quarter of 2009.

In December 2008, we reported completion of patient recruitment for the safety trial of the Phase 3 program with cetrorelix in BPH. Results of this study, involving 529 patients located in North America, as well as those of a QTc study, are expected by the end of 2009.

**Cetrotide<sup>®</sup>**

In December 2008, as discussed below, we sold our rights to royalties on future sales of Cetrotide<sup>®</sup>, covered by our license agreement with Merck Serono, to Cowen for gross consideration of \$52.5 million. Under the terms of the agreement with Cowen, the Company is entitled to an additional payment of \$2.5 million from Cowen contingent on 2010 net sales of Cetrotide<sup>®</sup> reaching a specified level.

**AEZS-108**

In February 2008, we reported that a first group of patients had been treated with our cytotoxic conjugate compound linked to doxorubicin, AEZS-108, for a European open-label, non-comparative multi-center Phase 2 trial in advanced ovarian and endometrial cancers.

In October 2008, we announced that we had entered the second stage of patient recruitment for our Phase 2 trial in ovarian cancer, after first stage data had shown two partial responses. In November 2008, we reported that we had entered the second stage of patient recruitment for our Phase 2 trial in endometrial cancer with AEZS-108. The decision to enter the second stage of patient recruitment was made following recent first stage data reporting one complete response and two partial responses among 14 patients with a diagnosis of disseminated endometrial cancer. The open-label, non-comparative multi-center Phase 2 program will treat up to 82 women with LHRH-

receptor positive ovarian and endometrial cancerous tumors, and results of the trial are expected in the fourth quarter of 2009.

**AEZS-112**

AEZS-112 is currently in a Phase 1 trial in patients with solid tumors and lymphoma. The Company is sponsoring and conducting this open-label, dose-escalation, multi-center, intermittent treatment trial in the United States. The trial will include up to 50 patients who have either failed standard therapy or for whom no alternative therapy exists. The primary endpoints of the trial will focus on determining the safety and tolerability of AEZS-112 as well as establishing the recommended Phase 2 dose and regimen. We expect progression of this trial in 2009 to identify maximum tolerated dose of AEZS-112.

AEZS-112 is the first anticancer drug in development involving two mechanisms of action, tubulin and topoisomerase II inhibition. AEZS-112 expresses different actions, such as pro-apoptotic and antiangiogenic properties.

**Ozarelix**

Our partner, Spectrum Pharmaceuticals, Inc. (“Spectrum”) released the results of a North American Phase 2 trial with ozarelix, a fourth generation LHRH antagonist in BPH. Spectrum indicated that ozarelix demonstrated sufficient clinical activity to justify its continued development. In early 2009, Spectrum initiated a North American multi-center, randomized, double-blind, placebo-controlled study in lower urinary tract symptoms due to BPH that will involve over 800 patients.

During the third quarter of 2008, we signed an agreement with Handok for the commercialization of ozarelix in BPH for the Korean and other Asian markets.

**Perifosine**

We are currently conducting a randomized, double-blind, placebo-controlled European multi-center Phase 2 trial with perifosine, an oral signal transduction inhibitor, combined with radiotherapy, in 160 patients with inoperable Stage III non-small cell lung cancer. We expect to disclose results related to this trial in the second quarter of 2009.

During 2008, our partner, Keryx Biopharmaceuticals, Inc. (“Keryx”), continued the development of perifosine with multiple Phase 1 and Phase 2 studies in North America in various cancers. Keryx expects to move perifosine into Phase 3 in at least one indication in North America in 2009.

**AEZS-130**

During the third quarter of 2008, we recovered worldwide rights from Ardana Bioscience Ltd. (“Ardana”) for the Growth Hormone Secretagogue compound, AEZS-130. Future development options are currently being evaluated for the use of this compound in growth hormone deficiencies.

**Corporate Developments*****Sale of Impavido®***

On March 1, 2008, we entered into a definitive purchase and sale agreement with respect to all rights related to the manufacture, production, distribution, marketing, sale and/or use of Impavido® (miltefosine) with Paladin for an aggregate purchase price of approximately \$9.2 million, payable in cash, subject to certain post-closing purchase price adjustments. The transaction, which closed on March 31, 2008, generated net cash proceeds of \$8.3 million, resulting in a gain of \$0.8 million.

***Sale of Building and Land***

On June 26, 2008, we sold our Quebec City building and land for a gross amount of \$7.1 million, payable in cash. The net proceeds received amounted to \$6.5 million, resulting in an additional loss on sale of \$0.8 million. In connection with this sale, we entered into a long-term lease agreement with the principal tenant of the building, agreeing to pay the principal tenant CAN\$300,000 (approximately \$246,305) as an incentive and service fee. This fee is included in the additional loss on sale, and the resulting payable is non interest-bearing and is due in bi-annual instalments of CAN\$30,000 (approximately \$24,630) over the next five years.

***Sale of Cetrotide® Royalty Stream***

In June 2003, we amended certain sections of our license and supply agreement with ARES Trading S.A. (“Merck Serono”) in which the latter was granted worldwide marketing, distribution and selling rights, except in Japan, for Cetrotide®, a compound used for *in vitro* fertilization (referred to as the License Agreement). Under the License Agreement, Merck Serono agreed to pay to us certain lump sum payments each calendar year up to and including December 31, 2010, as well as certain variable royalties through the expiry date of the Company’s underlying patent rights.

In November 2008, we entered into a purchase and sales agreement (“PSA”) with Cowen relating to our rights to royalties on future sales of Cetrotide® covered by the License Agreement.

In connection with the PSA, which was effective on October 1, 2008 and finalized in December 2008, we received \$52.5 million from Cowen, less certain transaction costs of \$1.0 million that had been advanced by Cowen to certain third-party firms and institutions on our behalf, resulting in net proceeds of \$51.5 million. Under the terms of the PSA, we are entitled to an additional payment of \$2.5 million contingent on 2010 net sales of Cetrotide<sup>®</sup> reaching a specified level.

Per the PSA, if cetorelix, the active substance in Cetrotide<sup>®</sup>, is approved for sale by European regulatory authorities in an indication other than *in vitro* fertilization, we have agreed to make a one-time cash payment to Cowen in an amount ranging from \$5.0 million up to a maximum of \$15.0 million. The amount which may be due to Cowen will be higher in proportion to the timing of the product's receiving European regulatory approval; that is, the earlier the product receives regulatory approval, the higher the amount payable to Cowen will be.

Also per the PSA, for each calendar quarter in which a royalty rate reduction—defined as the actual reduction by Merck Serono, for any calendar quarter(s), of the rate applied in calculating variable royalties under the License Agreement, to amounts less than pre-established percentages—has occurred or is continuing, we will pay Cowen a quarterly make-whole payment in an amount equal to the lesser of (i) the variable royalties in respect of such quarter that would have been received by Cowen if the aforementioned royalty rate reduction had not occurred or been continuing, and (ii) the difference of \$15.0 million less Cowen's net reduction payments, as defined.

Pursuant to the aforementioned transactions, we have certain obligations in the royalty agreement, including the supply of Cetrotide<sup>®</sup> to Merck Serono, the payment of royalties under the License Agreement, overseeing Merck Serono's compliance with the License Agreement, cooperation in handling any adverse claims or litigation involving the License Agreement and monitoring and defending any patent or trademark infringement.

We have recorded the proceeds as deferred revenues, which are recognizable as royalty revenues over the life of the License Agreement under the "units-of-revenue" method. Under that method, periodic royalty revenues are calculated by multiplying the ratio of the remaining deferred revenue amount to the total estimated remaining royalties that Merck Serono is expected to pay to Cowen over the term of the underlying arrangement by the royalty payments due to Cowen for the period.

We incurred a total of approximately \$4.8 million in financial advisor, legal and other transaction costs associated with the negotiation and finalization of the PSA. These costs have been capitalized in our consolidated balance sheet and are amortizable as part of selling, general and administrative ("SG&A") expenses in the same manner and over the same period in which the related deferred revenues are recognized as royalty revenues.

In this MD&A, the events and transactions associated with this sale are collectively referred to as the Cowen Transaction.

**Subsequent Event:**

**Cetrotrelax Development, Commercialization and Licensing Agreement**

On March 5, 2009, we entered into a development, commercialization and license agreement with sanofi-aventis for the development, registration and marketing of cetrotrelax in BPH for the US market. Under the terms of the agreement, sanofi-aventis will make an initial upfront payment to us of \$30.0 million. Also per the agreement, we will be entitled to receive a total of \$135.0 million in payments upon achieving certain pre-established regulatory and commercial milestones. Furthermore, we will be entitled to receive escalating double-digit royalties on future net sales of cetrotrelax for BPH in the United States, while retaining the option to co-promote the product in that territory.

**Consolidated Results of Operations**

**Quarterly Summary Consolidated Results of Operations Information (unaudited)**

(in thousands, except per share data)	Quarters ended			
	December 31, 2008	September 30, 2008	June 30, 2008	March 31, 2008
	\$	\$	\$	\$
Revenues	7,244	11,029	10,457	9,748
Loss from operations	(16,315)	(12,386)	(19,525)	(14,158)
Net loss	(14,493)	(13,879)	(20,579)	(10,866)
Net loss per share				
Basic and diluted	(0.27)	(0.26)	(0.39)	(0.20)

  

	Quarters ended			
	December 31, 2007	September 30, 2007	June 30, 2007	March 31, 2007
	\$	\$	\$	\$
Revenues	10,240	11,044	11,551	9,233
Loss from operations	(11,664)	(9,461)	(5,326)	(8,303)
Net loss from continuing operations	(13,854)	(8,112)	(4,928)	(5,143)
Net loss	(13,636)	(8,704)	(4,846)	(5,110)
Net loss per share from continuing operations				
Basic and diluted	(0.26)	(0.16)	(0.09)	(0.10)
Net loss per share				
Basic and diluted	(0.26)	(0.16)	(0.09)	(0.10)

## Fourth Quarter 2008 Results

**Consolidated revenues** were \$7.2 million for the quarter ended December 31, 2008, compared to \$10.2 million for the same quarter in 2007. The decrease in revenues is primarily due to lower quarter-over-quarter royalties related to our license agreement with Merck Serono. Subsequent to the Cowen Transaction, which was effective for royalty determination purposes on October 1, 2008, our periodic amortization of the gross proceeds received from Cowen, while still recognized as royalty revenues, have been lower than the royalty revenues recognized in the past, as receivable directly from Merck Serono. Additionally, quarter-over-quarter sales and royalties decreased due to the absence of sales of Impavido<sup>®</sup> in the fourth quarter of 2008, while license revenues witnessed a decrease due to the non-recurrence in 2008 of milestone payments received from Keryx, related to the perifosine Phase 2 trials.

**Consolidated SG&A expenses** were \$3.0 million for the quarter ended December 31, 2008, compared to \$5.1 million for the same quarter in 2007. The decrease in SG&A expenses is mainly related to the continued results of cost-saving measures that were implemented beginning in the second quarter of 2008.

**Consolidated research and development (“R&D”) expenses** were \$12.3 million for the quarter ended December 31, 2008, compared to \$13.6 million for the same quarter in 2007. The decrease in R&D expenses primarily relates to the comparative reduction in expenses incurred in connection with our Phase 3 program with cetorelix in BPH, which by the fourth quarter of 2008 was fully enrolled and less subject to larger front-end expenditures that were necessary in the earlier, fourth quarter 2007 stage of the program.

**Consolidated net loss** was \$14.5 million or \$0.27 per basic and diluted share for the quarter ended December 31, 2008, compared to \$13.6 million, or \$0.26 per basic and diluted share, for the same quarter in 2007. The increase in the consolidated net loss is largely attributable to a combination of lower sales and royalties, lower license fee revenues, lower manufacturing margins on Cetrotide<sup>®</sup> due in part to a \$0.7 million write-down to net realizable value of certain components of inventory, as well as to higher amortization expense due to the impairment of teverelix, as discussed below, partly offset by lower quarter-over-quarter SG&A expenses, higher net foreign exchange gains and lower income tax expense.

We expect that the consolidated net loss for the first quarter of 2009, excluding any impact of foreign exchange gains or losses, will be similar to the last quarter of 2008.

## Annual Consolidated Statements of Earnings

(in thousands, except per share data)	Years ended December 31,		
	2008	2007	2006
	\$	\$	\$
<b>Revenues</b>			
Sales and royalties	29,462	28,825	25,123
License fees	8,504	12,843	13,652
Other	512	400	24
	<b>38,478</b>	<b>42,068</b>	<b>38,799</b>
<b>Operating expenses</b>			
Cost of sales	19,278	12,930	11,270
Selling, general and administrative expenses	17,325	20,403	16,478
Research and development costs	57,448	39,248	27,422
R&D tax credits and grants	(343)	(2,060)	(1,564)
Depreciation and amortization			
Property, plant and equipment	1,515	1,562	2,816
Intangible assets	5,639	4,004	6,148
Impairment of long-lived asset held for sale	-	735	-
	<b>100,862</b>	<b>76,822</b>	<b>62,570</b>
<b>Loss from operations</b>	<b>(62,384)</b>	<b>(34,754)</b>	<b>(23,771)</b>
<b>Other income (expenses)</b>			
Interest income	868	1,904	1,441
Interest expense	(118)	(85)	(1,433)
Foreign exchange gain (loss)	3,071	(1,035)	319
Other	(79)	(28)	409
	<b>3,742</b>	<b>756</b>	<b>736</b>
<b>Share in the results of an affiliated company</b>	<b>-</b>	<b>-</b>	<b>1,575</b>
<b>Loss before income taxes from continuing operations</b>	<b>(58,642)</b>	<b>(33,998)</b>	<b>(21,460)</b>
<b>Income tax (expense) recovery</b>	<b>(1,175)</b>	<b>1,961</b>	<b>29,037</b>
<b>Net (loss) earnings from continuing operations</b>	<b>(59,817)</b>	<b>(32,037)</b>	<b>7,577</b>
<b>Net (loss) earnings from discontinued operations</b>	<b>-</b>	<b>(259)</b>	<b>25,813</b>
<b>Net (loss) earnings for the year</b>	<b>(59,817)</b>	<b>(32,296)</b>	<b>33,390</b>
<b>Net (loss) earnings per share from continuing operations</b>			
Basic	(1.12)	(0.61)	0.14
Diluted	(1.12)	(0.61)	0.14
<b>Net (loss) earnings per share from discontinued operations</b>			
Basic	-	-	0.50
Diluted	-	-	0.48
<b>Net (loss) earnings per share</b>			
Basic	(1.12)	(0.61)	0.64
Diluted	(1.12)	(0.61)	0.62

## Consolidated Revenues

**Consolidated revenues** are derived from sales and royalties as well as from license fees. Sales are derived from Cetrotide<sup>®</sup> (cetrotirelix acetate solution for injection), marketed for reproductive health assistance for *in vitro* fertilization and, prior to March 2008, Impavido<sup>®</sup> (miltefosine), marketed for the treatment of leishmaniasis, as well as from active pharmaceutical ingredients. Royalties are derived from Cetrotide<sup>®</sup> and, prior to the Cowen Transaction, payable by our partner, Merck Serono. Effective October 1, 2008, royalty revenues have been and will continue to be recognized as the deferred gross proceeds received from Cowen, and are amortized under the “units-of-revenue” method, as discussed above.

License fees are derived from non-periodic milestone payments, R&D contract fees and amortization of upfront payments received from our different licensing partners.

Consolidated sales and royalties increased to \$29.5 million for the year ended December 31, 2008, compared to \$28.8 million and \$25.1 million for each of the years ended December 31, 2007 and 2006, respectively. The increase in consolidated sales and royalties from 2007 to 2008 is mainly attributable to a large increase in sales of Cetrotide<sup>®</sup>, partly offset by lower sales of Impavido<sup>®</sup>.

The increase in consolidated sales and royalties from 2006 to 2007 is related to new sales of Cetrotide<sup>®</sup>, following the September 2006 product launch in the Japanese market, as well as year-over-year increased sales of Impavido<sup>®</sup>.

Consolidated sales and royalties are expected to decrease in 2009, due to lower royalty revenues expected to be recognized from the amortization of the deferred revenues received in connection with the Cowen Transaction.

Consolidated license fee revenues decreased to \$8.5 million for the year ended December 31, 2008, compared to \$12.8 million and \$13.7 million for each of the years ended December 31, 2007 and 2006, respectively. The decrease in consolidated license fee revenues from 2007 to 2008 is mainly attributable to non-recurring milestone payments received in 2007 from Ardana and from Keryx. Also, the decrease is related to the termination of our licensing agreement with Solvay Pharmaceuticals BV (“Solvay”) in 2007. We regained the worldwide ex-Japan rights for endometriosis from Solvay during 2007.

The decrease in consolidated license fee revenues from 2006 to 2007 is mainly attributable to a reduction in revenues related to services rendered through our collaboration with Solvay. We regained the worldwide ex-Japan rights for cetrotirelix in BPH from Solvay during 2006.

Consolidated license fee revenues are expected to increase in 2009, due in part to the amortization of the upfront payment to be received in connection with the cetorelix development, commercialization and licensing agreement entered into in March 2009 with sanofi-aventis, as discussed above.

### **Consolidated Operating Expenses**

**Consolidated cost of sales** increased to \$19.3 million for the year ended December 31, 2008, compared to \$12.9 million and \$11.3 million for each of the years ended December 31, 2007 and 2006, respectively. The year-over-year increases in the cost of sales are directly related to additional generated sales and royalties.

The higher percentage of cost of sales in 2008 compared to 2007 and 2006 is largely related to the product mix, which includes a high concentration of sales related to Cetrotide<sup>®</sup>, a product that is more expensive to produce. In addition, we wrote down certain elements of our inventory to their net realizable value at the end of 2008, which contributed approximately \$0.7 million to the increase in consolidated cost of sales compared to 2007.

We expect cost of sales as a percentage of consolidated sales and royalties to increase to approximately 75% in 2009, given the continued increased sales expectations relating to Cetrotide<sup>®</sup>.

**Consolidated SG&A expenses** decreased to \$17.3 million for the year ended December 31, 2008, compared to \$20.4 million and \$16.5 million for each of the years ended December 31, 2007 and 2006, respectively. The decrease in SG&A expenses in 2008 compared to 2007 is primarily related to the organizational changes and cost-saving measures that were implemented beginning in the second quarter of 2008.

The increase in SG&A expenses for the year 2007 compared to 2006 is primarily due to non-recurring corporate expenses of nearly \$2.7 million related to the appointment of David J. Mazzo, Ph.D., as the President and CEO of the Company, as well as Juergen Ernst as Chairman of the Board, the departure of the former CEO, Gilles Gagnon, as well as the departure of the founder and former Executive Chairman, Éric Dupont, Ph.D. The increase in SG&A is also attributable to increased royalties and commissions expenses directly related to sales and royalties of Cetrotide<sup>®</sup>.

We expect our SGA expenses to decrease in 2009 due to continuing cost-saving measures and despite additional royalty expense, which is payable related to proceeds received in connection with our recently signed development, commercialization and license agreement with sanofi-aventis, as discussed above.

**Consolidated R&D costs** were \$57.4 million for the year ended December 31, 2008, compared to \$39.2 million and \$27.4 million for each of the years ended December 31, 2007 and 2006, respectively. The increase in consolidated R&D costs for the year 2008 compared to 2007 is mainly attributable to the advancement of our Phase 3 program with our lead compound, cetorelix, in BPH.

Additional R&D expenses of \$11.8 million spent in 2007 compared to 2006 are mainly related to the advancement of our lead product cetrorelix, our LHRH antagonist in Phase 3 for BPH; as well as to further advancement of targeted, earlier-stage development programs including AEZS-108, our cytotoxic conjugate and AEZS-112, our tubulin inhibitor, both of which are in oncology.

The following table summarizes third-party R&D costs, by product, incurred by the Company during the year ended December 31, 2008.

(in thousands, except percentages)

Product	Status	Indication	Net R&D costs (unaudited)	
			\$	%
Cetrorelix	Phase 3 Phase 2	BPH and endometriosis	25,697	71.1
AEZS-108	Phase 2	Endometrial and ovarian cancers	1,259	3.5
Perifosine	Phase 2	Oncology	2,425	6.7
Ozarelix	Phase 2	BPH and prostate cancer	253	0.7
AEZS-112	Phase 1	Cancer	981	2.7
AEZS-126/ Erk PI3K	Preclinical	Cancer	1,609	4.5
Ghrelin receptor	Preclinical	Endocrinology and oncology	1,154	3.2
AEZS-115/ LHRH antagonist	Preclinical	Endocrinology and oncology	843	2.3
Other	Preclinical	Multiple	1,913	5.3
			36,134	100.0

We expect R&D investments to decrease by between \$4.0 million and \$6.0 million in 2009. This decrease will be related to the finalization of our three studies in our Phase 3 program for our lead compound, cetrorelix, in BPH, expected to occur in the third and fourth quarters of 2009, despite the continuing expenditures that will be required in connection with the filing of a New Drug Admission with the U.S. Food and Drug Administration and corresponding European agencies.

R&D investments in AEZS-108 are expected to increase slightly in 2009 in connection with our Phase 2 trials in advanced ovarian and endometrial cancers.

Our other programs will represent a lower portion of our investment in R&D for 2009, as our focus is on advancing our later-stage lead compounds cetorelix in BPH and AEZS-108 in advanced ovarian and endometrial cancers.

**R&D tax credits and grants** were \$0.3 million for the year ended December 31, 2008, compared to \$2.1 million and \$1.6 million for each of the years ended December 31, 2007 and 2006, respectively. The decrease of R&D tax credits and grants in 2008 compared to 2007 is attributable to our having utilized only Quebec provincial tax credits in 2008, while in 2007, we also reduced our income tax payable by more than \$1.6 million, following the elimination of income taxes related to the distributions made to our shareholders in connection with our disposal of Atrium.

The increase from 2006 to 2007 is related to non-recurring R&D tax credits which were used in 2007 and 2006 to reduce estimated income taxes that would otherwise have been payable on the gain on disposal of our former subsidiary Atrium through a secondary transaction in October 2006 and the distribution of our remaining interest in 2007.

We expect the utilization of R&D tax credits and grants to decrease slightly in 2009.

**Consolidated depreciation and amortization** increased to \$7.2 million for the year ended December 31, 2008, compared to 5.6 million and \$9.0 million for each of the years ended December 31, 2007 and 2006, respectively.

The increase from 2007 to 2008 was primarily related to a non-recurring impairment charge of approximately \$2.4 million, recorded as amortization expense, taken in the fourth quarter of 2008 and related to teverelix, which had been deemed impaired following Ardana's entering into voluntary administration. Ardana is party to an assignment agreement on which the cash recoverability of teverelix depends, and, as such, this customer's entering into voluntary administration has triggered the likelihood that no future cash flows will be received by the Company in connection with the aforementioned license agreement. This increase in amortization expense was partially offset by reductions in depreciation and amortization expenses related to long-lived assets held for sale, including the Quebec City building and land, and Impavido<sup>®</sup>, on which depreciation and amortization ceased during the final months of 2007. The underlying assets were sold in 2008, as discussed above.

The decrease in 2007 is primarily due to an impairment loss of \$2.9 million taken in 2006 on manufacturing equipment, patents and trademarks related to the termination of non-core pharmaceutical development projects.

**Impairment of long-lived asset held for sale** amounted to \$0.7 million for the year ended December 31, 2007. This impairment was related to the building and land held for sale for which the estimated fair value had been based on offers received by third parties.

**Consolidated loss from operations** increased to \$62.4 million for the year ended December 31, 2008, compared to \$34.8 million and \$23.8 million for each of the years ended December 31, 2007 and 2006, respectively. The increase in consolidated loss from operations in 2008 as compared to 2007 is largely attributable to a combination of lower license fee revenues, lower manufacturing margins, higher depreciation and amortization and higher R&D costs, partly offset by lower SG&A expenses.

The increase in loss from operations in 2007 as compared to 2006 is attributable to a combination of lower license revenues, increase in non-recurring G&A corporate expenses and additional R&D expenses mainly related to the advancement of our Phase 3 program with cetrotorelix in BPH. This increase in loss from operations in 2007 was partly offset by increased sales and royalties, as well as lower depreciation and amortization expenses.

We expect our consolidated loss from operations to decrease in 2009, mainly due to an expected increase in license fee revenues combined with continued decreasing SG&A and R&D expenses.

#### **Consolidated other income (expenses)**

**Consolidated interest income** amounted to \$0.9 million for the year ended December 31, 2008, compared to \$1.9 million and \$1.4 million for each of the years ended December 31, 2007 and 2006, respectively. Interest income is derived from our cash, cash equivalents and short-term investments, which totaled \$49.7 million as at December 31, 2008, \$41.4 million as at December 31, 2007 and \$60.5 million as at December 31, 2006. The decrease in consolidated interest income from 2007 to 2008 is due to the fact that less cash had been invested during 2008, with the exception of a large portion of the proceeds received in connection with the Cowen Transaction, though only in December 2008. The increase in consolidated interest income from 2006 to 2007 is directly related to the additional investment of net proceeds of \$45.0 million received in connection with the disposal of approximately 3.5 million shares of Atrium Innovations Inc. (“Atrium”), a former subsidiary of which we disposed in October 2006.

**Consolidated interest expense** amounted to \$0.1 million for the year ended December 31, 2008, compared to \$0.1 million and \$1.4 million for each of the years ended December 31, 2007 and 2006, respectively. The decrease from 2006 to 2007 is directly related to the full conversion of term loans into common shares completed in February 2006. Our long-term debt related to a non-interest bearing loan from the Canadian and Quebec Governments, for which the balance was paid in full in 2008.

**Consolidated foreign exchange gain (loss)** amounted to \$3.1 million for the year ended December 31, 2008, compared to (\$1.0 million) and \$0.3 million for each of the years ended December 31, 2007 and 2006, respectively. The increase in foreign exchange gains in 2008 is mainly attributable to advances to our German subsidiary, denominated in Euro, and with our US-based subsidiary, denominated in US dollars, and the corresponding strengthening of the Euro and the US dollar compared to the Canadian dollar.

The decrease from 2006 to 2007 is mainly related to advances, made in Euro, to our German subsidiary and the corresponding weakness of the Euro compared to the Canadian dollar.

The year-end conversion rates from the Euro and Canadian dollar to the US dollar can be summarized as follows:

1 US dollar equivalent to:	As at December 31,		
	2008	2007	2006
	\$	\$	\$
Euro	0.7145	0.6870	0.7579
Canadian dollar	1.2180	0.9913	1.1654

**Share in the results of an affiliated company** of \$1.6 million for the period ended December 31, 2006 relates to the investment in Atrium, recorded under the equity method, for the period from October 18 to December 31, 2006. As of January 2, 2007, the Company distributed its remaining interest in Atrium to our shareholders as a return of capital.

**Consolidated income tax (expense) recovery** was (\$1.2 million) for the year ended December 31, 2008, compared to \$2.0 million and \$29.0 million for each of the years ended December 31, 2007 and 2006, respectively. The increase in income tax expense from 2007 to 2008 is largely attributable to a minimum tax that is payable in Germany due to the tax accounting ramifications of transactions effected in connection with the Cowen Transaction and to the utilization, in 2007, of some of our future income tax assets following the non-recurring taxable capital gain realized in connection with the spin-off of Atrium.

The decrease in income tax recovery from 2006 to 2007 was related to the significant decrease in the valuation allowance with respect to the utilization of some of our future income tax assets against future tax liabilities related to the taxable capital gains that were realized by the Company in connection with the sale of Atrium shares in 2006 and the special distribution of our remaining interest at the beginning of 2007.

In 2009, we do not expect to record any significant income tax recovery or expense in our foreign or domestic entities.

**Consolidated net (loss) earnings from continuing operations** was (\$59.8 million) for the year ended December 31, 2008, compared to (\$32.0 million) and \$7.6 million for each of the years ended December 31, 2007 and 2006, respectively. The increase in net loss from 2007 to 2008 is largely attributable to a combination of lower license fee revenues, the increase in R&D costs related to the advancement of our Phase 3 program with cetrotorelix in BPH, lower manufacturing margins, higher depreciation and amortization and higher income tax expense in 2008, partly offset by lower SG&A expenses and higher net foreign exchange gains.

The increased consolidated net loss from continuing operations in 2007 is directly related to the increased loss from operations of nearly \$10.0 million, a one-time share in the results of Atrium of nearly \$1.6 million recorded in 2006 and a non-recurring future income tax recovery of nearly \$25.0 million recorded in 2006 related to the sale of Atrium shares and the special distribution of our remaining interest in January 2007.

**Consolidated net (loss) earnings from discontinued operations** amounted to (\$0.3 million) for the year ended December 31, 2007, compared to \$25.8 million for the year ended December 31, 2006. The year-over-year variation relates almost exclusively to the divestiture, in October 2006, of our interest in Atrium, whose results of operations were reported as discontinued operations for the year ended December 31, 2006 and detailed as follows:

(in thousands)

	\$
<b>Revenues</b>	239,535
<b>Earnings before the following items</b>	28,360
Gain on disposal of Atrium shares	29,248
Income tax expense	(19,923)
Loss on dilution of investments	(628)
<b>Earnings before non-controlling interest</b>	37,057
<b>Non-controlling interest</b>	(10,967)
<b>Net earnings from discontinued operations</b>	26,090

Also impacting consolidated net loss from discontinued operations were the results of operations related to Echelon Biosciences, Inc. (“Echelon”), which we disposed of in November 2007 and whose results were included in our consolidated statements of earnings (loss) for the year ended December 31, 2007, as follows:

(in thousands)	Years ended December 31,	
	2007	2006
	\$	\$
<b>Revenues</b>	<b>2,358</b>	2,593
<b>Loss before the following items</b>	<b>(206)</b>	(369)
Goodwill impairment	<b>(500)</b>	-
Loss on disposal of Echelon shares, net of cumulative translation adjustment	<b>(44)</b>	-
Income tax recovery	<b>491</b>	92
<b>Net loss from discontinued operations</b>	<b>(259)</b>	(277)

The year-over-year decrease in revenues from discontinued operations related to Echelon from 2006 to 2007 is due to the fact that 2007 revenues represent eleven months compared to twelve months for the year 2006.

**Consolidated net loss** was \$59.8 million, or \$1.12 per basic and diluted share, for the year ended December 31, 2008, compared to \$32.3 million, or \$0.61 per basic and diluted share, for the year ended December 31, 2007. The increase in consolidated net loss in 2008 as compared to 2007 is attributable to a combination of lower license fee revenues, lower manufacturing margins, higher depreciation and amortization, higher income tax expense and higher R&D costs, partly offset by lower SG&A expenses and higher net foreign exchange gains.

The increased net loss in 2007 is related to a higher loss from operations of nearly \$10.0 million, lower income tax recovery of nearly \$27.0 million related to the recognition of future income tax assets mainly attributable to the sale of Atrium shares in 2006 and the special distribution of our remaining interest in January 2007, as well as lower net earnings from discontinued operations of Atrium of nearly \$26.0 million.

We expect that the consolidated net loss for the year 2009 will decrease, mainly due to increased license fee revenues, to be recognized in connection with the cetorelix development, commercialization and licensing agreement entered into with sanofi-aventis, and with the expected continued reduction of R&D and SG&A expenses.

The weighted average number of shares outstanding used to calculate basic net earnings (loss) per share for both of the years ended December 31, 2008 and 2007 was 53.2 million shares, compared to 52.1 million shares for the year ended December 31, 2006. For diluted net earnings (loss) per share, the weighted average number of shares outstanding used for this calculation was 53.2 million shares for both of the years ended December 31, 2008 and 2007, compared to 52.5 million shares for the year ended December 31, 2006.

### Consolidated Balance Sheet Information

(Unaudited)

(in thousands)	As at December 31,		
	2008	2007	2006
	\$	\$	\$
Cash and cash equivalents	49,226	10,272	8,939
Short-term investments	493	31,115	51,550
Accounts receivable and other current assets	12,005	18,193	41,234
Property, plant and equipment, net	6,682	7,460	13,001
Other long-term assets	39,936	56,323	108,767
<b>Total assets</b>	<b>108,342</b>	<b>123,363</b>	<b>223,491</b>
Accounts payable and other current liabilities	22,121	21,480	15,624
Current portion of long-term debt and payable	49	775	686
Long-term debt and payable	172	-	687
Non-financial long-term liabilities	64,525	12,517	27,615
<b>Total liabilities</b>	<b>86,867</b>	<b>34,772</b>	<b>44,612</b>
<b>Shareholders' equity</b>	<b>21,475</b>	<b>88,591</b>	<b>178,879</b>
<b>Total liabilities and shareholders' equity</b>	<b>108,342</b>	<b>123,363</b>	<b>223,491</b>

The increase in cash and cash equivalents and the decrease in short-term investments from 2007 to 2008 are discussed in more detail below. The decrease in accounts receivable and other current assets from 2007 to 2008 is largely attributable to lower customer billings in December 2008 compared to the same period in 2007, lower grants receivable at the end of 2008 and the write-down to net realizable value of certain components of inventory in December 2008, as discussed above.

The decrease in other long-term assets is primarily due to the disposal, in 2008, of the long-lived assets which had been reported as held for sale as at December 31, 2007, as discussed above and the impairment charge that was taken relative to teverelix in the fourth quarter of 2008, partially offset by a net increase in deferred charges, due mainly to the capitalization of financial advisor, legal and other costs incurred in connection with the Cowen Transaction. The increase in non-financial long-term liabilities is primarily attributable to the increase in deferred revenues following the receipt of proceeds from the Cowen Transaction, as well as an increase in employee future benefits related mainly to employees in our German subsidiary.

The decrease in shareholders' equity from 2007 to 2008 is almost entirely attributable to the increase in consolidated deficit due to the current year net loss and the decrease of accumulated other comprehensive income, which in turn is largely made up of cumulative translation adjustments.

The increase in cash and cash equivalents and the decrease in short-term investments from 2006 to 2007 are discussed in more detail below. The decrease in accounts receivable and other current assets from 2006 to 2007 is mainly attributable to the utilization of future tax assets following the taxable capital gain realized in connection with the spin-off of Atrium, as well as the reduction of current assets of discontinued operations related to Echelon. The decrease in net property, plant and equipment from 2006 to 2007 is primarily the result of the reclassification of long-lived assets held for sale to other long-term assets, which resulted in an increase in 2007 to the latter, offset by a significant decrease due to the disposal of Atrium, which had been carried in the balance sheet as of December 31, 2006 under the equity method at a value of \$57.1 million.

Accounts payable and other current liabilities increased from 2006 to 2007 largely as a result of an increased volume of supplier invoices in December 2007 compared to the same period in 2006, while the decrease in non-financial long-term liabilities was mainly attributable to the decrease in long-term deferred tax liabilities and a decrease in the long-term portion of deferred revenues not yet amortized at year-end.

The overall decrease in shareholders' equity from 2006 to 2007 relates to the reduction of share capital in the amount of \$137.9 million as a result of the distribution to our shareholders of our remaining interest in Atrium. This decrease was offset by an increase in other capital to adjust for the effects of the corresponding difference between the fair value and the book value of Atrium, net of income taxes and cumulative translation adjustment, of \$71.1 million. Also contributing to the reduction in shareholders' equity from 2006 to 2007 was the contribution of the annual net loss to the consolidated deficit as well as an increase in the cumulative translation adjustment.

## Financial Liabilities, Obligations and Commitments

We have certain contractual obligations and commercial commitments. Commercial commitments mainly include R&D services and manufacturing agreements related to the execution of our Phase 3 program with cetorelix in BPH. The following table summarizes future cash requirements with respect to these obligations.

Payments due in					
(in thousands)	Carrying amount	2009	2010-2011	2012-2013	After 2013
	\$	\$	\$	\$	\$
<b>Long-term payable</b>	221	49	98	74	-
<b>Operating leases</b>	10,366	2,191	4,241	2,503	1,431
<b>Commercial commitments</b>	20,528	15,743	3,974	811	-
<b>Total</b>	31,115	17,983	8,313	3,388	1,431

## Outstanding Share Data

As at March 9, 2009, there were 53,187,470 common shares issued and outstanding, and there were 4,667,428 stock options outstanding.

It is important to note that historical patterns of expenditures cannot be taken as an indication of future expenditures. The amount and timing of expenditures and availability of capital resources vary substantially from period to period, depending on the level of research and development activity being undertaken at any one time and on the availability of funding from investors and prospective commercial partners.

## Capital disclosures

Our objective in managing capital composed of shareholders' equity is to ensure a sufficient liquidity position to finance our R&D activities, SG&A expenses, working capital and overall capital expenditures. We make every effort to manage our liquidity to minimize dilution to our shareholders.

Initially, we had funded our activities through public offerings of common shares and convertible term loans. More recently, however, we have tried to optimize our liquidity needs by non-dilutive sources, including the sale of non-core assets and future rights to royalties, investment tax credits and grants, interest income, licensing, service and royalties.

During 2008, we fulfilled our obligation on the loan from the federal and provincial governments with a nominal value of CAN\$800,000.

In connection with the sale of the Quebec City building and land discussed above, we entered into a long-term lease agreement with the principal tenant of the building. As part of the agreement, we agreed to pay the principal tenant CAN\$300,000 (approximately \$246,305) as an incentive and service fee. The resulting payable is non-interest bearing and is due in bi-annual installments of CAN\$30,000 (approximately \$24,630) over the next five years.

Our capital management objective remains the same as that of previous years. The policy on dividends is to retain cash to keep funds available to finance the activities required to advance our product development pipeline, prioritizing our lead product candidate, cetorelix, in Phase 3 for BPH.

We are not subject to any capital requirements imposed by any regulators or any other external source.

### **Liquidity, Cash Flows and Capital Resources**

Our operations and capital expenditures are mainly financed through cash flows from operating activities, selling of non-core assets and other non-dilutive activities.

Our cash, cash equivalents and short-term investments amounted to \$49.7 million as at December 31, 2008, compared to \$41.4 million as at December 31, 2007. Possible additional operating losses and/or possible investments in the acquisition of complementary businesses or products may require additional financing. As at December 31, 2008, cash, cash equivalents and short-term investments of the Company included CAN\$3.8 million and EUR32.8 million.

Short-term investments do not include asset-backed commercial paper affected by liquidity issues.

Based on our assessment, which takes into account the proceeds received in connection with the Cowen Transaction, the signing of the development, commercialization and license agreement with sanofi-aventis, as well as our strategic plan and corresponding budgets and forecasts, we believe that we have sufficient liquidity and financial resources to fund planned expenditures and other working capital needs for at least the next 12-month period following the balance sheet date of December 31, 2008.

We may endeavour to secure additional financing, as required, through strategic alliance arrangements, the issuance of new share capital, as well as through other non-dilutive activities.

The variation of our liquidity by activity is explained below, not considering any cash flows used in or provided by discontinued operations.

## Operating Activities

Cash flows used in our continuing operating activities amounted to \$1.3 million for the year ended December 31, 2008, compared to \$25.7 million and \$15.9 million for each of the years ended December 31, 2007 and 2006, respectively. The significant decrease in cash used in operating activities from 2007 to 2008 relates in large proportion to the net cash proceeds received in connection with the Cowen Transaction, in addition to higher upfront payments received from certain customers and higher cash collections of trade accounts receivable. These cash inflows were partially offset by increased cash expenditures that contributed to the increase in our net loss, as well as by payments made, which were mainly related to financial advisor, legal and other costs incurred in connection with the Cowen Transaction, as well as to a higher volume of trade accounts payable settlements.

The increase in net cash used in 2007 compared to 2006 is primarily attributable to lower license revenues, increased non-recurring corporate expenses, additional investments in R&D related to the initiation of our Phase 3 program in BPH for cetorelix, as well as to the further advancement of targeted, earlier-stage development programs.

We expect net cash used in continuing operating activities to increase in 2009 due to the absence of cash royalty receipts that were payable in connection with the License Agreement with Merck Serono prior to the Cowen Transaction and as we continue our Phase 3 clinical program with cetorelix in BPH and further advance our targeted, earlier-stage development programs. These cash outflows will be partially offset by the receipt of the upfront payment from sanofi-aventis in connection with the cetorelix development, commercialization and licensing agreement, as discussed above.

## Financing Activities

Net cash used in continuing financing activities was \$1.2 million for the year ended December 31, 2008, compared to \$1.1 million and \$0.7 million for each of the years ended December 31, 2007 and 2006, respectively. These funds were used mainly for the repayments of our long-term debt and payable, as well as in connection with the filing of a shelf prospectus.

## Investing Activities

Cash provided by continuing investing activities (excluding the changes in short-term investments) amounted to \$13.6 million for the year ended December 31, 2008, while cash flows used in continuing investing activities (excluding the changes in short-term investments) was \$3.0 million for the year ended December 31, 2007, compared to \$0.5 million for the year ended December 31, 2006. The increase in cash provided by investing activities from 2007 to 2008 relates primarily to the disposals of the Quebec City building and land and of Impavido<sup>®</sup>, both of which had been reported as long-lived assets held for sale as at December 31, 2007.

The increase in net cash used in continuing investing activities in 2007 compared to 2006 is mainly related to the acquisition of equipment that is necessary to support clinical trials.

We expect that cash provided by investing activities (excluding the changes in short-term investments) will decrease in 2009, mainly due to the expected non-recurrence of cash proceeds received in connection with the disposal of long-lived assets held for sale.

## **Critical Accounting Policies and Estimates**

Our financial statements are prepared in accordance with Canadian GAAP. A summary of significant and pertinent measurement and disclosure differences between Canadian and US GAAP is provided in note 27 to our 2008 annual consolidated financial statements. The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosures of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting years. Significant estimates are generally made in connection with the calculation of revenues, research and development expenses, stock-based compensation expense, as well as in determining the allowance for doubtful accounts, inventory and provisions for obsolete inventory, future income tax assets and liabilities, the useful lives of property, plant and equipment and intangible assets with finite lives, the valuation of intangible assets and goodwill, the fair value of stock options granted, employee future benefits and certain accrued liabilities. We base our estimates on historical experience, where relevant, and on various other assumptions that we believe to be reasonable under the circumstances. Actual results could differ from those estimates.

The following summarizes our critical accounting policies and other policies that require the most significant judgment and estimates in the preparation of our consolidated financial statements.

### **Revenue Recognition and Deferred Revenues**

The Company is currently in a phase in which potential products are being further developed or marketed jointly with strategic partners. Existing licensing agreements usually foresee one-time payments (upfront payments), payments for research and development services in the form of cost reimbursements, milestone payments and royalty receipts for licensing and marketing product candidates. Revenues associated with those multiple-element arrangements are allocated to the various elements based on their relative fair value.

Agreements containing multiple elements are divided into separate units of accounting if certain criteria are met, including whether the delivered element has stand-alone value

to the customer and whether there is objective and reliable evidence of the fair value of the undelivered obligation(s). The consideration received is allocated among the separate units based on each unit's fair value or using the residual method, and the applicable revenue recognition criteria are applied to each of the separate units.

License fees representing non-refundable payments received upon the execution of license agreements are recognized as revenue upon execution of the license agreements when we have no significant future performance obligations and when collectibility of the fees is assured. Upfront payments received at the beginning of licensing agreements are not recorded as revenue when received but are amortized based on the progress to the related research and development work. This progress is based on estimates of total expected time or duration to complete the work, which is compared to the period of time incurred to date in order to arrive at an estimate of the percentage of revenue earned to date.

Milestone payments, which are generally based on developmental or regulatory events, are recognized as revenue when the milestones are achieved, collectibility is assured, and when there are no significant future performance obligations in connection with the milestones.

In those instances where we have collected upfront or milestone payments but have ongoing future obligations related to the development of the drug product, we consider the milestone payments and the remaining obligations under the contract as a single unit of accounting. In those circumstances where the collaboration does not require specific deliverables at specific times or at the end of the contract term, but rather our obligations are satisfied over a period of time, revenue recognition is deferred and amortized over the period of its future obligations.

Royalty revenue, based on a percentage of sales of certain declared products sold by third parties, is recorded when we have fulfilled the terms in accordance with the contractual agreement and have no future obligations, the amount of the royalty fee is determinable and collection is reasonably assured.

Proceeds received in connection with the Cowen Transaction are deferred and recognized over the life of the license agreement pursuant to the "units-of-revenue" method, as discussed above.

Revenues from sales of products are recognized, net of estimated sales allowances and rebates, when title passes to customers, which is at the time goods are shipped, when there are no future performance obligations, when the purchase price is fixed and determinable, and collection is reasonably assured.

### **Research and Development Costs**

Research costs are expensed as incurred. Development costs are expensed as incurred except for those which meet generally accepted criteria for deferral, which are

capitalized and amortized against operations over the estimated period of benefit. To date, no costs have been deferred.

## **Impairment of Long-Lived Assets and Goodwill**

Property, plant and equipment and intangible assets with finite lives are reviewed for impairment when events or circumstances indicate that carrying values may not be recoverable. Impairment exists when the carrying value of the asset is greater than the undiscounted future cash flows expected to be provided by the asset. The amount of impairment loss, if any, is the excess of its carrying value over its fair value, which in turn is determined based upon discounted cash flows or appraised values, depending of the nature of assets.

Goodwill, which represents the excess of the purchase price over the fair values of the net assets of entities acquired at the respective dates of acquisition, is tested for impairment annually or more frequently if events or changes in circumstances indicate that it might be impaired. Testing for impairment is accomplished mainly by determining whether the fair value of a reporting unit exceeds the net carrying amount of that reporting unit as of the assessment date. If the fair value is greater than the carrying amount, no impairment is necessary. In the event that the carrying amount of a reporting unit exceeds its fair value, an impairment loss is recognized in an amount equal to the excess. Fair value of goodwill is estimated in the same way as goodwill is determined at the date of the acquisition in a business combination, that is, the excess of the fair value of the reporting unit over the fair value of the identifiable net assets of the reporting unit.

## **Income Taxes**

We operate in multiple jurisdictions, and our earnings are taxed pursuant to the tax laws of these jurisdictions. Our effective tax rate may be affected by the changes in, or interpretations of, tax laws in any given jurisdiction, utilization of net operating losses and tax credit carry-forwards, changes in geographical mix of income and expense, and changes in management's assessment of matters, such as the ability to realize future tax assets. As a result of these considerations, we must estimate our income taxes in each of the jurisdictions in which we operate. This process involves estimating our actual current tax exposure, together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in future tax assets and liabilities, which are included in our consolidated balance sheet. We must then assess the likelihood that our future tax assets will be recovered from future taxable income and establish a valuation allowance if, based on available information, it is more likely than not that some or all of the future income tax assets will not be realized. Establishing or increasing a valuation allowance increases our income tax expense.

Significant management judgment is required in determining our provision for income taxes, our income tax assets and liabilities, and any valuation allowance recorded against our net income tax assets. The valuation allowance is based on our estimates of taxable income by jurisdiction in which we operate and the period over which our income tax assets will be recoverable. In the event that actual results differ from these estimates or we adjust these estimates in future periods, we may need to amend our valuation allowance, which could materially impact our financial position and results of operations.

## **Stock-Based Compensation Costs**

We account for all forms of employee stock-based compensation using the fair value-based method. This method requires that we make estimates about the risk-free interest rate, the expected volatility of our shares and the expected life of the awards.

## **New Accounting Standards**

### ***Impact of accounting standards adopted in 2008***

On January 1, 2008, we adopted the Canadian Institute of Chartered Accountants, (“CICA”) Handbook Section 1535, *Capital Disclosures* (“Section 1535”); Section 3862, *Financial Instruments – Disclosures* (“Section 3862”); Section 3863, *Financial Instruments – Presentation* (“Section 3863”); and Section 3031, *Inventories* (“Section 3031”).

Section 1535 establishes guidelines for disclosure of information regarding an entity’s capital which will enable users of its financial statements to evaluate an entity’s objectives, policies and processes for managing capital, including disclosures of any externally imposed capital requirements and the consequences of non-compliance.

Section 3862 and Section 3863, which replace Section 3861, *Financial Instruments – Disclosure and Presentation*, require the disclosure of additional details of financial asset and liability categories as well as a detailed discussion on the risks associated with our financial instruments. The presentation requirements are carried forward unchanged

The CICA issued Section 3031, which replaced Section 3030 of the same title. This standard requires that inventories be measured at the lower of cost and net realizable value and includes guidance on the determination of cost, including allocation of overheads and other costs. The standard also requires that similar inventories within a consolidated group be measured using the same method. Section 3031 also requires the reversal of previous write-downs to net realizable value when there is a subsequent increase in the value of inventories. We have adopted this standard effective January 1, 2008, and there has been no impact on the consolidated financial statements.

### ***Impact of accounting pronouncements not yet adopted***

In February 2008, the CICA issued Handbook Section 3064, *Goodwill and Intangible Assets*. This standard provides guidance on the recognition of intangible assets and the criteria for asset recognition, clarifying the applications of the concept of matching revenues and expenses, whether these assets are separately acquired or are developed internally. The standard will apply to our interim and annual financial statements for periods beginning on January 1, 2009. We do not expect that adoption of this standard will have a significant impact on the consolidated financial statements.

In January 2009, the CICA issued Handbook Section 1582, *Business Combinations*, which replaces the existing standards. This section establishes the standards for the accounting of business combinations and states that all assets and liabilities of an acquired business will be recorded at fair value. Obligations for contingent considerations and contingencies will also be recorded at fair value at the acquisition date. The standard also states that acquisition-related costs will be expensed as incurred and that restructuring charges will be expensed in the periods after the acquisition date. This standard is applied prospectively to business combinations with acquisition dates on or after January 1, 2011. Earlier adoption is permitted. We are currently evaluating the impact, if any, that adopting this standard will have on our consolidated financial statements.

In January 2009, the CICA issued Handbook Section 1601, *Consolidated Financial Statements*, which replaces the existing standards and establishes the standards for preparing consolidated financial statements and is effective for 2011. Earlier adoption is permitted. We are currently evaluating the impact, if any, that adopting this standard will have on our consolidated financial statements.

In January 2009, the CICA issued Handbook Section 1602, *Non-controlling Interests*, which establishes standards for the accounting of non-controlling interests of a subsidiary in the preparation of consolidated financial statements subsequent to a business combination. This standard is effective for 2011. Earlier adoption is permitted. We are currently evaluating the impact, if any, that adopting this standard will have on our consolidated financial statements.

In January 2009, the CICA's Emerging Issue Committee ("EIC") issued Abstract EIC-173, *Credit Risk and the Fair Value of Financial Assets and Liabilities*, which requires entities to take both counterparty credit risk and their own credit risk into account when measuring the fair value of financial assets and liabilities, including derivatives. EIC-173 will be effective for interim and annual periods beginning on or after January 1, 2009. We do not expect that adoption of this guidance will have a significant impact on our consolidated financial statements.

### **International Financial Reporting Standards ("IFRS")**

We are currently evaluating the potential impact that could result from preparing our consolidated financial statements in accordance with IFRS, given that the Canadian Accounting Standards Board confirmed that IFRS will replace current Canadian standards and interpretations as Canadian GAAP for publicly accountable enterprises. The adoption of IFRS will have an impact on our consolidated financial statements, as well as on a wide range of operational and performance measures, beginning on January 1, 2011.

To date, we have performed a high-level diagnostic that has identified pertinent differences between IFRS and current accounting policies and procedures that conform to Canadian GAAP. We have also developed a formal plan for IFRS conversion and the related transition from current standards. Activities under that plan will include, among other things, the identification and documentation of pertinent accounting and reporting differences between IFRS and Canadian GAAP; the choice of IFRS accounting policies, including consideration of elections available under IFRS 1, *First-time Adoption of International Financial Reporting Standards*; determination of the impact of conversion on internal controls, accounting systems and other business solutions and processes; and the development of training to assist appropriate employees in the transition to and ongoing compliance with IFRS.

Activities in connection with our IFRS implementation plan will continue throughout 2009, and we will provide required disclosures regarding the status of our plan.

## Outlook for 2009

We expect to disclose first efficacy results of our Phase 3 program in BPH with our lead endocrinology compound, cetorelix, in the third quarter of 2009. Results for the second efficacy trial of this same program are expected in the fourth quarter of 2009. Results for the safety trial and the QTc trial are expected by the end of 2009.

In Q4 2009, we expect to disclose Phase 2 results with AEZS-108 in advanced ovarian and endometrial cancers.

We will continue to seek business development opportunities from our extensive product pipeline.

As pertaining to liquidity, our expectation is that cash flows from operations will not proceed linearly throughout the year, but will instead be positively impacted in the first half of 2009 due to the receipt of the \$30.0 million upfront payment from sanofi-aventis, as discussed above, partly offset by payments expected to be made in connection with the pivotal long-term safety trial and the thorough QTc trial for cetorelix in BPH.

## Financial and Other Instruments

### Foreign Currency Risk

Since we operate on an international scale, we are exposed to currency risks as a result of potential exchange rate fluctuations. For the year ended December 31, 2008, we were not a party to any forward-exchange contracts, and no forward-exchange contracts were outstanding as at March 9, 2009.

Beginning on January 1, 2009, due to changes in facts and circumstances, the Company and all its subsidiaries will use the euro as their functional currency. As such, all foreign currency exposure risk on inter-company transactions will be eliminated.

### **Credit Risk**

Financial instruments, which potentially subject the Company to concentrations of credit risk, consist primarily of cash and cash equivalents, short-term investments and accounts receivable. Cash and cash equivalents are maintained with high-credit quality financial institutions. Short-term investments consist primarily of bonds and notes issued by high-credit quality corporations and institutions. Consequently, management considers the risk of non-performance related to cash and cash equivalents and investments to be minimal.

Generally, we do not require collateral or other security from customers for trade accounts receivable; however, credit is extended following an evaluation of creditworthiness. In addition, we perform ongoing credit reviews of all our customers and establish an allowance for doubtful accounts when accounts are determined to be uncollectible.

### **Interest Rate Risk**

We are exposed to market risk relating to changes in interest rates with regard to our short-term investments.

## **Related Party Transactions and Off-Balance Sheet Arrangements**

We did not enter into transactions with any related parties during the year ended December 31, 2008.

As at December 31, 2008, we did not have any interest in variable interest entities or any other off-balance sheet arrangements.

## **Risk Factors and Uncertainties**

### **Risks Associated with Operations**

- Many of our products are currently at an early development stage. It is impossible to ensure that the R&D activities related to these products will result in the creation of profitable operations;
- We are currently developing our products based on R&D activities conducted to date, and we may not be successful in developing or introducing to the market these or any other new products or technology. If we fail to develop and deploy

new products on a successful and timely basis, we may become non-competitive and unable to recover the R&D or other expenses we incur to develop and test new products;

- Even if successfully developed, our products may not gain market acceptance among physicians, patients, healthcare payers and the medical community, which may not accept or utilize our products. If our products do not achieve significant market acceptance, our business and financial condition will be materially adversely affected. In addition, we may fail to further penetrate our core markets and existing geographic markets or successfully expand our business into new markets; the growth in sales of our products, along with our operating results, could be negatively impacted. Our ability to further penetrate our core markets and existing geographic markets in which we compete or to successfully expand our business into additional countries in Europe, Asia or elsewhere, to the extent we believe that we have identified attractive geographic expansion opportunities in the future, is subject to numerous factors, many of which are beyond our control. We cannot assure that our efforts to increase market penetration in our core markets and existing geographic markets will be successful. Our failure to do so could have an adverse effect on our operating results;
- We rely heavily on our proprietary information in developing and manufacturing our product candidates. Despite efforts to protect our proprietary rights from unauthorized use or disclosure, third parties may attempt to disclose, obtain, or use our proprietary information or technologies;
- We have to forge and maintain strategic alliances to develop and market products in our current pipeline. If we are unable to reach agreements with such collaborative partners, or if any such agreements are terminated or substantially modified, we may be unable to obtain sufficient licensing revenue for our products, which might have a material adverse effect on their development and on us;
- In carrying out our operations, we are dependent on a stable and consistent supply of ingredients and raw materials. There can be no assurance that we will be able, in the future, to continue to purchase products from our current suppliers or any other supplier on terms similar to current terms or at all. An interruption in the availability of certain raw materials or ingredients, or significant increases in the prices paid by us for them, could have a material adverse effect on our business, financial condition, liquidity and operating results.

### **Cash Flows and Financial Resources**

Based on our current plans, we will need to raise additional funds for future operating costs, research and development activities, preclinical studies, and clinical trials necessary to bring our potential products to market, particularly, for cetrorelix in BPH, or to potentially establish marketing, sales and distribution capabilities. We may endeavour

to secure additional financing, as required, through strategic alliance arrangements, the issuance of new share capital, as well as through other financing opportunities.

However, there can be no assurance that these financing efforts will be successful or that we will continue to be able to meet our ongoing cash requirements. It is possible that financing may not be available or, if available, will not be on acceptable terms. The availability of financing will be affected by the results of our preclinical and clinical development, including the cetorelix Phase 3 program, the AEZS-108 Phase 2 study, as well as other studies ongoing from our pipeline. It can also be affected by our ability to obtain regulatory approvals, the market acceptance of our products, the state of the capital markets generally, the status of our listing on the NASDAQ and TSX markets, strategic alliance agreements, and other relevant commercial considerations.

We believe that we would be able to obtain long-term capital, if necessary, to support our corporate objectives, including the clinical development program of our products. Our planned cash requirements may vary materially in response to a number of factors, including: R&D on our products; clinical trial results; increases in our manufacturing capabilities; changes in any aspect of the regulatory process; and delays in obtaining regulatory approvals. Depending on the overall structure of current and future strategic alliances, we may have additional capital requirements related to the further development of existing or future products.

We have not entered into any forward currency contracts or other financial derivatives to hedge foreign exchange risk and, therefore, we are subject to foreign currency transaction and translation gains and losses. Foreign exchange risk is managed primarily by satisfying foreign denominated expenditures with cash flows or assets denominated in the same currency. However, with companies operating in foreign countries, we are more exposed to foreign currency risk.

### **Key Personnel**

Our success is also dependent upon our ability to attract and retain a highly qualified work force, and to establish and maintain close relations with research centers. The competition in that regard is very severe. Our success is dependent to a great degree on our senior officers, scientific personnel and consultants. The failure to recruit qualified staff and the loss of key employees could compromise the pace and success of product development.

### **Acquisition Program**

We intend to continue to acquire new technologies and/or businesses. However, there is no assurance that we will be able to make certain acquisitions or that we will succeed in integrating the newly-acquired technologies or businesses into its operations. The failure to successfully integrate the personnel and operations of businesses which we may acquire in the future with ours could have a material adverse effect on our operations and results.

### **Volatility of Share Prices**

Share prices are subject to changes because of numerous different factors related to its activity including reports of new information, changes in the Company's financial situation, the sale of shares in the market, the Company's failure to obtain results in line with the expectations of analysts, an announcement by the Company or any of its competitors concerning technological innovation, etc. During the past few years, shares of Aeterna Zentaris, other biopharmaceutical companies, and the investment market in general have been subject to extreme fluctuations that were unrelated to the operational results of the companies affected. There is no guarantee that the market price of the Company's shares will be protected from any such fluctuations in the future.

### **Delisting Risk**

There can be no assurance that our common shares will remain listed on the NASDAQ Market ("NASDAQ"). On October 24, 2008, we announced that we had received a notification from NASDAQ regarding the failure by the Company to comply with NASDAQ's minimum bid price requirements. Although NASDAQ has temporarily suspended enforcement of its minimum bid price requirements, such requirements will be reinstated in October 2009. If we fail to meet any of NASDAQ's continued listing requirements and NASDAQ attempts to enforce compliance with its rules, our common shares may be delisted from NASDAQ. Any delisting of our common shares may adversely affect a shareholder's ability to dispose, or obtain quotations as to the market value, of such shares.

**A more comprehensive list of the risks and uncertainties affecting us can be found in our Annual Report or Form 20-F for the financial year ended December 31, 2008 filed with the Canadian Securities Regulatory Authorities at [www.sedar.com](http://www.sedar.com) and with the United States Securities and Exchange Commission at [www.sec.gov/edgar.shtml](http://www.sec.gov/edgar.shtml) and investors are urged to consult such risk factors.**

### **Disclosure Controls and Procedures**

Under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures as at December 31, 2008. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures are effective as at December 31, 2008.

## Management's Annual Report on Internal Control over Financial Reporting

Æterna Zentaris' management is responsible for establishing and maintaining adequate internal control over financial reporting. Our internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with Canadian GAAP, which differ in certain respects from US GAAP, as discussed above.

Our internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of Æterna Zentaris; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with Canadian GAAP, and that receipts and expenditures of the Company are being made only in accordance with authorizations of Company management; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of Company assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management conducted an evaluation of the effectiveness of our internal control over financial reporting based on the criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this evaluation, management concluded that our internal control over financial reporting was effective as at December 31, 2008.

## Changes in Internal Controls over Financial Reporting

There have been no changes in our internal control over financial reporting during the year ended December 31, 2008 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

During 2008, in the course of our evaluation, we identified significant deficiencies in our internal control over financial reporting which we do not believe, either individually or in the aggregate, resulted in a material weakness to our internal control over financial reporting.

The design of any system of controls and procedures is based in part upon certain assumptions about the likelihood of certain events. There can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, including conditions that are remote.

On behalf of management,

A handwritten signature in cursive script that reads "Dennis Turpin".

Dennis Turpin, CA  
Senior Vice President and Chief Financial Officer  
March 9, 2009