

predict

> to prevent



Corporate Profile

PreMD Inc.'s mission is to realize the promise of predictive medicine to prevent life-threatening diseases, particularly cardiovascular disease and cancer. Our innovative tests include:

- PREVU* Point of Care (POC) Skin Sterol Test
- PREVU* LT Skin Sterol Test (lab-processed format)
- PREVU* PT Skin Sterol Test (consumer format)
- ColorectAlert™
- LungAlert™
- Breast cancer test

PreMD is based in Toronto, Ontario and has research facilities at internationally renowned McMaster University, in Hamilton, Ontario.

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BRENT NORTON, MD, MBA
President and
Chief Executive Officer

2006 Outlook

- **Definitive heart attack data for PREVU* expected**
- **Major milestones expected**
- **Strategic partnership for cancer products a key priority**
- **Potential to break even by year end**

Dear Shareholders and Friends,

This is our first letter to shareholders since changing our name to PreMD Inc., a name rooted in our achievements and evocative of our mission to challenge conventional thinking about disease management with the concept of “predicting to prevent”.

We continued to deliver on that mission in fiscal 2005 on many levels. We worked with McNeil Consumer Healthcare to support the start of PREVU* Point of Care (POC) Skin Sterol Test’s commercialization. We launched significant new studies aimed at expanding PREVU*’s regulatory claims for use and commercial opportunities in multiple markets, including the life insurance industry. We continued to build credibility for PREVU* with presentations in forums such as the American College of Cardiology and Canadian Cardiovascular Congress, and papers published in leading medical journals, such as *Atherosclerosis* and *American Heart Journal*.

Likewise, we took some important strides with our cancer portfolio, including the start of a ColorectAlert™ study with the U.S. National Cancer Institute’s (NCI) Early Detection Research Network (EDRN) and a pivotal study with our breast cancer test at the University of Louisville, as well as the presentation of interim LungAlert™ data from the International Early Lung Cancer Action Program (I-ELCAP) study.

Moreover, we strengthened our financial position by raising CDN\$9.8 million in the U.S. and Canadian capital markets, thereby ensuring that we have the resources to pursue strategic growth initiatives.

While we are proud of these achievements, every business faces challenges, and PreMD is no exception. While the pace of commercialization for PREVU* did not meet our expectations, we are pleased to report that we achieved \$1.6 million in annual revenue, the highest in our history and a base upon which to build.

We are confident in both the need and demand for PREVU*. McNeil’s strategy is focused on pursuing sizable opportunities and developing successful business models in a variety of risk assessment markets that can be replicated on a greater scale, again and again. These opportunities include cardiovascular screening clinics, health and wellness centers, retail health clinics, employee health programs, primary care physicians and the life insurance industry, to name a few. We are encouraged by the scope and potential of the initiatives underway and by McNeil’s increasing – and significant – investment in the technology. Some of these initiatives will be evident in the year ahead.

Where McNeil’s focus is on marketing, PreMD’s is on increasing the value of the PREVU* technology as a predictive test, potentially one that predicts heart attacks. In fiscal 2006, we expect data from the Predictor of Advanced Subclinical Atherosclerosis (PASA) trial, which is examining the relationship between skin cholesterol and carotid intima media thickness (CIMT), and, by reference, heart attack. If the prospective data supports what we have seen in past studies, we anticipate receiving regulatory clearance for PREVU* as a predictive test for risk of heart attack as early as this year.

Message to Shareholders

While there are several tests or tools that can provide information about heart disease risk, there is no simple, non-invasive and effective tool that can predict who is actually going to have a heart attack. In fact, about half of the people who die of heart disease die suddenly, without any prior warning. Clearly, expanding PREVU*'s regulatory claim for use would have tremendous implications for the test's commercial potential as well as the enterprise value of PreMD.

Additionally, data from the ARISE study, expected later this year, will further illuminate the relationship between skin cholesterol and heart attack. It will also provide valuable information about PREVU*'s ability to monitor patient response to AtheroGenics, Inc.'s anti-inflammatory therapy for atherosclerosis, which could ultimately result in an additional regulatory claim and new marketing opportunities for our technology.

Another important PREVU* milestone we are working towards in 2006 is the completion of the PREPARE study for PREVU* LT, the lab-processed format of the skin sterol technology, in the life insurance industry. Pending favorable data, we expect to make regulatory submissions for PREVU* LT in the United States, Canada and Europe.

Likewise, our promising cancer portfolio is an important contributor to PreMD's value. ColorectAlert™, LungAlert™ and our breast cancer test have all shown better sensitivity for early-stage colorectal, lung and breast cancers than other currently available alternatives and are much less expensive.

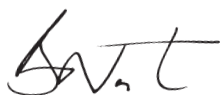
We expect to increase investment in our cancer portfolio to accelerate our push to market. Our ColorectAlert™ study with the EDRN is progressing and we will continue to look for opportunities in 2006 to participate in additional trials. For LungAlert™, we have enrolled the targeted 1,000 patients in the I-ELCAP study, and are aiming to expand our participation in this international study. We are also looking towards the completion of our pivotal breast cancer study. Overall, we are establishing a critical mass of data and have already taken early steps to initiate discussions with potential marketing partners for our cancer portfolio.

Above all, we are committed to reducing the grim toll of cardiovascular disease and cancer around the world. Every year, 17 million people will die from cardiovascular diseases. Colorectal, lung and breast cancers combined claim the lives of about two million people annually. It is the potential of our products to save lives that drives our team to innovate and excel. I extend thanks to our employees for their tireless efforts and dedication.

I would also like to thank you, our shareholders, for your continuing support and enthusiasm for our mission. Collectively, management and insiders own approximately 20 percent of PreMD's outstanding shares. We have a personal stake in PreMD's future and are focused on doing what is necessary to create increased, sustainable value. We expect 2006 to be a productive year as we conclude several clinical and development initiatives. At the same time, we anticipate additional revenues and milestone payments related to the completion of our strategic objectives. As these goals are achieved, we expect to move towards breaking even, possibly by the end of 2006.

We look forward to reporting on our progress throughout the year.

Sincerely,



DR. BRENT NORTON

President and Chief Executive Officer

Management's Discussion and Analysis of Financial Condition and Operating Results

The following discussion and analysis should be read in conjunction with the audited financial statements and notes thereto for the years ended December 31, 2005, 2004 and 2003, which have been prepared in accordance with Canadian generally accepted accounting principles. Some of the statements contained in this Management's Discussion and Analysis of Financial Condition and Operating Results constitute forward-looking statements. These statements relate to future events or to PreMD's future financial performance and involve known and unknown risks, uncertainties and other factors that may cause PreMD's actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements.

Unless otherwise noted, all dollar amounts referenced herein are in Canadian dollars.

VISION

PreMD Inc. ("PreMD" or the "Company"), formerly IMI International Medical Innovations Inc., is a predictive medicine company dedicated to improving health outcomes with non- or minimally invasive tools for the early detection of life-threatening diseases, particularly cardiovascular disease and cancer.

CORPORATE OVERVIEW

PreMD's products are designed to identify those patients at risk for disease. With early detection, cardiovascular disease and cancer can be more effectively treated, or perhaps even prevented altogether. PreMD is developing easy-to-use, accurate and cost-effective tests designed for use right at the point of care, in the doctor's office, at the pharmacy, and, eventually, in some cases, right at home.

Our product development pipeline includes:

Coronary Artery Disease Risk Assessment:

- PREVU* Point of Care ("POC") Skin Sterol Test (cleared for sale in the U.S., Canada and Europe)
- PREVU* LT Skin Sterol Test, a lab-processed format
- PREVU* PT Skin Sterol Test, a consumer format

Cancer Screening Tests:

- ColorectAlert™
- LungAlert™
- Breast cancer test

GROWTH STRATEGY

Our objective is to be a leader in the field of predictive medicine. To achieve this goal, we are pursuing the following strategies:

Identify and Target Significant Markets with Unmet Needs

We concentrate our efforts on medical conditions where there is a well-defined global need and demand for tests to detect serious or life-threatening diseases which we believe we can successfully develop and bring to market. We believe that early detection, intervention and ongoing monitoring can significantly improve patient outcomes.

Ensure a Multiple Product Pipeline

We pursue sustained development by maintaining a portfolio of products at different stages, which helps to mitigate risk while enhancing opportunities to generate value for stakeholders.

We continuously assess and study other possible applications of our technologies. In addition, we continue to seek out and evaluate new, proprietary technologies that have undergone initial proof-of-principle tests and that may offer clear cost/benefit trade-offs to products currently available on the market. The acquisition of new technologies is a key component of our growth strategy.

Maintain a Strong Clinical Program

We maintain an active clinical program and are currently involved in 15 studies. Our objectives are to advance product development and to build a critical mass of data to support new regulatory claims and indications for use. Our clinical program, along with the publications and presentations it generates, enhances the scientific validation and credibility of PreMD's products. In turn, this validation improves strategic partnering opportunities and helps to expand the potential commercial market for our tests.

Pursue Strategic Relationships

We build collaborative relationships with leading companies and institutions to conduct clinical trials and to assist with the development of our products. Some of PreMD's previous and current relationships include The Cleveland Clinic Foundation, U.S. National Cancer Institute, AtheroGenics, Inc., X-Rite, Incorporated, University of Texas M.D. Anderson Cancer Center, Montreal Heart Institute and National Heart, Lung and Blood Institute.

PreMD also seeks, at the appropriate time, to out-license its products to major diagnostic, pharmaceutical or consumer goods companies for any or all of the related marketing, sales, manufacturing and distribution. This strategy allows us to minimize the expenses and risks of large-scale product development and commercialization. In addition, through these relationships, we gain the benefit of others' expertise, which enhances our ability to pursue multiple product opportunities.

Establish and Maintain Strong Intellectual Property Portfolio

Patents and other proprietary rights are essential to our business. We file patent applications to protect technology, inventions and improvements to technology or inventions that are considered important. Such applications may cover composition of matter, the production of active ingredients and their novel applications. PreMD has acquired, by license or assignment, rights to patents and applications filed in Canada, the U.S. and internationally. We also rely upon trade secrets, non-patented proprietary know-how and continuing technological innovation to develop and maintain our competitive position.

KEY STRATEGIC RELATIONSHIP: MCNEIL CONSUMER HEALTHCARE

On May 10, 2002, as amended on December 20, 2002 and December 9, 2005, PreMD entered into an agreement with McNeil Consumer Healthcare ("McNeil"), a Johnson & Johnson company, to market and distribute PreMD's test for coronary artery disease in Canada and in the insurance laboratory field in the United States and Mexico.

The amended agreement provides McNeil with exclusive rights, in these fields and territories, to the professional skin cholesterol test system and the future version for consumer use, both of which will be jointly developed by McNeil and PreMD. The term of the agreement is 15 years and requires McNeil to purchase our skin cholesterol test and to pay ongoing royalties to PreMD on sales, in addition to a series of financial milestone payments of up to \$3.3 million which will be based on McNeil's achievement of specified annual sales levels of the licensed products. PreMD may terminate this agreement if certain minimum levels of sales are not met.

On May 28, 2004, as amended on December 9, 2005, PreMD completed an exclusive worldwide licensing agreement with McNeil to sell PreMD's skin cholesterol tests under the brand name PREVU* Skin Sterol Test, expanding on the previous agreement. Under the financial terms of the agreement, which has a minimum term of 10 years, PreMD received a \$3.0 million up-front payment and can receive a series of additional payments of up to \$16.4 million (over and above the Canadian agreement payments) upon the achievement of specific milestones. In addition to revenue for the sales of products to McNeil, PreMD will also receive royalties on McNeil's sales of the products.

In fiscal 2005 McNeil made PREVU* POC Skin Sterol Test available for sale to medical professionals in North American and select European markets.

CONVERTIBLE DEBENTURE FINANCING

On August 30, 2005, PreMD completed a private placement financing of convertible debentures, maturing on August 30, 2009, for gross proceeds of \$9,828,000 (US\$8,210,000) less issue fees and expenses of \$862,000 (resulting in net proceeds of \$8,966,000). The unsecured debentures bear interest at an annual rate of 7% payable quarterly in cash or common shares at the Company's option. The number of common shares issuable in satisfaction of interest payments is dependent on the trading price of common shares at the time of the applicable interest date. The debentures are convertible into common shares at any time during the term, at the option of the holder, at \$3.47 per share (subject to adjustment). If all the debentures were converted to common shares, it would result in the issuance of an additional 2,882,195 common shares. Purchasers of the convertible debentures also received warrants to purchase 1,288,970 common shares at any time before August 30, 2010 at an exercise price of \$3.57 per common share (subject to adjustment). At any time after one year from the date of issuance of the warrants, the warrants may also be exercised by means of a cashless exercise by the holder.

Under Canadian GAAP, the convertible debentures are separated into liability, equity and warrant components, net of pro rata issue fees and expenses, as described in note 5 to the consolidated financial statements.

Under U.S. GAAP, no value is assigned to the equity conversion feature of the convertible debentures but a value is assigned to the warrants. The issue fees and expenses are fully deferred and are amortized over the life of the debentures. This difference is described more fully in note 10 to the consolidated financial statements.

Use of Proceeds

On August 30, 2005, we reported that the net proceeds of the financing would be used for working capital purposes, including to:

- Accelerate the development of the cancer portfolio;
- Expand the Company's pipeline of technologies; and
- Pursue strategic growth opportunities.

A summary of the use of proceeds is as follows:

Description of Use of Proceeds	Estimated Total Use of Proceeds	Approximate Use of Proceeds October 1– December 31, 2005
Accelerate the development of cancer tests	\$ 3,000,000	\$ 236,000
Other general working capital	5,966,000	1,112,000
Total	\$ 8,966,000	\$ 1,348,000

MARKET POTENTIAL

Market for Disease Detection

Predictive medicine is an important growth market, driven by four key factors:

The Aging Population

As the population ages, the incidences of both cardiovascular disease and cancer increase, among other diseases. According to the most recent United States Census Bureau data published in 2000, the U.S. population aged 65 and older is projected to double by 2030. By 2030, individuals aged 65 and older will account for 20% of the U.S. population. Around the world, the aging population has contributed to dramatic growth in health care spending.

Escalating Health Care Costs

In most countries around the world, total health care spending is at an unsustainable level. In many nations, including the United States, health care spending is growing at a rate that exceeds economic growth. In 2004 in the U.S., health care spending accounted for approximately 15.3% of the gross domestic product. Faced with escalating expenditures, governments, insurers and consumers are evaluating and implementing cost containment strategies. We believe that technologies that are patient-friendly, easy to use and cost effective while maintaining quality of care represent a significant market opportunity.

Innovative Technologies Enable Improved Risk Assessment

Technological advances have created more effective, easy-to-use devices, enabling risk assessment to be moved closer to the patient. This has resulted in the earlier, more cost-effective identification of disease and the initiation of therapy or prevention at an earlier stage. The use of screening and monitoring diagnostics for early intervention, improved treatment and ongoing monitoring has emerged as an important component of managed health care.

Trend Towards Health Self-Management

The trend towards greater use of point-of-care testing and self-diagnosis began in the early 1980s and is expected to continue. Increasingly, people are focused on personal wellness and the vital role of the individual in health maintenance. Similarly, the aging population is demanding better preventative care that is patient-friendly.

Theta Reports projected strong growth in the worldwide market of total point-of-care tests performed in a professional setting (in a physician's office, at a pharmacy, etc.) from 2000 to 2005. Similarly, between 2002 and 2007 the global over-the-counter ("OTC") market for home diagnostic testing is expected to increase by 49%, at a compound annual growth rate of 8.3%.

Coronary Artery Disease ("CAD") Risk Assessment: The Role of Skin Sterol

Overview

According to the most recent data available from the World Health Organization, cardiovascular diseases, particularly heart attack and stroke, claim the lives of 17 million worldwide annually. Coronary artery disease, or heart disease, accounts for 7.2 million of these deaths. According to the American Heart Association, in the U.S., every 26 seconds an American will suffer a coronary event, and about every minute someone will die from one.

Cholesterol is a soft, waxy substance that is produced by the body, as well as obtained from eating certain foods, such as meat, eggs, and other animal products. Cholesterol is transported in the blood by plasma lipoproteins. The deposit of cholesterol on to damaged blood vessel walls results in the development of a lesion that eventually reduces the intravascular space as well as the flexibility of the afflicted blood vessel. This atherosclerotic plaque results in increased risk not only for coronary artery disease, but also for angina pectoris and sudden cardiac death, stroke, and peripheral vascular disease.

Traditional Risk Factors

High blood cholesterol is considered to be a major risk factor for coronary artery disease. In the U.S., the National Cholesterol Education Program, a nationwide effort to reduce the prevalence of high blood cholesterol launched by the U.S. National Institutes of Health in 1985, has spurred significant growth in the market for cholesterol and other risk assessment tests. Clinical laboratories in the U.S. are estimated to perform approximately 250 million cholesterol tests per year and another 290 million clinical laboratory tests are performed in the rest of the world.

However, blood cholesterol tests may be highly variable in results over a series of days, are relatively expensive to perform and require a fasting blood sample from the patient. Additionally, several studies suggest that about half of all heart attack patients actually have blood cholesterol levels within what is considered a normal, healthy range.

While blood cholesterol remains an important risk factor for heart disease, it is widely accepted that several risk factors for CAD must be considered together to provide an accurate picture of absolute risk of disease.

Absolute cardiovascular disease risk is determined by a combination of all cardiovascular risk factors present, and accurate assessment of risk level is the key to effective treatment and risk management. Other traditional risk factors include increasing age, heredity, tobacco smoking, high blood pressure, physical inactivity, diet, obesity and diabetes mellitus. A number of other emerging factors that have demonstrated a link to heart disease include C-reactive protein ("CRP"), homocysteine, carotid intima-media thickness ("CIMT"), electron-beam tomography for coronary calcium, ankle/brachial blood pressure index ("ABI"), and soluble intercellular adhesion molecule ("ICAM-1"), among others. Many of these factors are costly to measure or assess, are resource intensive and inappropriate for a primary care setting, and require invasive procedures.

Skin Sterol: A New Risk Factor for Coronary Artery Disease

PREVU* POC Skin Sterol Test is a patient-friendly and cost-effective tool that assesses patients at risk of coronary artery disease.

PREVU* non-invasively measures the amount of cholesterol, or sterol, in the skin tissues. As a new risk factor for heart disease, skin sterol provides valuable additional information to traditional CAD risk assessment. Skin contains over 11% of the body's cholesterol and ages in parallel with vascular connective tissue. As blood vessel walls accumulate cholesterol, the skin tissues also accumulate cholesterol. Clinical studies suggest that skin sterol, a new risk factor for heart disease, can distinguish healthy individuals, those at risk of developing atherosclerosis and those with overt disease. Emerging evidence supports the use of non-invasive tests, such as skin sterol, to detect subclinical, or hidden, disease. Identifying patients with high subclinical cardiovascular disease is the key to preventing a first cardiac event and reducing the overall burden of heart disease.

Management's Discussion and Analysis of Financial Condition and Operating Results

Competitive Landscape

We are not aware of any other test currently marketed or in development that non-invasively measures skin cholesterol. We are aware that research has been undertaken using other testing approaches that employ body fluids, such as saliva and tears. The stage of development of such approaches is unknown. We have 38 issued patents and patents pending internationally related to the skin sterol technology and nine patents and patents pending related to our color-reading technology, which is used across PreMD's product lines.

Cancer: Screening Tests for Early-Stage Disease

Overview

The American Cancer Society defines cancer as a group of diseases characterized by uncontrolled growth and spread of abnormal cells. If the spread is not controlled, it can result in death. Cancer is the second leading cause of death in the U.S., with 564,830 deaths expected in 2006, exceeded only by heart disease.

Cancer is caused by both external factors, such as tobacco, chemicals and diet, and internal factors, such as inherited mutations and mutations that occur from metabolism. Although anyone can be diagnosed with cancer, the risk of developing cancer increases as an individual ages, with most cases affecting adults beginning in middle age. About 76% of cancers are diagnosed in persons aged 55 and older.

Preventing cancer and improving health outcomes depend in part on lifestyle changes and more effective treatment options. Preventing cancer is also contingent on early detection and better screening tests to identify disease at the very earliest stage possible. Many of the clinical tests currently in use are not sufficiently sensitive or specific to detect all cancers at a curable stage or to evaluate risk accurately enough to guide effective interventions. Currently, just 39% of colorectal cancers are found at an early, localized stage. Only 16% of lung cancers are detected at a localized stage. Most breast cancers have been present for six to 10 years by the time they are detected by mammography.

PreMD's Novel Cancer Tests: Detecting Early-Stage Disease

The use of early detection and risk assessment biomarkers will enable the detection of cancer at its earliest stages and identify those people at risk for cancer before they develop the disease. Accordingly, intervention efforts can be focused on prevention rather than treatment.

PreMD's tests offer significant advantages to currently available alternatives based on sensitivity, ease of use, convenience, patient compliance and cost.

Our patented cancer technology detects a carbohydrate marker, or sugar, associated with cancerous and pre-cancerous conditions. This sugar is detected by a chemical reaction performed on a specimen placed on a test membrane by a physician following a routine exam; the test does not require a blood sample, dietary restrictions or any patient preparation. To date, we have developed three effective, painless and low-cost tests based on this technology for early-stage colorectal cancer, using a sample of rectal mucus; for lung cancer, using a sample of sputum coughed up from the lungs; and to detect breast cancer, using nipple aspirate fluid.

Our tests have performed well in clinical studies to date:

- ColorectAlert is the only low-cost test that we are aware of reporting greater than 50% sensitivity for early-stage disease;
- LungAlert has been shown to identify more than half of all early-stage cancers; and
- In initial studies, the breast cancer test has been shown to identify early-stage disease.

There is an urgent need for affordable, easy-to-use initial screening tests for early-stage colorectal, lung and breast cancers. Such tests could be used to identify those high-risk patients who would benefit from sophisticated, more expensive diagnostic tests such as colonoscopy, spiral computed tomography ("CT") and mammography.

Competitive Landscape

We are aware of other diagnostic tests under development for the detection of colorectal, lung and breast cancers and are currently monitoring their progress. For colorectal cancer, some of the firms involved in the development or marketing of products include Enterix Inc., EXACT Sciences Corporation and E-Z-EM Inc.

To our knowledge, there are no U.S. Food and Drug Administration ("FDA")-approved tumor markers for lung cancer, although several are believed to be in development. Several tests for lung cancer exist, but due to their low ability to detect cancer or their high cost, management believes that they are not suitable for cancer screening. Other companies developing diagnostic tests for lung cancer are Biomoda Inc., Xillix Technologies Corp. and Perceptronix Medical Inc.

In the breast cancer field, other companies are developing relatively expensive proteomic- and genomic-based screening tests for cancer using nipple aspirate fluid, including Power3 Medical, Cytoc Corporation and NeoMatrix LLC.

We have 22 patents and patents pending internationally related to our cancer technologies, and nine patents and patents pending related to our color-reading technology, which is used across PreMD's product lines.

GOALS AND ACHIEVEMENTS

	2005 Goals	2005 Achievements	2006 Goals
PREVU* Skin Sterol Test	Sales launch of PREVU* POC	PREVU* POC made available for sale to medical professionals in U.S., Canada and select European markets	<ul style="list-style-type: none"> • Complete insurance study and marketing launch • Complete PASA¹ study • Achieve expanded regulatory claims for PREVU* POC in U.S. • Achieve regulatory clearance for PREVU* LT in U.S., Canada and E.U. • Publish and present data in scientific publications and forums • Complete development and internal validation of home test
	Additional publications and presentations	Four scientific presentations and four publications	
	Launch major study in insurance testing industry	Launched study with LabOne and a number of life insurers	
	Complete Montreal Heart Institute study	Enrolled one-third of study's targeted 600 patients	
	Initiate regulatory process for PREVU* LT in Canada and E.U.	Contingent upon data from clinical studies, particularly PASA and the insurance study	
	Initiate clinical trial for home test	Prototype development continued to address stability of reagents	
	Initiate major study to expand regulatory claims for PREVU* POC	PASA study initiated at six sites in U.S.	
	Secure reinstatement of two abandoned skin sterol patents	Petition to U.S. PTO ² was denied; subsequently filed request for reconsideration in February 2006	<ul style="list-style-type: none"> • Pursue legal action against law firm responsible for managing PreMD's patent portfolio at the time when the maintenance fees for the two patents in question should have been paid
ColorectAlert	Start major clinical trial	Began study with the U.S. NCI's Early Detection Research Network ("EDRN") for a major validation study including a variety of markers for colorectal cancer	<ul style="list-style-type: none"> • Advance EDRN study • Initiate an additional clinical trial • Initiate partnering discussions
LungAlert	Work with I-ELCAP ³ to expand role to additional sites	Successfully completed enrollment of targeted 1,000 patients at Princess Margaret Hospital	<ul style="list-style-type: none"> • Expand role in I-ELCAP at Princess Margaret Hospital in Toronto • Add an additional I-ELCAP site • Initiate partnering discussions • Submit data for publication and/or presentation
	Develop additional studies at Princess Margaret Hospital in Toronto	Continuing to evaluate opportunities	
Breast Cancer Test	Start pivotal breast cancer study	Started pivotal study at the University of Louisville	<ul style="list-style-type: none"> • Complete pivotal study • Initiate partnering discussions • Submit data for publication and/or presentation

⁽¹⁾ Predictor of Advanced Subclinical Atherosclerosis

⁽²⁾ United States Patent and Trademark Office

⁽³⁾ International Early Lung Cancer Action Program

CLINICAL PROGRAM

PreMD maintains an active clinical program. Please refer to our Annual Information Form for the fiscal year ended December 31, 2005, available at www.sedar.com, for a summary of the development and clinical evaluations of our skin sterol and cancer technologies to date.

CRITICAL ACCOUNTING POLICIES AND CRITICAL ACCOUNTING ESTIMATES

PreMD prepares its consolidated financial statements in accordance with Canadian generally accepted accounting principles ("Canadian GAAP") consistently applied within the framework of the significant accounting policies summarized below. The significant differences between Canadian and United States generally accepted accounting principles ("U.S. GAAP") are described and reconciled in note 10 to the consolidated financial statements as at and for the year ended December 31, 2005. Our critical accounting policies include basis of consolidation, foreign currency translation, use of estimates, financial instruments, inventory, deferred financing fees, revenue recognition, recording of research and development expenses, useful lives of capital assets and of acquired technology, recovery of tax credits, the valuation of stock-based compensation and income taxes.

New Pronouncements

Effective January 1, 2005, PreMD adopted the guidelines relating to the disclosure requirements of variable interest entities as required by the Canadian Institute of Chartered Accountants' ("CICA") Accounting Guideline No. 15 ("AcG-15"), "Consolidation of Variable Interest Entities". There was no impact as a result of adopting this pronouncement.

The CICA issued Section 1530 of the CICA Handbook, "Comprehensive Income", effective for fiscal years beginning on or after October 1, 2006. The section describes how to report and disclose comprehensive income and its components. Comprehensive income is the change in a company's net assets that results from transactions, events and circumstances from sources other than the company's shareholders. It includes items that would not normally be included in net earnings, such as unrealized gains or losses on available-for-sale investments.

The CICA also made changes to Section 3250 of the CICA Handbook, "Surplus", and reissued it as Section 3251, "Equity", also effective for fiscal years beginning on or after October 1, 2006. The changes in how to report and disclose equity and changes in equity are consistent with the new requirements of Section 1530, "Comprehensive Income". Adopting these sections on January 1, 2007 will require us to start reporting the following items in the consolidated financial statements: (i) comprehensive income and its components; and (ii) accumulated other comprehensive income and its components.

The CICA issued Section 3855 of the CICA Handbook, "Financial Instruments – Recognition and Measurement", effective for fiscal years beginning on or after October 1, 2006. It describes the standards for recognizing and measuring financial assets, financial liabilities and non-financial derivatives. This section requires that:

- All financial assets be measured at fair value, with some exceptions, such as loans and investments that are classified as held-to-maturity;
- All financial liabilities be measured at fair value if they are derivative or classified as held for trading purposes. Other financial liabilities are measured at their carrying value; and
- All derivative financial instruments be measured at fair value, even when they are part of a hedging relationship.

We are currently evaluating the impact on our consolidated financial statements of adopting this section on January 1, 2007.

Management's Discussion and Analysis of Financial Condition and Operating Results

The CICA issued Section 3861 of the CICA Handbook, "Financial Instruments – Disclosure and Presentation". Adopting this section would impact the classification of a financial instrument, or its component parts, as a liability or as an equity instrument in accordance with the substance of the contractual arrangement on initial recognition. We are currently evaluating the impact on our consolidated financial statements of adopting this section on January 1, 2007.

The CICA recently issued Section 3865 of the CICA Handbook, "Hedges". The section is effective for fiscal years beginning on or after October 1, 2006, and describes when and how hedge accounting can be used. Hedging is an activity used by a company to change an exposure to one or more risks by creating an offset between:

- Changes in the fair value of a hedged item and a hedging item; and
- Changes resulting from a risk exposure relating to a hedged item and a hedging item.

Hedge accounting ensures that all gains, losses, revenues and expenses from the derivative and the item it hedges are recorded in the income statement in the same period. We are currently evaluating the impact on our consolidated financial statements of adopting this section on January 1, 2007.

Basis of Consolidation

The accompanying consolidated financial statements include the accounts of the company and its wholly owned subsidiaries, PreMD International Inc., Berne, incorporated under the laws of Switzerland, and 6211178 Canada, Inc., incorporated under the laws of Canada. All significant intercompany transactions have been eliminated upon consolidation.

Foreign Currency Translation

Foreign operations are considered integrated and are translated using the temporal method. Monetary items are translated using the exchange rate in effect at the year end and non-monetary items are translated at historical exchange rates. Revenue and expenses are translated at the average rate for the year except for amortization of capital assets, which is translated at the same exchange rates as the assets to which it relates. Exchange gains or losses are included in the determination of net loss for the year.

Use of Estimates

In preparing the consolidated financial statements in conformity with Canadian GAAP, PreMD is required to make estimates and assumptions that affect the recorded amounts of assets and liabilities, the disclosure of contingent assets and liabilities as at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ materially from these estimates. Significant estimates made by management include stock option valuation assumptions, achievement of milestones for stock options, valuation of acquired technologies, useful lives of long-lived assets, and accruals for clinical trials in process based on percentage completion.

Financial Instruments

The carrying values of cash and cash equivalents, short-term investments, other receivables and accounts payable and accrued liabilities are considered to approximate their respective fair values due to their short-term nature.

The fair values of the equity and warrant components of the convertible debentures are recorded as "equity component of convertible debentures" and "warrants", respectively, net of allocated financing costs. The carrying value of the convertible debentures is recorded as a liability and is being accreted to its maturity value through charges to income for the imputed interest.

Inventory

Inventory of raw materials is valued at the lower of cost and replacement cost. Inventories of finished goods are valued at the lower of cost and net realizable value, determined on a first-in, first-out basis.

Deferred Financing Fees

Financing fees relating to the issue of convertible debentures are pro-rated between the liability and the equity and warrant components of the debentures. The expenses related to the liability component are deferred and are amortized on a straight-line basis over the term of the debentures. Should the debentures be converted, the unamortized balance of financing costs will be transferred to capital stock. The “equity component of convertible debentures” and “warrants” are recorded net of the respective allocated financing costs.

Capital Assets

Capital assets are recorded at acquisition cost less accumulated amortization.

Purchases of molds required for the manufacture of products are capitalized and amortized over the useful life of the asset on the basis of units produced. The amortization expense for molds is recorded as a cost of inventory.

We provide for amortization on a declining balance basis, unless otherwise indicated, at rates which are expected to charge operations with the cost of the assets over their estimated useful lives as follows:

Manufacturing equipment	useful life on basis of units produced
Computer equipment	30%
Furniture and equipment	20%
Research instrumentation	30%
Laboratory equipment	20%
Leasehold improvements	straight-line over the term of the lease

Acquired Technology

Patents and technology acquired by PreMD are recorded at acquisition cost and are amortized on a declining balance basis at 20% per year. Management reviews the value of unamortized technology costs annually by comparing the value to the future potential revenue or benefits. We record a writedown in acquired technology when there is a change in circumstances, such as unfavorable clinical trial results, suggesting an impairment has occurred.

Revenue Recognition

The Company earns 100% of its revenue from one customer, under the terms of two contracts. These contracts outline the terms for all products and services provided to the customer, and are considered multiple revenue arrangements. Under the terms of EIC 142 – “Revenue Arrangements with Multiple Deliverables”, products and services under these contracts are separated into units of accounting for revenue recognition purposes.

Non-refundable, up-front payments received from licensees are deferred and recognized into income on a straight-line basis over the respective terms of the agreements. Milestone payments received from licensees are recorded as income in the period when the respective milestones are achieved. Revenue from sales of products to licensees is recognized when title passes to the customers, which generally occurs when the products are shipped to the licensee, provided that PreMD has not retained any significant risks of ownership or future obligations with respect to the products shipped. Royalty revenues are based on sales by licensees and are recorded as income in the period earned and reported by the licensees.

Research and Development and Related Investment Tax Credits

Research and development expenditures include related salaries, subcontractor fees, product development expenses including patent costs, clinical trials costs and an allocation of administrative expenses and corporate costs specifically attributable to research and development. Research and development excludes any costs associated with the acquisition of capital assets and acquired technology. Research and development expenditures are charged to expenses as incurred unless management believes a development cost meets the generally accepted criteria for deferral. All development costs incurred to date have been expensed. Reimbursements for specific expenditures received through collaboration funding have been applied against research and development expense.

Management's Discussion and Analysis of Financial Condition and Operating Results

Investment tax credits earned as a result of incurring qualified scientific research and experimental development expenses are recorded when the amounts are readily determinable. The amounts are recorded as follows:

- For capital assets – as a reduction of the cost of the related asset; and
- For operating expenses – as a recovery within the consolidated statements of loss and deficit.

Stock-Based Compensation

We have two stock-based compensation plans for employees, directors and consultants, which are described in note 6(d) to the consolidated financial statements. Certain of the stock options granted vest over a fixed term and others vest based on performance upon the achievement of certain milestones, although no performance options have been granted since 2002.

CICA Handbook Section 3870 requires that options issued be accounted for using the fair value method of accounting. Non-cash compensation expense for fixed term options is recorded over the term of the vesting period whereas compensation expense for performance options is recorded when it is determined that achievement of the milestone is likely. Prior to 2003, no compensation expense was recognized for stock options granted to employees. For stock options awarded to employees prior to January 1, 2003 but subsequent to January 1, 2002, pro forma disclosure of net loss and net loss per share is provided as if these awards were accounted for using the fair value method. Consideration paid on the exercise of stock options and warrants is credited to capital stock.

Shares issued to employees under the share purchase plan are accounted for as direct awards of stock and are recognized as a non-cash compensation expense in the consolidated statements of loss and deficit.

Income Taxes

PreMD applies the asset and liability method of accounting for income taxes. Under this method, future income tax assets and liabilities are determined based on differences between the financial reporting and tax bases of assets and liabilities and are measured using substantively enacted tax rates and laws that are expected to be in effect when the differences are expected to reverse. Valuation allowances are provided if it is more likely than not that some or all of the future tax assets will not be realized.

ECONOMIC DEPENDENCE

Sales to one customer represented 100% of total sales in 2005 (2004 – 100%). Accounts receivable from this customer represented approximately 99% of the total receivable at December 31, 2005 (2004 – 100%).

DISCLOSURE CONTROLS AND PROCEDURES

Our corporate disclosure policy outlines our approach to the determination and dissemination of material information and the circumstances under which confidentiality of information will be maintained. The policy extends to the conduct of directors, officers, spokespersons and other employees and agents of the Company and all methods that the Company uses to communicate to the public.

The Chief Executive Officer and Chief Financial Officer of the Company have evaluated the effectiveness of PreMD's disclosure controls and procedures as of December 31, 2005 and have concluded that our disclosure controls and procedures are effective and provide reasonable assurance that material information relating to the Company is reported to them in a timely manner and that such information is disclosed within the time periods specified under the applicable legislation.

OPERATING RESULTS

Annual Financial Information

The following selected financial information has been derived from the audited consolidated financial statements of PreMD as at and for the years ended December 31, 2005, 2004 and 2003.

Operating Results	Year Ended December 31, 2005	Year Ended December 31, 2004	Year Ended December 31, 2003
Product sales	\$ 425,730	\$ 183,258	\$ nil
License revenue	1,153,308	302,080	16,900
Total expenses	6,512,146	6,192,649	4,561,179
Investment tax credits	198,923	205,000	223,146
Interest income	173,130	123,626	258,422
Net Loss	\$ 4,989,705	\$ 5,568,899	\$ 4,062,711
Net loss per share: basic and diluted	\$ 0.23	\$ 0.26	\$ 0.19
Financial Position	December 31, 2005	December 31, 2004	December 31, 2003
Total assets	\$ 11,293,190	\$ 6,996,079	\$ 8,074,027
Long-term debt	5,893,340	nil	nil
Shareholders' Equity			
Total shareholders' equity	\$ 1,844,297	\$ 2,496,842	\$ 7,438,279
Cash dividends declared per share	\$ nil	\$ nil	\$ nil

As at the date of this Management's Discussion and Analysis of Financial Condition and Operating Results, the total issued and outstanding common shares of the Company were 21,553,112.

YEAR ENDED DECEMBER 31, 2005 COMPARED WITH 2004

Net Loss

The consolidated loss for the year ended December 31, 2005 was \$4,990,000 or \$(0.23) per share compared with a loss of \$5,569,000 or \$(0.26) per share for the year ended December 31, 2004, a decrease of \$579,000. The improvement resulted from an increase in sales and license revenue of \$1,094,000, which was partially offset by an increase in interest and imputed interest of \$484,000 on convertible debentures, issued on August 30, 2005.

Revenue

Product sales of PREVU* Skin Sterol Tests to our licensee, McNeil Consumer Healthcare, amounted to \$426,000 in 2005 compared with \$183,000 in 2004. McNeil made PREVU* POC available for sale in 2005 to medical professionals in Canada, the U.S. and select European markets.

Management's Discussion and Analysis of Financial Condition and Operating Results

As reported in 2004, we completed a worldwide licensing agreement with McNeil to sell our cardiovascular products under the brand name PREVU* Skin Sterol Test. The upfront cash payments from both the worldwide agreement and the original Canadian agreement of \$3,000,000 and \$100,000, respectively, have been deferred and are being recognized into income on a straight-line basis over the relative terms of the agreements (10 and 15 years, respectively). Thus, the amounts being recognized into income for 2005 and 2004 are \$307,000 and \$182,000, respectively. Furthermore, minimum sales levels in the agreement provided additional revenue of \$194,000 and \$120,000 in 2005 and 2004, respectively, which was reported as license revenue. Milestone revenues amounted to a further \$638,000 in license revenue for 2005 compared with nil in 2004. Total license revenue amounted to \$1,153,000 for 2005 compared with \$302,000 in 2004.

Cost of Sales and Gross Profit

Cost of product sales exceeded sales for 2005 by \$3,000, compared to \$7,000 in 2004. The loss resulted from development costs for label and software changes to inventory. It is expected that sales will generate positive gross margins in the future.

Research and Development

Research and development expenditures for the year increased by \$507,000 to \$3,120,000 from \$2,613,000 in 2004.

The variance for the year reflects:

- A \$410,000 increase in spending on clinical trials for skin cholesterol and cancer to \$898,000 from \$488,000 in 2004. This increase is related to additional trials for skin cholesterol to lead to additional regulatory approvals, a new trial for breast cancer and continuation of the lung cancer trial (the "I-ELCAP" study). PreMD currently has 15 clinical trials ongoing;
- Increased legal fees on intellectual property, which amounted to \$331,000 compared with \$292,000 in fiscal 2004. These costs include \$189,000 in 2005 (\$96,000 in 2004) related to the petition for reinstatement of two U.S. patents for skin cholesterol that had been deemed abandoned;
- An increase of \$135,000 in subcontract research to \$451,000 in support of the development of a second-generation color reader for the skin cholesterol test. This was partially offset by a decrease in product development expenditures for supplies of \$55,000;
- An increase in stock-based compensation expense of \$23,000 resulted in non-cash expenses for research personnel of \$147,000 in 2005 compared with \$124,000 for 2004. This reflects the amortization of the 2003 and 2004 grants as well as the 2005 grants; and
- A decrease in compensation of \$53,000, reflecting lower incentive payments for the year for performance milestones.

In August 2004, PreMD learned that two of its U.S. patents had been listed as abandoned by the United States Patent and Trademark Office ("U.S. PTO") for failure to pay maintenance fees. The failure to pay these maintenance fees occurred when the files were transferred between U.S. and Canadian patent agents. PreMD filed a petition for reinstatement of the patents.

In response to this petition, in February 2005 the U.S. PTO denied PreMD's request for reinstatement but identified specific items that PreMD should address, specifically regarding the credentials and procedures of PreMD's patent agents and their performance of clerical functions related to the payment of the maintenance fees. In June 2005, PreMD filed a request for consideration. On December 23, 2005, the U.S. PTO notified PreMD of its decision not to reinstate the two patents. Subsequent to year end, in February 2006 PreMD filed a request for reconsideration with the U.S. PTO. PreMD has authorized legal action against the law firm that was responsible for managing its patent portfolio at the time when the maintenance fees for the two patents in question should have been paid. The U.S. PTO found that the patents lapsed as a result of the law firm's failure to use its established docketing procedures regarding payment of the maintenance fees. Damages claimed in that action have yet to be quantified.

General and Administration Expenses

General and administration expenses amounted to \$2,655,000 compared with \$3,355,000 in 2004, a decrease of \$700,000.

The decrease for the year reflects:

- A reduction of \$434,000 in professional expenses resulting from the non-recurring expenditure of \$478,000 incurred in 2004 for the unsolicited offer to acquire the shares of IBEX Technologies Inc. ("IBEX");
- A reduction of \$54,000 in stock-based compensation for options for administrative personnel and consultants. This resulted in a non-cash expense of \$422,000 compared with \$476,000 in 2004. The 2004 amount included \$95,000 as the fair value of the cashless exercise of options by an officer of PreMD;
- A reduction in investor relations expenses by \$61,000 following the completion of some consulting contracts during 2005;
- A reduction in compensation of \$38,000, reflecting lower incentive payments for 2005 for performance milestones; and
- A reduction of \$45,000 in travel expenses as a result of fewer international business development meetings.

Interest on Convertible Debentures

Interest on convertible debentures (issued on August 30, 2005) amounted to \$228,000 in 2005 compared to nil in 2004. The debentures bear interest at an annual rate of 7%, payable quarterly in either cash or stock. Imputed interest of \$256,000 (compared to nil in 2004) represents the amortization of the fair value of the warrants and equity component of the debentures.

Amortization

Amortization expenses for equipment and acquired technology for 2005 amounted to \$210,000 compared with \$224,000 in 2004. The amortization of production molds amounted to \$3,000 in 2005 (2004 – \$7,000), and was recorded as a cost of inventory. Purchases of equipment to support administration, clinical trials and manufacturing amounted to \$130,000 in 2005 and \$165,000 in 2004. Amortization of deferred financing fees amounted to \$43,000 for 2005 compared to nil in 2004. The financing fees are amortized over the life of the convertible debentures.

Investment Tax Credits

Recoveries of provincial scientific investment tax credits ("ITCs") amounted to \$199,000 for 2005 compared with \$205,000 in 2004.

Management's Discussion and Analysis of Financial Condition and Operating Results

Interest Income

Interest income amounted to \$173,000 for 2005, compared with \$124,000 for 2004. The increase resulted from the investment of the proceeds on the convertible debentures in August 2005.

U.S. GAAP

For purposes of U.S. GAAP, the consolidated loss for 2005 was \$4,782,000 compared with \$5,478,000 in 2004.

Other

The increase in accounts receivable as at December 31, 2005 reflects the milestone revenues receivable from our licensee, referred to above under "Revenue".

The financing fees related to the convertible debenture are pro-rated between the debt and the fair value of the equity and warrant features. The debt portion is deferred and amortized over the term of the debenture. The unamortized portion amounted to \$478,000 at December 31, 2005.

There is a significant decrease of \$730,000 in accounts payable in 2005 compared with 2004. The 2004 amount included an amount for the purchase of inventory of approximately \$340,000 and most of the expenses related to the IBEX offer.

In August 2005, PreMD issued \$9,828,000 (US\$8,210,000) unsecured convertible debentures. As explained in note 5 to the consolidated financial statements, \$5,893,000 is recorded as a liability, \$1,178,000 as warrants and \$2,393,000 as an equity instrument.

YEAR ENDED DECEMBER 31, 2004 COMPARED WITH 2003

Net Loss

The consolidated loss for the year ended December 31, 2004 was \$5,569,000 or (\$0.26 per share) compared with a loss of \$4,063,000 or (\$0.19 per share) for the year ended December 31, 2003, an increase of \$1,506,000.

Revenue

In 2004, we made initial shipments of PREVU* Skin Sterol Test to our marketing partner, McNeil Consumer Healthcare, for total product-related sales of \$183,000.

In Q2 2004, we completed a worldwide licensing agreement with McNeil to sell our cardiovascular products under the brand name PREVU* Skin Sterol Test. The upfront cash payments from both the worldwide agreement and the original Canadian agreement of \$3,000,000 and \$100,000, respectively, have been deferred and are being recognized into income on a straight-line basis over the terms of the agreements (10 and 15 years, respectively). Thus, the amounts being recognized into income for 2004 and 2003 are \$182,000 and \$17,000, respectively. Furthermore, minimum sales levels in the agreement provided an additional \$120,000 revenue in 2004 which was reported as license revenue. Therefore, total license revenue amounted to \$302,000 for 2004 compared with \$17,000 in 2003.

Research and Development

Research and development expenditures for the year increased by \$694,000 to \$2,613,000 from \$1,919,000 in 2003.

The variance for the year reflected:

- A \$253,000 increase in spending on clinical trials for skin cholesterol and cancer to \$488,000 from \$235,000 in 2003. This increase was related to the I-ELCAP lung cancer trial and the large skin cholesterol study with AtheroGenics, Inc. that commenced in the latter part of 2003;
- Increased filing fees on intellectual property, which amounted to \$196,000 compared with \$92,000 in fiscal 2003. During the year, we filed new patents on skin cholesterol in numerous European countries. In addition, we incurred costs of \$96,000 related to filing a petition for reinstatement of two U.S. patents for skin cholesterol that had been deemed abandoned;
- Increases in total compensation and benefits for research personnel of \$221,000, reflecting annual increases plus accruals for incentive compensation based on performance;
- Increases in subcontract research expenditures of \$114,000, as we continued further development of new prototypes of laboratory and consumer (over-the-counter) formats of the skin cholesterol technology; and
- A reduction in stock-based compensation, which was prospectively adopted in 2003, resulted in non-cash expenses for research personnel of \$124,000 in 2004 compared with \$189,000 for 2003, reflecting fewer options being granted in 2004.

General and Administration Expenses

General and administration expenses amounted to \$3,355,000 compared with \$2,362,000 in 2003, an increase of \$993,000. The increase for the year reflected:

- A non-recurring cost of \$478,000 in 2004 related to our unsolicited offer to acquire the shares of IBEX. We allowed the offer to expire in December 2004 and did not complete the purchase;
- A \$221,000 increase in stock-based compensation for options for administrative personnel that resulted in a non-cash expense of \$476,000 for the year compared with \$255,000 for 2003. This increase was primarily for options granted in 2004 pursuant to a U.S. consulting contract that vested over nine months and for the cashless exercise of options by an officer of PreMD;
- An \$80,000 increase in professional fees, primarily due to legal fees related to finalizing the global licensing agreement with McNeil;
- A \$64,000 increase in insurance premiums over 2003 as a result of our listing on the American Stock Exchange ("Amex") in September 2003;
- A reduction to nil in 2004 (\$179,000 in 2003) for costs related to PreMD's U.S. listing on Amex in 2003;
- A reduction in travel expenses by \$76,000 following completion of the McNeil agreement as a result of less foreign travel; and
- An increase of \$160,000 in total compensation and benefits for administration personnel reflecting annual increases plus accrued incentive compensation based on performance.

Management's Discussion and Analysis of Financial Condition and Operating Results

On November 2, 2004, PreMD announced an unsolicited offer to acquire all of the issued and outstanding common shares of IBEX, a Toronto Stock Exchange-listed company based in Montreal. The offer expired on December 16, 2004 without PreMD taking up any shares of IBEX.

Amortization

Amortization expenses for equipment and acquired technology for 2004 amounted to \$224,000 compared to \$281,000 in 2003. Purchases of equipment amounted to \$165,000 in 2004 and \$386,000 in 2003. The amortization of molds for manufacturing inventory was recorded as a cost of inventory and amounted to \$7,000 (2003 – nil).

Investment Tax Credits

Recoveries of provincial ITCs amounted to \$205,000 for 2004 compared with \$223,000 in 2003. The December 2003 tax credit receivable of \$180,000 was received from the government in 2005.

Interest Income

Interest income amounted to \$124,000 for 2004 compared with \$258,000 for 2003, reflecting lower interest rates on invested cash and lower cash balances through most of the year.

U.S. GAAP

For purposes of U.S. GAAP, the consolidated loss for 2004 was \$5,478,000 compared with \$3,949,000 in 2003.

Other

There was a significant increase of \$882,000 in accounts payable in 2004 compared with 2003. This includes the purchase of inventory of approximately \$340,000 in December, clinical trial costs of \$85,000 and most of the expenses related to the IBEX offer.

CONTRACTUAL OBLIGATIONS

As at December 31, 2005, PreMD had certain contractual obligations and commitments related to ongoing clinical trials and research agreements as follows:

	Total	Less than 1 Year	1–2 Years	2–5 Years
Clinical trials	\$ 2,478,000	\$ 1,698,000	\$ 780,000	\$ nil
Research agreements	72,000	72,000	nil	nil
Operating leases	431,000	137,000	139,000	155,000
Total	\$ 2,981,000	\$ 1,907,000	\$ 919,000	\$ 155,000

Certain other obligations, totaling up to \$345,000, are only payable upon the achievement of specific events.

The \$9,828,000 (US\$8,210,000) convertible debentures we issued on August 30, 2005 are payable in U.S. dollars and are due in August 2009.

LIQUIDITY AND CAPITAL RESOURCES

As at December 31, 2005, PreMD had cash, cash equivalents and short-term investments totaling \$8,679,000 (\$5,196,000 as at December 31, 2004). We invest our funds in short-term financial instruments and marketable securities. Cash used in operating activities during the year amounted to \$5,308,000 compared with \$1,370,000 in 2004. For 2004, cash used in operating activities included \$2,818,000 of deferred revenue received from McNeil as part of the upfront license fees that are being recognized into income over the life of the agreements.

On August 30, 2005, the Company issued \$9,828,000 (US\$8,210,000) unsecured convertible debentures, maturing on August 30, 2009, for net proceeds of \$8,966,000 after deducting issue fees and expenses of \$862,000. The issue costs attributable to the liability component have been deferred and will be amortized over the life of the debt. The issue costs attributable to the equity component of the convertible debentures and the warrants have been deducted from the respective balances.

To date, we have financed our activities through product sales, license revenues, the issuance of shares and convertible debentures and the recovery of provincial ITCs. Management believes that, based on historical cash expenditures and the current expectation of further revenues from product sales, royalties and license revenues, our existing cash resources together with the ITC receivable of \$200,000 will be sufficient to meet our current operating and capital requirements through at least 2008.

However, our future capital requirements will depend on many factors, including sales and license revenue growth, continued progress in our product development and clinical programs, time and expense associated with regulatory filings, prosecuting and enforcing our patent claims, and costs associated with obtaining regulatory approvals.

RESEARCH AND DEVELOPMENT

In 2005, we spent \$3,120,000 on PreMD-sponsored research and development activities, compared with \$2,613,000 and \$1,919,000 in 2004 and 2003, respectively. Below is a summary of our products and the related stages of development for each product in clinical development. The summary contains forward-looking statements regarding timing of completion of product development phases. The actual timing of completion of those phases could differ materially from the estimates produced in the table.

Coronary Artery Disease ("CAD") Risk Assessment Technology

Product	Description	Phase of Development	2005 Expenses	Next Phase for 2006
PREVU* POC Skin Sterol Test (previously known as Cholesterol 1,2,3™)	Point-of-care skin cholesterol test that provides information about an individual's risk of coronary artery disease	Regulatory clearance in Canada, U.S. and Europe		Clinical trials for additional regulatory claims; prepare for new regulatory submission; commercial sales
PREVU* LT Skin Sterol Test	Lab-processed skin test	Clinical trials in progress		Complete clinical trials; prepare for regulatory submission; commercial launch in select markets
PREVU* PT Skin Sterol Test	Semi-quantitative consumer test	Prototype development		Complete development and internal validation
Total expenditures on skin cholesterol:			\$ 2,025,000	

Cancer

Product	Description	Phase of Development	2005 Expenses	Next Phase for 2006
ColorectAlert™ and Colopath™	Mucus test for detection of colorectal cancer	2,000 patients tested in clinical trials	\$ 309,000	Advance additional clinical trials for regulatory clearance
LungAlert™	Sputum test for detection of lung cancer	Automation of procedures; 1,000 patients tested in clinical trials	\$ 309,000	Publish/present scientific papers; initiate clinical trials for regulatory clearance
Breast Cancer Test	Nipple aspirate test for detection of breast cancer	Completed pilot clinical trial	\$ 66,000	Complete pivotal clinical study

RISKS AND UNCERTAINTIES

The forward-looking statements contained in this report are based on management's current expectations and are subject to a number of factors and uncertainties that could cause actual results or outcomes to differ materially from those described in such forward-looking statements. Investors should carefully consider the risks and uncertainties described below. This list of risks and uncertainties below is not exhaustive. Furthermore, additional risks and uncertainties not presently known to PreMD or that PreMD believes to be immaterial may also adversely affect PreMD's business.

Prospects for companies in the biotechnology industry generally may be regarded as uncertain given the nature of the industry and the significant degree of risk involved in research, development and marketing. Accordingly, investments in biotechnology companies should be regarded as speculative.

Interest Rate and Foreign Exchange Risk

PreMD is exposed to market risk related to changes in interest and foreign currency exchange rates, each of which could adversely affect the value of our current assets and liabilities. Our cash is invested in short-term, high-grade securities with varying maturities. Since PreMD's intention is to hold these securities to maturity, adverse changes in interest rates would not have a material effect on PreMD's results of operations. PreMD also makes commitments with foreign suppliers for clinical trials and other services. Adverse changes in foreign exchange rates could increase the costs of these services.

Changes in foreign exchange could also affect our ability to repay the convertible debentures since they are payable in U.S. dollars on maturity in August 2009.

Volatility of Trading Market for PreMD's Common Shares

The volatility of PreMD's share price may affect the trading market for PreMD's common shares. There can be no assurance that an active trading market for the common shares will be sustained. Our share price could fluctuate significantly in the future for a number of reasons, including, among others, future announcements concerning PreMD, quarterly variations in operating results, the introduction of competitive products, reports of results of clinical trials, regulatory developments, and intellectual property developments.

In addition, stock markets, in general, and the market for shares of biotechnology and life science companies, in particular, have experienced extreme price and volume fluctuations in recent years that may be unrelated to the operating performance or prospects of the affected companies. These broad market fluctuations may affect the market price of PreMD's common shares.

Other Risks

Additionally, as a company in the early stages of commercialization, there are several risks related to operations, technology access and acceptance, and product performance that have the potential to materially adversely affect PreMD's long-term prospects. While management is optimistic about PreMD's future, the following risks and uncertainties, without limitation, should be considered in evaluating the Company:

- PreMD has no experience in marketing products. If we cannot successfully market and cause acceptance of our products, we will be unable to execute PreMD's business plan;
- If PreMD is unable to generate significant revenue and become profitable in the near future, our business will fail. We anticipate that substantially all of our revenue for the next few years will be derived from and dependent on McNeil's commercialization of PREVU* Skin Sterol Test;
- If we cannot obtain additional financing required to support business growth, we will be unable to fund PreMD's continuing operations in the future;
- We will need to generate cash to pay interest and principal on the convertible debentures. Any conversion of the debentures, exercise of the warrants, or issuance of common shares to pay interest, when permitted, would dilute the interests of our current shareholders;
- PreMD's success depends in part on obtaining and maintaining meaningful patent protection on our products and technologies. The protection offered by our patents and patent applications may be challenged, invalidated or circumvented by our competitors, and there is no guarantee that we will be able to obtain or maintain patent protection for our products or product candidates. In addition, our petition to reinstate two of our U.S. patents was denied by the U.S. PTO and, accordingly, we could face additional competition from companies seeking to exploit the intellectual property that was previously covered by these patents;
- We rely on third parties to manufacture some of our products and any delays, volume constraints or mistakes on the part of such manufacturers could result in cancelled orders and a loss of revenue for PreMD;
- PreMD faces potential risks of product liability, which may divert funding from ongoing operations and harm operating results;
- If we are unable to acquire future technology necessary for our products, PreMD may be unable to commercialize new products;
- The loss of any key employee could impair our ability to execute PreMD's business plan;
- Intense competition in the diagnostics industry may harm PreMD's ability to license and develop products;
- Any inability by PreMD to develop products and comply with government regulations may hinder or prevent the development and sale of PreMD's products;
- PreMD may not be able to obtain reimbursement for its products as governments attempt to control rising healthcare costs; and
- We do not anticipate paying dividends on our common shares, which may affect investors who require a certain amount of liquidity on their investment.

A detailed discussion of risks and uncertainties is contained in our Annual Information Form for the fiscal year ended December 31, 2005, which is filed with the Ontario Securities Commission ("OSC") and available at www.sedar.com, and in PreMD's reports and documents filed from time to time with the U.S. Securities and Exchange Commission ("SEC"), available at www.sec.gov. Except as required by law, PreMD is not under any obligation, and expressly disclaims any obligation to update forward-looking statements. You should carefully consider the factors set forth in these other reports or documents that PreMD files with the OSC and the SEC.

QUARTERLY FINANCIAL INFORMATION

The following is a summary of unaudited quarterly financial information for each of the last eight quarters.

	2005				2004			
	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
Product sales	\$ 40,768	\$ 39,902	\$ 332,701	\$ 12,359	\$ 83,258	\$ nil	\$ 100,000	\$ nil
License revenue	918,804	79,698	78,081	76,725	196,905	76,725	26,725	1,725
Investment tax credits	31,000	70,000	47,923	50,000	50,000	55,000	63,000	37,000
Interest income	85,781	36,076	22,383	28,890	34,933	31,549	29,637	27,507
Net loss	\$ 788,825	\$ 1,443,941	\$ 1,455,027	\$ 1,301,912	\$ 1,803,625	\$ 1,202,908	\$ 1,479,666	\$ 1,082,700
Net loss per share⁽¹⁾: – basic and diluted	\$ 0.04	\$ 0.07	\$ 0.07	\$ 0.06	\$ 0.08	\$ 0.06	\$ 0.07	\$ 0.05

⁽¹⁾ Net loss per share has been calculated on the basis of net loss for the period divided by the weighted average number of common shares outstanding during the period. The weighted average number of common shares outstanding for the year ended December 31, 2005 was 21,487,008 (December 31, 2004: 21,276,497).

Q4 2005 COMPARED WITH Q4 2004

The net loss for the three months ended December 31, 2005 was \$789,000 (\$0.04 per share) compared with \$1,804,000 (\$0.08 per share) for the three months ended December 31, 2004, a reduction of \$1,015,000.

Two significant factors contributed to this improvement. First, license fees primarily related to the receipt of milestone payments from our licensee increased revenue by \$722,000 during the quarter. Second, in 2004 we incurred a non-recurring expense of \$478,000 related to an offer to acquire the shares of another company.

Toronto, Canada
March 28, 2006

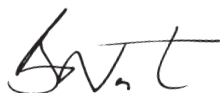
Management's Responsibility for Financial Reporting

The management of the Company is responsible for the preparation of the accompanying consolidated financial statements. These financial statements have been prepared in accordance with Canadian generally accepted accounting principles and, where appropriate, include estimates based on careful judgment. Management has determined these amounts on a reasonable basis in order to ensure that the financial statements are presented fairly, in all material respects. Financial information contained elsewhere in this annual report is consistent with the consolidated financial statements.

PreMD maintains a system of internal accounting and administrative controls that are designed to provide reasonable assurance, at a reasonable cost, that the financial information is accurate and reliable and that the assets are appropriately accounted for and adequately safeguarded.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal control. The Board carries out this responsibility through an Audit Committee, which includes two non-management directors, and meets periodically with management and the external auditors, Ernst & Young LLP. The auditors have unrestricted access to the Audit Committee. The Audit Committee reviews PreMD's quarterly and annual consolidated financial statements and recommends their approval by the Board. The Committee also recommends the appointment of the external auditors who are appointed at PreMD's Annual Meeting.

The consolidated financial statements have been audited by Ernst & Young, on behalf of the shareholders, in accordance with Canadian generally accepted auditing standards.

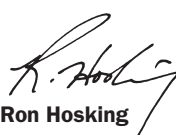


Brent Norton

President and Chief Executive Officer

Toronto, Canada

March 28, 2006



Ron Hosking

Vice President, Finance, and Chief Financial Officer

Report of Independent Auditor

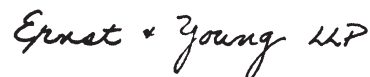
To the Shareholders of

PreMD Inc. (formerly, IMI International Medical Innovations Inc.)

We have audited the consolidated balance sheets of **PreMD Inc.** as at December 31, 2005 and 2004 and the consolidated statements of loss and deficit and cash flows for the years ended December 31, 2005, 2004 and 2003. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian Generally Accepted Auditing Standards and the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2005 and 2004 and the results of its operations and its cash flows for the years ended December 31, 2005, 2004 and 2003 in conformity with Canadian generally accepted accounting principles.



Chartered Accountants

Toronto, Canada

February 17, 2006

Consolidated Balance Sheets

PreMD Inc

(formerly, IMI International Medical Innovations Inc.)

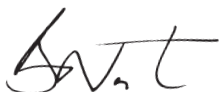
Incorporated under the laws of Canada

[In Canadian dollars]

As at December 31	2005 \$	2004 \$
ASSETS		
Current		
Cash and cash equivalents	773,199	239,458
Short-term investments	7,905,883	4,956,945
Accounts receivable [note 3]	881,891	222,348
Inventory	36,306	267,500
Prepaid expenses and other receivables	317,264	137,015
Investment tax credits receivable	200,000	389,000
Total current assets	10,114,543	6,212,266
Deferred financing fees, net of accumulated amortization of \$43,059 [2004 – nil] [note 5]	477,725	–
Capital assets, net [note 4]	410,636	420,955
Acquired technology, net of accumulated amortization of \$856,970 [2004 – \$784,398]	290,286	362,858
	11,293,190	6,996,079
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Accounts payable	291,125	1,021,086
Accrued liabilities	655,113	566,951
Current portion of deferred revenue [note 8[a]]	311,915	306,900
Total current liabilities	1,258,153	1,894,937
Convertible debentures [note 5]	5,893,340	–
Deferred revenue [note 8[a]]	2,297,400	2,604,300
Total liabilities	9,448,893	4,499,237
Commitments [note 8]		
Shareholders' equity		
Capital stock [note 6]	24,449,826	24,192,321
Contributed surplus [note 6]	1,840,979	1,328,187
Equity component of convertible debentures [note 5]	2,393,145	–
Warrants [notes 5, 6[c] and 8[b][ii]]	1,373,718	200,000
Deficit	(28,213,371)	(23,223,666)
Total shareholders' equity	1,844,297	2,496,842
	11,293,190	6,996,079

See accompanying notes

On behalf of the Board:



Brent Norton, MD, MBA

Director



Stephen A. Wilgar

Director

Consolidated Statements of Loss and Deficit

[In Canadian dollars]

Years ended December 31	2005 \$	2004 \$	2003 \$
REVENUE			
Product sales <i>[note 3]</i>	425,730	183,258	–
License revenue <i>[note 3]</i>	1,153,308	302,080	16,900
	1,579,038	485,338	16,900
Cost of product sales, including amortization of \$3,456 [2004 – \$6,600]	428,650	190,214	–
Gross profit	1,150,388	295,124	16,900
EXPENSES			
Research and development	3,120,276	2,612,770	1,918,800
General and administration	2,655,056	3,355,451	2,361,602
Interest on convertible debentures <i>[note 5]</i>	228,481	–	–
Imputed interest on convertible debentures <i>[note 5]</i>	255,529	–	–
Amortization	252,804	224,428	280,777
	6,512,146	6,192,649	4,561,179
RECOVERIES AND OTHER INCOME			
Investment tax credits	198,923	205,000	223,146
Interest	173,130	123,626	258,422
	372,053	328,626	481,568
Net loss for the year	(4,989,705)	(5,568,899)	(4,062,711)
Deficit, beginning of year	(23,223,666)	(17,654,767)	(13,592,056)
Deficit, end of year	(28,213,371)	(23,223,666)	(17,654,767)
Basic and diluted loss per share	\$ (0.23)	\$ (0.26)	\$ (0.19)
Weighted average number of common shares outstanding	21,487,008	21,276,497	20,967,677

See accompanying notes

Consolidated Statements of Cash Flows

[In Canadian dollars]

Years ended December 31	2005 \$	2004 \$	2003 \$
OPERATING ACTIVITIES			
Net loss for the year	(4,989,705)	(5,568,899)	(4,062,711)
Add items not involving cash			
Amortization	256,260	231,028	280,777
Stock-based compensation costs included in:			
Research and development expense	147,085	123,925	189,105
General and administration expense	421,812	476,164	255,112
Loss on sale of capital asset	–	6,098	3,873
Imputed interest on convertible debentures	255,529	–	–
Deduct gain on foreign exchange	(35,734)	–	–
Net change in non-cash working capital			
balances related to operations <i>[note 9]</i>	(1,061,397)	544,015	(54,970)
Increase (decrease) in deferred revenue	(301,885)	2,818,100	(6,900)
Cash used in operating activities	(5,308,035)	(1,369,569)	(3,395,714)
INVESTING ACTIVITIES			
Short-term investments	(3,065,568)	1,678,190	3,326,608
Purchase of capital assets	(130,310)	(164,789)	(385,605)
Sale of capital assets	–	628	2,775
Cash provided by (used in) investing activities	(3,195,878)	1,514,029	2,943,778
FINANCING ACTIVITIES			
Issuance of convertible debentures <i>[note 5]</i>	9,827,616	–	–
Financing fees <i>[note 5]</i>	(861,328)	–	–
Issuance of capital stock, net of issue costs	198,400	33,373	363,110
Cash provided by financing activities	9,164,688	33,373	363,110
Effect of exchange rate changes on cash and cash equivalents	(127,034)	–	–
Net increase (decrease) in cash and cash equivalents during the year	533,741	177,833	(88,826)
Cash and cash equivalents, beginning of year	239,458	61,625	150,451
Cash and cash equivalents, end of year	773,199	239,458	61,625
Represented by:			
Cash	773,199	173,302	61,625
Cash equivalents	–	66,156	–
	773,199	239,458	61,625

See accompanying notes

Notes to Consolidated Financial Statements

December 31, 2005 [In Canadian dollars, unless otherwise noted]

1. NATURE OF THE COMPANY

PreMD Inc., formerly IMI International Medical Innovations Inc. [the “Company”], operates in a single business segment and is a predictive medicine company dedicated to improving health outcomes with tools for the early detection of life-threatening diseases, particularly cardiovascular disease and cancer. The Company develops easy-to-use, accurate and cost-effective tests designed for use in point-of-care and laboratory environments and licenses the global marketing rights to third parties.

The Company currently owns patents for a test used to measure skin cholesterol and has in-licensed the technologies for tests to detect the presence of a cancer-specific marker for use in colorectal, lung and breast cancer. In addition, the Company has patents and patents pending for color measurement in biological reactions and has a right of first refusal on certain genomics-related technologies in the predictive medicine field.

2. SIGNIFICANT ACCOUNTING POLICIES

New pronouncements

Effective January 1, 2005, the Company adopted the guidelines relating to the disclosure requirements of variable interest entities as required by the Canadian Institute of Chartered Accountants’ [“CICA”] Accounting Guideline No. 15 [“AcG-15”], “Consolidation of Variable Interest Entities”. There was no impact as a result of adopting this pronouncement.

The CICA issued Section 1530 of the CICA Handbook, “Comprehensive Income”. It is effective for fiscal years beginning on or after October 1, 2006. The section describes how to report and disclose comprehensive income and its components. Comprehensive income is the change in a company’s net assets that results from transactions, events and circumstances from sources other than the company’s shareholders. It includes items that would not normally be included in net earnings, such as unrealized gains or losses on available-for-sale investments.

The CICA also made changes to Section 3250 of the CICA Handbook, “Surplus”, and reissued it as Section 3251, “Equity”. The section is also effective for fiscal years beginning on or after October 1, 2006. The changes in how to report and disclose equity and changes in equity are consistent with the new requirements of Section 1530, “Comprehensive Income”. Adopting these sections on January 1, 2007 will require the Company to start reporting the following items in the consolidated financial statements: comprehensive income and its components; and, accumulated other comprehensive income and its components.

The CICA issued Section 3855 of the CICA Handbook, “Financial Instruments – Recognition and Measurement”. The section is effective for fiscal years beginning on or after October 1, 2006. It describes the standards for recognizing and measuring financial assets, financial liabilities and non-financial derivatives. This section requires that:

- All financial assets be measured at fair value, with some exceptions, such as loans and investments that are classified as held-to-maturity;
- All financial liabilities be measured at fair value if they are derivatives or classified as held for trading purposes. Other financial liabilities are measured at their carrying value; and
- All derivative financial instruments be measured at fair value, even when they are part of a hedging relationship.

The Company is currently evaluating the impact on its consolidated financial statements of adopting this section on January 1, 2007.

The CICA issued Handbook Section 3861, “Financial Instruments – Disclosure and Presentation”. Adopting this section would impact the classification of a financial instrument, or its component parts, as a liability or as an equity instrument in accordance with the substance of the contractual arrangement on initial recognition. The Company is currently evaluating the impact on its consolidated financial statements of adopting this section on January 1, 2007.

The CICA recently issued Section 3865 of the CICA Handbook, "Hedges". The section is effective for fiscal years beginning on or after October 1, 2006, and describes when and how hedge accounting can be used. Hedging is an activity used by a company to change an exposure to one or more risks by creating an offset between:

- Changes in the fair value of a hedged item and a hedging item; and
- Changes resulting from a risk exposure relating to a hedged item and hedging item.

Hedge accounting ensures that all gains, losses, revenues and expenses from the derivative and the item it hedges are recorded in the statement of loss and deficit in the same period. The Company is currently evaluating the impact on its consolidated financial statements of adopting this section on January 1, 2007.

The consolidated financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles ["Canadian GAAP"] consistently applied within the framework of the significant accounting policies summarized below. The significant differences between Canadian and United States generally accepted accounting principles ["U.S. GAAP"] are described and reconciled in note 10.

Basis of consolidation

The accompanying consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries, PreMD International Inc., Berne, incorporated under the laws of Switzerland, and 6211178 Canada Inc., incorporated under the laws of Canada. All significant intercompany transactions and balances have been eliminated upon consolidation.

Foreign currency translation

Foreign operations are considered integrated and are translated using the temporal method. Monetary items are translated using the exchange rate in effect at the year end and non-monetary items are translated at historical exchange rates. Revenue and expenses are translated at the average rate for the year except for amortization of capital assets, which is translated at the same exchange rates as the assets to which it relates. Exchange gains or losses are included in the determination of net loss for the year.

Use of estimates

The preparation of consolidated financial statements in conformity with Canadian GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting periods. Actual results could differ materially from those estimates.

Cash and cash equivalents

Cash and cash equivalents comprise cash on hand and highly liquid investments that are readily convertible into cash with maturities of less than 90 days when purchased. Cash equivalents at December 31, 2005 were comprised of funds with an average interest rate of 2.9% [2004 – 1.8%].

Short-term investments

Short-term investments are carried at the lower of cost and market. Short-term investments at December 31, 2005 were comprised of money market funds and fixed income securities with interest rates of approximately 3.6% [2004 – 2.4%]. Short-term investments are comprised of highly liquid investments with maturity periods greater than 90 days but less than one year when purchased.

Financial instruments

The carrying values of cash and cash equivalents, short-term investments, other receivables and accounts payable and accrued liabilities are considered to approximate their respective fair values due to their short-term nature.

Notes to Consolidated Financial Statements

December 31, 2005 [In Canadian dollars, unless otherwise noted]

The fair values of the equity and warrant components of the convertible debentures are recorded as “equity component of convertible debentures” and “warrants”, respectively, net of the allocated financing costs. The carrying value of the convertible debentures is recorded as a liability and is being accreted to its maturity value through charges to income for the imputed interest [note 5].

Inventory

Inventory of raw materials is valued at the lower of cost and replacement cost. Inventories of finished goods are valued at the lower of cost and net realizable value, determined on a first-in, first-out basis.

Deferred financing fees

Financing costs relating to the issue of convertible debentures are pro-rated between the liability and the equity and warrant components of the debentures [note 5]. The expenses related to the liability component are deferred and are amortized on a straight-line basis over the term of the debentures. Should the debentures be converted, the unamortized balance of financing costs will be transferred to capital stock. The “equity component of convertible debentures” and the “warrants” are recorded net of the respective allocated financing costs.

Capital assets

Capital assets are recorded at acquisition cost less accumulated amortization.

Purchases of molds required for the manufacture of products are capitalized and amortized over the useful life of the asset on the basis of units produced. The amortization expense for molds is recorded as a cost of inventory.

The Company provides for amortization on a declining balance basis, unless otherwise indicated, at rates which are expected to charge operations with the cost of the assets over their estimated useful lives as follows:

Manufacturing equipment	useful life on basis of units produced
Computer equipment	30%
Furniture and equipment	20%
Research instrumentation	30%
Laboratory equipment	20%
Leasehold improvements	straight-line over the term of the lease

Acquired technology

Patents and technology acquired by the Company are recorded at acquisition cost and are amortized on a declining balance basis at 20% per year. The Company records a writedown in acquired technology when there is a change in circumstances, such as unfavorable clinical trial results, suggesting an impairment has occurred.

Guarantees

Many of the Company’s agreements, specifically those related to financing, research and development and supply arrangements, include indemnification provisions where the Company may be required to make payments to the counterparty. Such payments relate to personal injury resulting from clinical trials and from breach of fundamental representation and warranty terms in the agreements with respect to matters such as corporate status, title of assets, consents to transfer, employment matters, litigation and other potential material liabilities. The maximum potential amount of future payments that the Company could be required to make under these indemnification provisions is not reasonably quantifiable as certain indemnifications are not subject to a monetary limitation. At December 31, 2005, management believes there is only a remote possibility that the indemnification provisions would require any material cash payment.

The Company indemnifies its directors and officers against any and all claims or losses reasonably incurred in the performance of their service to the Company to the extent permitted by law. The Company has acquired and maintains liability insurance for its directors and officers.

Revenue recognition

The Company earns 100% of its revenue from one customer, under the terms of two contracts. These contracts outline the terms for all products and services provided to the customer, and are considered multiple revenue arrangements. Under the terms of EIC 142 – “Revenue Arrangements with Multiple Deliverables”, products and services under these contracts are separated into units of accounting for revenue recognition purposes.

Non-refundable, up-front payments received from licensees are deferred and recognized in income on a straight-line basis over the respective terms of the agreements. Milestone payments received from licensees are recorded as income in the period when the respective milestones are achieved. Revenue from sales of products to licensees is recognized when title passes to the customers, which generally occurs when the products are shipped to the licensee, provided the Company has not retained any significant risks of ownership or future obligations with respect to the products shipped. Royalty revenues are based on sales by licensees and are recorded as income in the period earned and reported by the licensees.

Research and development and related investment tax credits

Research and development expenditures include related salaries, subcontractor fees, product development expenses including patent costs, clinical trials costs and an allocation of administrative expenses and corporate costs specifically attributable to research and development. Research and development excludes any costs associated with the acquisition of capital assets and acquired technology. Research and development expenditures are charged to expenses as incurred unless management believes a development cost meets the generally accepted criteria for deferral. All development costs incurred to date have been expensed. Reimbursements for specific expenditures received through collaboration funding have been applied against research and development expense.

Investment tax credits earned as a result of incurring qualified scientific research and experimental development expenses are recorded when the amounts are readily determinable. The amounts are recorded as follows:

- For capital assets – as a reduction of the cost of the related asset; and
- For operating expenses – as a recovery within the consolidated statements of loss and deficit.

Stock-based compensation

The Company has two stock-based compensation plans for employees, directors and consultants, which are described in note 6[d]. Certain of the stock options granted vest over a fixed term and others vest based on performance upon the achievement of certain milestones, although no performance options have been granted since 2002.

CICA Handbook Section 3870 requires that options issued be accounted for using the fair value method of accounting. Non-cash compensation expense for fixed term options is recorded over the term of the vesting period whereas compensation expense for performance options is recorded when it is determined that achievement of the milestone is likely. Prior to 2003, no compensation expense was recognized for stock options granted to employees. For stock options awarded to employees prior to January 1, 2003 but subsequent to January 1, 2002, pro forma disclosure of net loss and loss per share is provided as if these awards were accounted for using the fair value method. Consideration paid on the exercise of stock options and warrants is credited to capital stock.

Shares issued to employees under the share purchase plan are accounted for as direct awards of stock and are recognized as a non-cash compensation expense in the consolidated statements of loss and deficit [note 6[e]].

Income taxes

The Company applies the asset and liability method of accounting for income taxes. Under this method, future income tax assets and liabilities are determined based on differences between the financial reporting and tax bases of assets and liabilities and are measured using substantively enacted tax rates and laws that are expected to be in effect when the differences are expected to reverse. Valuation allowances are provided if it is more likely than not that some or all of the future tax assets will not be realized.

Notes to Consolidated Financial Statements

December 31, 2005 [In Canadian dollars, unless otherwise noted]

Loss per share

Loss per share has been calculated on the basis of net loss for the year divided by the weighted average number of common shares outstanding during the year. Diluted loss per share reflects the dilution that would occur if outstanding stock options and warrants were exercised or converted into common shares using the treasury stock method. The inclusion of the Company's stock options, conversion feature of the convertible debentures, and warrants in the computation of diluted loss per share would have an anti-dilutive effect on loss per share. Therefore, stock options and warrants have been excluded from the calculation of diluted loss per share. Consequently, there is no difference between basic loss per share and diluted loss per share.

3. ECONOMIC DEPENDENCE AND CONCENTRATION OF CREDIT RISK

Sales to one customer represented 100% of total sales in 2005 [2004 – 100%]. Accounts receivable from this customer represented 99% of the total receivable at December 31, 2005 [2004 – 100%].

4. CAPITAL ASSETS

Capital assets consist of the following:

	2005		
	Cost \$	Accumulated amortization \$	Net book value \$
Manufacturing equipment	20,585	10,056	10,529
Computer equipment	293,388	185,361	108,027
Furniture and equipment	65,609	44,064	21,545
Research instrumentation	669,183	452,701	216,482
Laboratory equipment	60,496	14,787	45,709
Leasehold improvements	23,159	14,815	8,344
	1,132,420	721,784	410,636
	2004		
	Cost \$	Accumulated amortization \$	Net book value \$
Manufacturing equipment	18,150	6,600	11,550
Computer equipment	270,704	143,925	126,779
Furniture and equipment	60,172	39,357	20,815
Research instrumentation	606,104	373,439	232,665
Laboratory equipment	25,501	7,735	17,766
Leasehold improvements	21,479	10,099	11,380
	1,002,110	581,155	420,955

5. CONVERTIBLE DEBENTURES

On August 30, 2005, the Company completed a financing by way of a private placement of convertible debentures maturing on August 30, 2009, for gross proceeds of \$9,827,616 (US\$8,210,000). The unsecured debentures bear interest at an annual rate of 7% payable quarterly in cash or common shares at the Company's option. The number of common shares issuable in satisfaction of interest payments is dependent on the trading price of the shares at the time of the applicable interest payment date. The debentures are convertible to common shares at any time during the term, at the option of the holder, at \$3.47 per share. If all the debentures were converted to common shares it would result in the issuance of an additional 2,882,195 common shares. Purchasers of the convertible debentures also received warrants to purchase 1,288,970 common shares at any time before August 30, 2010, at an exercise price of \$3.57 per common share. At any time after one year from the date of issuance of the warrants, the warrants may also be exercised by means of a cashless exercise by the holder.

Of the total amount of the financing, \$5,917,209 was recorded as a liability. The fair value of the equity component of the convertible debentures at the date of grant is estimated at \$2,393,145 (net of expenses of \$228,292), using the Black-Scholes option pricing model. The fair value of the warrants is estimated at \$1,176,718 (net of expenses of \$112,252), determined using the Black-Scholes option pricing model. The assumptions used to calculate the fair value of the equity component and the warrants are as follows:

	Equity component	Warrants
Expected volatility	42.7%	41.7%
Risk-free interest rate	3.35%	3.35%
Expected option life	4 years	5 years
Dividend yield	nil	nil

The table below presents a summary of the offering:

	Proceeds \$	Financing fees \$	Net \$
Issuance of convertible debenture	9,827,616	861,328	8,966,288
Equity component of convertible debentures	(2,621,437)	(228,292)	(2,393,145)
Warrants	(1,288,970)	(112,252)	(1,176,718)
Liability component of convertible debenture	5,917,209	520,784	5,396,425

The liability component will be accreted over time by a charge to the consolidated statement of loss and deficit for imputed interest at an effective rate of 12.75% and at maturity will be equal to the face value of the debentures. All cash repayments, default payments or redemptions of the principal under the debentures shall be made in U.S. dollars.

The table below presents a reconciliation of the valuation of the liability component from date of issue to December 31, 2005:

	\$
Issuance of convertible debenture, August 30, 2005	5,917,209
Changes in foreign exchange rates	(279,398)
Imputed interest	255,529
Balance, December 31, 2005	5,893,340

Notes to Consolidated Financial Statements

December 31, 2005 [In Canadian dollars, unless otherwise noted]

6. CAPITAL STOCK AND CONTRIBUTED SURPLUS

[a] Authorized

The authorized capital stock of the Company consists of an unlimited number of common shares, without nominal or par value, and an unlimited number of preferred shares, issuable in series.

[b] Issued and outstanding shares

	Number #	Stated value \$	Contributed surplus \$	Total \$
Common shares				
Balance, December 31, 2002	20,781,960	23,666,596	119,288	23,785,884
Expiry of warrants	–	–	191,000	191,000
Stock-based compensation expense [note 6[d]]	–	–	413,705	413,705
Issued under share purchase plan [note 6[e]]	8,942	27,147	–	27,147
Issued on exercise of options [note 6[d]]	290,000	238,070	–	238,070
Repayment of share purchase loans	180,000	125,040	–	125,040
Balance, December 31, 2003	21,260,902	24,056,853	723,993	24,780,846
Expiry of warrants	–	–	115,200	115,200
Stock-based compensation expense [note 6[d]]	–	–	488,994	488,994
Issued under share purchase plan [note 6[e]]	1,830	7,595	–	7,595
Issued on exercise of options [note 6[d]]	8,150	23,368	–	23,368
Issued on cashless exercise of options	27,713	94,500	–	94,500
Repayment of share purchase loans	15,000	10,005	–	10,005
Balance, December 31, 2004	21,313,595	24,192,321	1,328,187	25,520,508
Expiry of warrants [note 6[c]]	–	–	3,000	3,000
Stock-based compensation expense [note 6[d]]	–	–	509,792	509,792
Issued under share purchase plan [note 6[e]]	23,167	59,105	–	59,105
Issued on exercise of options [note 6[d]]	31,000	78,400	–	78,400
Repayment of share purchase loans	180,000	120,000	–	120,000
Balance, December 31, 2005	21,547,762	24,449,826	1,840,979	26,290,805

On September 13, 2004, an executive of the Company exercised, on a cashless basis, 75,000 options to acquire common shares of the Company at \$2.15 per share. The Company issued 27,713 common shares to the executive with an aggregate value equal to the difference between the exercise price of the options and the fair market value of the Company's common shares [\$94,500] on September 13, 2004. The Toronto Stock Exchange and the Board of Directors of the Company approved this cashless exercise.

[c] Warrants

Year ended December 31, 2004 transactions

Pursuant to a research collaboration agreement dated October 31, 2000, the Company granted warrants to purchase up to 50,000 common shares at an exercise price of \$4.50; these warrants are to be issued in annual increments of 10,000 warrants exercisable immediately and expiring in one year. During each of the years ended December 31, 2004, 2003, 2002, 2001 and 2000, the Company issued 10,000 of these warrants, all of which expired unexercised on October 31, 2005, 2004, 2003, 2002 and 2001, respectively.

For valuation purposes, the Company has applied the Black-Scholes option pricing model to determine the estimated fair value of the warrants. The assumptions used to calculate the fair value of the warrants are as follows: expected volatility of 44%, risk-free interest rate of 3.94%, and expected warrant life of one year.

[d] Options

Under the 1998 Stock Option Plan, the Company grants options to its employees, directors and consultants. The Company may issue options for up to 3,500,000 common shares. As at December 31, 2005, 2,742,998 options had been issued, of which 2,473,785 remain outstanding under this plan and the remaining 757,002 are eligible to be issued. The exercise price of each option granted may not be less than the market price of the Company's stock at the time of the grant and no option may have a term exceeding 10 years.

Certain of the options vest over a fixed term and others vest based on performance upon the achievement of certain milestones. A summary of the status of the two types of options is presented below:

Fixed stock options

Fixed stock options vest on an annual basis over a period of up to five years. The status of fixed stock options as at December 31, 2005, 2004 and 2003 and changes during the years ended on those dates is presented below:

	December 31, 2005		December 31, 2004		December 31, 2003	
	Number of shares #	Weighted average exercise price \$	Number of shares #	Weighted average exercise price \$	Number of shares #	Weighted average exercise price \$
Outstanding, beginning of year	1,954,285	3.54	1,757,035	3.45	1,310,750	3.44
Granted	549,500	3.02	406,000	3.79	559,285	3.43
Exercised	(31,000)	2.53	(33,613)	2.24	(20,000)	2.65
Expired or forfeited	(175,000)	3.79	(175,137)	3.50	(93,000)	3.32
Outstanding, end of year	2,297,785	3.41	1,954,285	3.54	1,757,035	3.45
Options exercisable end of year	1,458,114		1,258,957		973,700	

The following table presents information about fixed stock options outstanding at December 31, 2005:

Range of exercise prices \$	Number outstanding #	Weighted average remaining life [in years]	Weighted average exercise price \$	Number exercisable #	Weighted average exercise price \$
2.50 – 2.99	1,062,785	2.82	2.87	480,114	2.81
3.20 – 3.97	460,500	1.90	3.54	379,900	3.46
4.00 – 4.09	754,500	2.29	4.01	586,100	4.01
6.05	20,000	2.43	6.05	12,000	6.05
	2,297,785			1,458,114	

Notes to Consolidated Financial Statements

December 31, 2005 [In Canadian dollars, unless otherwise noted]

The assumptions used to calculate the fair value of stock compensation expense using the Black-Scholes option pricing model are approximately as follows:

	2005	2004	2003
Expected volatility	42.2%	50.1%	54.3%
Risk-free interest rate	3.66%	3.79%	4.06%
Expected option life	5 years	5 years	5 years

Dividend yield assumption used for all years presented was nil.

The Black-Scholes option pricing model, used by the Company to calculate option values, as well as other accepted option valuation models were developed to estimate fair value of freely tradable, fully transferable options without vesting restrictions, which significantly differ from the Company's stock option awards. These models also require highly subjective assumptions, including future stock price volatility and expected time until exercise, which greatly affect the calculated values. Accordingly, management believes that these models do not necessarily provide a reliable single measure of the fair value of the Company's stock option awards.

Performance stock options

Performance stock options vest immediately upon the achievement of certain milestones as determined by the Board of Directors at the time of issuance. The performance stock option milestones include criteria measured by product-related goals and corporate goals. Product-related goals include: product development, completion of clinical trials, regulatory submissions, regulatory approvals, signing of marketing partners and commercial launch of the Company's products. The corporate goals include: successful investor and public relations activities related to media publications and investor analyst coverage, as well as financial goals including completion of financings and government grants.

The status of performance stock options as at December 31, 2005, 2004 and 2003 and changes during the years ended on those dates is presented below:

	December 31, 2005		December 31, 2004		December 31, 2003	
	Number of shares #	Weighted average exercise price \$	Number of shares #	Weighted average exercise price \$	Number of shares #	Weighted average exercise price \$
Outstanding, beginning of year	176,000	3.46	214,750	3.54	487,750	1.96
Exercised	-	-	(2,250)	3.45	(270,000)	0.69
Expired or forfeited	-	-	(36,500)	3.93	(3,000)	3.55
Outstanding, end of year	176,000	3.46	176,000	3.46	214,750	3.54
Options exercisable end of year	85,825		85,825		111,275	

The following table presents information about performance stock options outstanding at December 31, 2005:

Range of exercise prices \$	Number outstanding #	Weighted average remaining life [in years]	Weighted average exercise price \$	Number exercisable #	Weighted average exercise price \$
2.50 – 3.45	70,000	0.10	2.64	44,625	2.63
4.00	106,000	0.58	4.00	41,200	4.00
	176,000			85,825	

The Company has not granted any performance stock options since 2002.

The table below presents pro forma net loss and basic and diluted loss per common share as if stock options granted to employees between January 1, 2002 and December 31, 2002 had been determined based on the fair value method.

	2005 \$	2004 \$	2003 \$
Net loss as reported	(4,989,705)	(5,568,899)	(4,062,711)
Estimated stock-based compensation costs	(116,286)	(223,830)	(250,350)
Pro forma net loss	(5,105,991)	(5,792,729)	(4,313,061)
Pro forma basic and diluted loss per common share	\$ (0.24)	\$ (0.27)	\$ (0.21)

The assumptions used to calculate the fair value of stock-based compensation costs using the Black-Scholes pricing model are approximately as follows: expected volatility of 54.3%; risk-free interest rate of 4.06%; dividend yield of nil; and an expected life of the options of five years.

[e] Employee share purchase plan

As a result of ongoing interest by its employees and directors in purchasing shares of the Company, the Company implemented a share purchase plan effective March 22, 1999, as amended. Pursuant to the terms of the plan, the Company will match the value of the common shares purchased by its employees or directors by issuing from treasury an equal number of common shares, up to a maximum value of the lesser of 50% of the maximum allowable annual contribution for registered retirement savings plans [being \$8,250 as at December 31, 2005], or 9% of the employee's annual salary. The maximum number of common shares which may be issued by the Company pursuant to the share purchase plan is 350,000. Under the plan, the Company issued 23,167 common shares to employees and directors during the year ended December 31, 2005, and 1,830 and 8,942 shares during the years ended December 31, 2004 and 2003, respectively.

Notes to Consolidated Financial Statements

December 31, 2005 [In Canadian dollars, unless otherwise noted]

7. INCOME TAXES

[a] Significant components of the Company's future tax assets are as follows:

	2005 \$	2004 \$
Future tax assets		
Federal tax loss carryforwards	2,450,000	1,957,000
Ontario tax loss carryforwards	1,612,000	1,357,000
Investment tax credits	1,700,000	1,352,000
Financing and share issue costs	263,000	224,000
SR&ED expenditures	3,380,000	2,714,000
Capital assets	99,000	72,000
Deferred revenue	684,000	731,000
Future tax assets before valuation allowance	10,188,000	8,407,000
Valuation allowance	10,188,000	8,407,000
Net future tax assets	–	–

No net future tax assets have been recognized in the consolidated financial statements as the realization of the net future tax assets does not meet the more likely than not recognition criteria.

[b] The Company has accumulated tax losses for federal and provincial purposes in Canada. The Company also has unclaimed federal scientific research investment tax credits. The losses and investment tax credits can be used to offset future years' Canadian taxable income, the benefit of which has not been recorded in the accounts.

The approximate tax losses and investment tax credits expire as follows:

	Federal \$	Ontario \$	Investment tax credits \$
2006	832,000	989,000	–
2007	1,062,000	1,340,000	–
2008	1,562,000	1,562,000	–
2009	2,887,000	2,887,000	18,000
2010	2,018,000	2,018,000	247,000
2011	–	–	337,000
2012	–	–	297,000
2013	–	–	397,000
2014	494,000	494,000	423,000
2015	2,223,000	2,223,000	464,000
	11,078,000	11,513,000	2,183,000

[c] The Company has available scientific research and experimental development ["SR&ED"] expenditures for income tax purposes which may be carried forward indefinitely to reduce future years' taxable income. The total of such expenditures accumulated to December 31, 2005 is approximately \$9,358,000. The potential income tax benefits associated with these expenditures have not been recorded in the accounts.

[d] The Company is entitled to receive provincial investment tax credits relating to SR&ED costs incurred, the benefits of which have been accrued in the accounts.

[e] The following is a reconciliation of the provision for (recovery of) income taxes between those that are expected, based on substantially enacted rates, to those currently reported:

	2005		2004		2003	
	\$	%	\$	%	\$	%
Loss before income taxes	(4,989,705)		(5,568,899)		(4,062,711)	
Expected recovery of						
income taxes	(1,802,281)	(36.1)	(2,011,486)	(36.1)	(1,487,765)	(36.7)
Permanent differences	299,044	6.0	268,428	4.8	15,568	0.4
Reduction in future tax rates	-	-	-	-	(232,606)	(5.7)
Tax losses and other future						
tax assets not tax benefited	1,503,237	30.1	1,743,058	31.3	1,704,803	42.0
	nil		nil		nil	

8. COMMITMENTS

[a] Commercialization agreements

Pursuant to an agreement dated May 10, 2002, as amended on December 20, 2002 and December 9, 2005, the Company licensed to McNeil Consumer Healthcare ["McNeil"] the right to market and distribute the Company's test for coronary artery disease in Canada and for the insurance laboratory field in the United States and Mexico. The term of the agreement is 15 years and requires McNeil to purchase the Company's skin cholesterol test and to pay ongoing royalties to the Company based on McNeil's sales, in addition to a series of financial milestone payments of up to \$3,300,000, which will be based on McNeil's achievement of specified annual sales levels of the licensed products. The Company may terminate this agreement if certain minimum levels of sales are not met. Since all future royalties and milestone payments under this agreement are based on sales by McNeil, the Company is unable at this time to estimate the aggregate future payments that could be received under this agreement.

On May 28, 2004, as amended on December 9, 2005, the Company signed an additional marketing agreement with McNeil and completed an exclusive worldwide licensing agreement to sell the Company's skin cholesterol tests under the brand name PREVU* Skin Sterol Test. The agreement has a minimum term of 10 years. Under the financial terms of the agreement, the Company received a non-refundable \$3,000,000 upfront payment and can receive a series of additional payments of up to \$16,388,000 [over and above the Canadian agreement payments] upon the achievement of specific milestones. In addition to sales of products to McNeil, the Company will also receive royalties based on McNeil's sales of the products.

[b] Research and collaboration agreements

The Company has entered into agreements with various clinical sites to conduct clinical trials on its technologies. The Company is committed, upon the progressive completion of the trials, to make further payments of approximately \$2,478,000.

The Company has acquired or is developing in collaboration with others a number of technologies that will require the Company to make payments upon the successful achievement of certain technological milestones. Additionally, in connection with the development of the technologies, the Company has entered into research agreements whereby a minimum fee will be paid for research and development to be carried out by other parties. The Company is committed, upon the successful achievement of future operating performance milestones, to make further payments of approximately \$345,000 to these parties.

Notes to Consolidated Financial Statements

December 31, 2005 [In Canadian dollars, unless otherwise noted]

[i] Pursuant to agreements [the "ColorectAlert™ License Agreements"] dated March 27, 1998, May 1, 1998 and October 23, 2001 between the Company and Dr. A.K.M. Shamsuddin [the "ColorectAlert™ Inventor"], the Company acquired a license, including the three existing United States and Japanese patents, for a technology that detects a carbohydrate marker associated with cancerous and pre-cancerous conditions ["ColorectAlert™"]. Pursuant to the terms of the agreements, the Company is required to make payments upon achieving certain research and development milestones as well as royalty payments based on revenues from sales of this technology. As at December 31, 2005, the Company has made milestone payments under the ColorectAlert™ License Agreements of approximately \$328,000. Future milestone payments, upon completion of specific milestones, could amount to as much as \$120,000. In addition, the Company granted warrants to purchase up to 100,000 common shares at exercise prices ranging from \$3.50 to \$4.50 per share to the ColorectAlert™ Inventor. The agreements do not provide for a fixed termination date and may only be terminated by the parties in the event of a material breach by the other party.

[ii] The Company entered into an agreement with Procyon Biopharma Inc. ["Procyon"] dated March 19, 2001, as amended [the "Procyon License Agreement"], whereby the Company has the right to complete the development, clinical trials and regulatory submission for the technology and is entitled to develop, manufacture, market and distribute the ColoPath™ technology exclusively on a global basis. Pursuant to the terms of the Procyon License Agreement, all new patents will be owned by the Company. Procyon is entitled to payments based on the completion of certain research and development milestones as well as a royalty payment based on sales of all mucus-based colorectal cancer tests. As at December 31, 2005, the Company has made milestone payments under the Procyon License Agreement of \$125,000. Future milestone payments, upon completion of specific milestones, could amount to as much as \$225,000. The Procyon License Agreement does not have a fixed termination date and it may be terminated upon written agreement of the parties, if the Company has not at that time engaged in any clinical work or product development in connection with the research and development of ColorectAlert™ or ColoPath™ or met minimum levels of sales of these products. In addition, the Company granted to Procyon warrants to purchase up to 75,000 common shares at an exercise price of \$4.50 per share in connection with this agreement. These warrants expired unexercised on March 19, 2004.

[c] Key man life insurance

A subsidiary of the Company, 6211178 Canada Inc. [the "Subsidiary"], owns life insurance policies for the CEO in the amount of \$8,000,000, with the Subsidiary as the named beneficiary. In the event of the CEO's death, the Subsidiary shall use 75% of the insurance proceeds to purchase the CEO's common shares in the Company from his estate. Pursuant to the terms of the insurance agreement, on January 1 of each year, the Subsidiary shall ensure that the amount of the insurance policy is not less than 100% of the fair market value of the CEO's common shares at that date. The Company owns an additional life insurance policy for the CEO in the amount of \$3,000,000.

[d] Operating leases and other commitments

The Company has future minimum annual lease payments under operating leases for its office premises and laboratory facilities as follows:

	\$
2006	137,000
2007	139,000
2008	135,000
2009	20,000
2010 and thereafter	nil
	<u>431,000</u>

9. CONSOLIDATED STATEMENTS OF CASH FLOWS

Changes in non-cash working capital balances related to operations comprise:

	2005 \$	2004 \$	2003 \$
Accounts receivable	(659,543)	(211,648)	–
Inventory	231,194	(267,500)	–
Prepaid expenses and other receivables	(180,249)	186,774	(99,063)
Investment tax credits receivable	189,000	(209,000)	91,000
Accounts payable and accrued liabilities	(641,799)	1,045,389	(46,907)
	(1,061,397)	544,015	(54,970)

Excluded from the consolidated statements of cash flows for the years ended December 31, 2005, 2004 and 2003 is the issuance of warrants paid as consideration for services of nil, nil and \$6,000, respectively, as described in note 6[c].

During 2005, the Company paid \$228,481 for interest on convertible debentures and nil for income taxes. During 2004 and 2003, the Company did not pay any amounts for interest or income taxes.

10. RECONCILIATION OF CANADIAN TO UNITED STATES GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

The Company prepares its consolidated financial statements in accordance with Canadian GAAP, which, as applied in these consolidated financial statements, conforms in all material respects to U.S. GAAP, except as follows:

	2005 \$	2004 \$	2003 \$
Net loss for the year [Canadian GAAP]	(4,989,705)	(5,568,899)	(4,062,711)
Adjustments			
Amortization of acquired technology [a]	72,572	90,715	113,393
Imputed interest on convertible debentures [b]	154,900	–	–
Amortization of deferred financing fees [c]	(19,364)	–	–
Net loss and comprehensive loss for the year			
[U.S. GAAP] [e]	(4,781,597)	(5,478,184)	(3,949,318)
Basic and diluted loss per share			
[U.S. GAAP]	\$ (0.22)	\$ (0.26)	\$ (0.19)
Weighted average number of common shares outstanding			
Basic and diluted	21,487,008	21,276,497	20,967,677

Basic loss per common share is determined using the weighted average number of common shares outstanding during the years. As a result of the net losses for the years ended December 31, 2005, 2004 and 2003, the potential dilutive effect of the exercise of stock options and warrants was anti-dilutive, and therefore, it has not been included in the calculation of diluted loss per share.

Notes to Consolidated Financial Statements

December 31, 2005 [In Canadian dollars, unless otherwise noted]

Consolidated balance sheet items, which would differ under U.S. GAAP, are as follows:

	2005 \$	2004 \$	2003 \$
ASSETS			
Acquired technology, net [a]	-	-	-
Deferred financing fees [c]	686,653	-	-
	11,211,832	6,633,221	7,620,454
LIABILITIES AND SHAREHOLDERS' EQUITY			
Convertible debentures [b]	8,359,877	-	-
	11,915,430	4,499,237	635,748
Shareholders' equity			
Capital stock [d]	29,182,269	28,924,764	28,789,296
Additional paid-in capital [d]	4,735,952	3,049,442	2,557,448
Deficit [a] [b] [c] [d]	(34,621,819)	(29,840,222)	(24,362,038)
	(703,598)	2,133,984	6,984,706
	11,211,832	6,633,221	7,620,454

[a] Acquired technology

Under U.S. GAAP, the Company's acquired technology, which is primarily comprised of patents and know-how which require regulatory approval to be commercialized and which has no proven alternative future uses, is considered in-process research and development and is immediately expensed upon acquisition in accordance with FAS 2, "Accounting for Research and Development Costs". The Company's acquired technology does not have an alternative future use given its specialized nature and limited alternative use. Under Canadian GAAP, the acquired technology is considered to be a development asset that is capitalized and amortized over its expected useful life.

[b] Convertible debentures

Under U.S. GAAP, no value is assigned to the equity conversion feature of the convertible debentures. In accordance with APB 14, a value is assigned to the warrants when they are detachable from the convertible debentures. Under Canadian GAAP, the fair values of the equity and warrant components of the convertible debentures are recorded as "equity component of convertible debentures" and "warrants", respectively. As a result, there is no difference in the value assigned to warrants under Canadian GAAP and U.S. GAAP. The fair value assigned to the convertible debentures under U.S. GAAP is recorded as a liability and is being accreted to its maturity value through charges to income for the imputed interest at an effective interest rate of 3.52% [Canadian GAAP effective interest rate of 12.75%].

[c] Deferred financing fees

Under U.S. GAAP, financing fees relating to the issue of convertible debentures are pro-rated between the liability and warrant components of the debentures. Under Canadian GAAP, the financing fees are allocated between the liability and the equity and warrant components. The expenses related to the liability component are deferred and amortized over the term of the debentures whereas the equity and warrant components are netted against their respective fair values. The resulting difference is that the financing fees allocated to the liability component under U.S. GAAP are higher than under Canadian GAAP, and therefore, additional amortization expense is recorded.

[d] Stock options and warrants

Prior to 2003, the Company did not recognize compensation expense relating to stock options under Canadian or U.S. GAAP. Effective January 1, 2003, the Company adopted the provisions of FAS 123, which aligned with the provisions of CICA Handbook Section 3870. Prior to January 1, 2003, the Company recognized compensation expense for the fixed and performance stock options granted to employees in accordance with APB 25. APB 25 required the Company to recognize compensation expense relating to the intrinsic value of the options when the market price of the underlying stock is greater than the exercise price of the stock options on the grant date. Compensation expense recorded prior to January 1, 2003 is recorded as “additional paid in capital” and is reclassified to capital stock upon exercising of the actual options. Under Canadian GAAP, there was no recognition of compensation expense related to employee options prior to January 1, 2003. Under U.S. GAAP, warrants are recorded as “additional paid in capital”.

[e] Comprehensive income

FAS 130, “Reporting Comprehensive Income”, establishes standards for the reporting and display of comprehensive income and its components in general purpose financial statements. Comprehensive income is defined as the change in net assets of a business enterprise during a period from transactions and other events and circumstances from non-owner sources, and includes all changes in equity during a period. For the years presented, the Company did not have any material transactions that would otherwise have had an impact on comprehensive income. As such, net loss for the year under U.S. GAAP is equal to comprehensive income.

[f] FAS 123 pro forma disclosures

FAS 123 requires pro forma disclosures of net loss and loss per share as if the fair value method, as opposed to the intrinsic value-based method, of accounting for employee stock options had been applied for performance options granted prior to January 1, 2003.

The following table presents the Company’s net loss and loss per share on a pro forma basis using the fair value method as determined by the Black-Scholes option pricing model:

	2005 \$	2004 \$	2003 \$
Net loss for the year			
U.S. GAAP – as reported	(4,781,597)	(5,478,184)	(3,949,318)
Pro forma stock-based compensation expense [d]	(225,923)	(376,879)	(428,226)
Net loss under U.S. GAAP – pro forma	(5,007,520)	(5,855,063)	(4,377,544)
Basic and diluted loss per share [U.S. GAAP]			
As reported	\$ (0.22)	\$ (0.26)	\$ (0.19)
Pro forma	\$ (0.23)	\$ (0.28)	\$ (0.21)
Weighted average number of common shares outstanding			
Basic and diluted	21,487,008	21,276,497	20,967,677

Notes to Consolidated Financial Statements

December 31, 2005 [In Canadian dollars, unless otherwise noted]

The assumptions used to calculate the fair value of stock compensation expense for performance options granted in the respective years prior to 2003 using the Black-Scholes option pricing model are as follows:

	High	Low
Expected volatility	62.3%	55.5%
Risk-free interest rate	6.19%	4.56%
Expected option life	5 years	5 years
Dividend yield	nil	nil

[g] Additional consolidated balance sheet information

Accounts payable and accrued liabilities consisted primarily of accruals related to clinical trials of \$372,420 [2004 – \$236,023; 2003 – \$142,000] and amounts owing to trade creditors of \$573,818 [2004 – \$1,352,014; 2003 – \$302,435].

In accordance with Canadian GAAP, the Company's cash and cash equivalents and short-term investments are carried at the lower of cost or market, based on quoted market prices. Under U.S. GAAP, these investments would have been classified as held-to-maturity and would be recorded at amortized cost. There is no significant difference between cost under Canadian GAAP and amortized cost under U.S. GAAP.

[h] Recent accounting developments

The Financial Accounting Standards Board issued Statement 123(R), "Share-Based Payment", which is a revision of FAS 123 and supersedes APB Opinion No. 25. FAS 123(R) requires all share-based payments to employees to be recognized in the financial statements based on their fair values. Pro forma disclosure will no longer be permitted. FAS 123(R) will be effective for fiscal years beginning after June 15, 2005. The Company is currently reviewing this standard, but has not yet determined its impact on the consolidated financial statements.

11. COMPARATIVE CONSOLIDATED FINANCIAL STATEMENTS

The comparative consolidated financial statements for the years ended December 31, 2004 and 2003 have been reclassified from statements previously presented to conform to the presentation of the 2005 consolidated financial statements.

Corporate Governance

MESSAGE FROM THE CHAIRMAN

Dear Fellow Shareholders,

The theme of this year's report, *Predict to Prevent*, embodies the mission that inspired the founding of this Company in 1992 to save lives through early detection of deadly diseases. As you have read throughout these pages, PreMD is today fulfilling that mission.

PreMD's 2005 accomplishments are highlighted in the Message to Shareholders on page 1. As a director of the Company since 1993, it is personally rewarding to see PreMD transition from a research and development organization to a commercial entity with significant, long-term growth potential.

That being said, during the year, PreMD faced some challenges. The pace of PREVU*'s commercialization was slower than anticipated, a disappointment for me as it was for all shareholders. Although PreMD is not at liberty to divulge the details of McNeil's strategy for PREVU*, I can tell you that it is evolving favorably. I believe that McNeil is making considerable progress in introducing PREVU* in select markets, and that, in time, the results will speak for themselves. The McNeil relationship is a key strategic asset for our Company and is fully supported by the Board of Directors.

Additionally, the United States Patent and Trademark Office (U.S. PTO) informed the Company in December of its decision not to reinstate two U.S. patents related to PreMD's skin sterol technology. These two patents were previously listed as abandoned for failure to pay maintenance fees. PreMD has filed a request for reconsideration with the U.S. PTO and authorized legal action against the law firm that was responsible for managing its patent portfolio at the time when the maintenance fees should have been paid.

What is important for shareholders to know is that the two patents in question remain in force in all other jurisdictions. Additionally, in the U.S., PreMD has an additional two patents in force in the field as well as three patents pending. Worldwide, PreMD has 38 patents or patents pending related to PREVU*. Finally, PREVU* is the product of years of proprietary development and expertise that is exclusive to PreMD.

It is equally important for shareholders to know that the fundamentals of this Company are sound. PreMD has unique, world-class technologies with tremendous commercial potential. It has established strategic relationships with leading, internationally renowned institutions in the cardiovascular and cancer fields. Moreover, the Company is well capitalized, prudently managed and has the flexibility to pursue growth opportunities.

The Board of Directors is ultimately responsible for stewardship of the Company, and together with management, oversees PreMD's business and relationships with concern for the best interests of shareholders, employees, partners and the community. The Board of Directors of PreMD has demonstrated a strong commitment to the Company, with an average attendance rate of 86% at the seven board meetings held in 2005.

I am pleased to tell you that PreMD is fully compliant with all pertinent requirements of the U.S. Securities and Exchange Commission (SEC) and Ontario Securities Commission. Additionally, PreMD adheres to the corporate governance principles put forth by the Toronto Stock Exchange (TSX) and the American Stock Exchange (Amex). Notably, PreMD's five-person Board of Directors consists of four unrelated, or independent, directors as defined by the TSX and Amex. This composition ensures analysis free from bias and aligns management decision-making in the best interests of stakeholders. More information on fiscal 2005 governance initiatives is available in PreMD's information circular.

I am as confident as ever that PreMD has a bright future as a world leader in predictive medicine. On behalf of the Board of Directors, I would like to personally thank you, our shareholders, for your continuing trust and support, and, above all, for believing in PreMD as we do.

Sincerely,



Stephen A. Wilgar

Chairman of the Board

BOARD OF DIRECTORS

Stephen A. Wilgar, BA, MBA^{1,3}
Chairman

- Past President, Warner-Lambert Canada, Asia, Australia and Latin America
- Presently serves on the Board of Directors of AIM PowerGen Corporation (Chairman) and Electrohome Ltd.

Anthony F. Griffiths, BA, MBA^{1,2,3}
Consultant and Corporate Director

- Presently serves on the Board of Directors of Russel Metals Inc. (Chairman), Alliance Atlantis Communications Inc., Vitran Corporation Inc., Hub International Limited, Fairfax Financial Holdings Limited, Novadaq Technologies, Inc.

Ron Henriksen, MBA^{2,3}
Chief Investment Officer, Twilight Ventures, LLC

- Presently serves on the Board of Directors of QLT, Inc., ANGEL Learning, Cytori Therapeutics and BioStorage Technologies

Brent Norton, MD, MBA
President and Chief Executive Officer, PreMD

David Rosenkrantz, P.ENG.^{1,2,4}
President, Patuca Securities Limited

- Presently serves on the Board of Directors of Stellar Pharmaceuticals Inc., Carfinco Income Fund, and Medisystem Technologies Inc. (Lead Director)

1 – Audit Committee

2 – Compensation and Corporate Governance Committee

3 – Nominating Committee

4 – Chairman of the Audit Committee

From left to right: Stephen Wilgar, Anthony Griffiths, Ron Henriksen, Brent Norton and David Rosenkrantz



Management Listing and Scientific Advisory Board

SCIENTIFIC ADVISORY BOARD (SAB)

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Chairman

Professor (and former Dean)
Departments of Medicine and Pathology
Faculty of Health Sciences
McMaster University
Hamilton, Ontario

Herbert A. Fritsche, Jr., PhD
Professor, Biochemist and Chief of Clinical Chemistry
Department of Pathology and Laboratory Medicine
University of Texas
M.D. Anderson Cancer Center
Houston, Texas

Norman Marcon, MD, FRCPC
Gastroenterologist and Past-Chief
Division of Gastroenterology
St. Michael's Hospital

Associate Professor of Medicine
University of Toronto
Toronto, Ontario

Dennis L. Sprecher, MD
Director, Dyslipidemia Discovery Medicine
GlaxoSmithKline

Adjunct Professor
University of Pennsylvania
Department of Cardiology, University of Pennsylvania
Medical Center Presbyterian
Philadelphia, Pennsylvania

Cardiologist, Adjunct Staff (formerly head of Preventative Cardiology)
The Cleveland Clinic Foundation
Cleveland, Ohio

MANAGEMENT

Brent Norton, MD, MBA
President and Chief Executive Officer

Michael Eveleigh, PhD
Executive Vice President, Clinical and Regulatory Affairs

Ron Hosking, CA
Vice President, Finance, and Chief Financial Officer

Tim Currie, BA
Vice President, Corporate Development

Sarah Borg-Olivier, BA
Director, Communications

Laila Gurney, B.Sc., M.Sc., RAC
Director, Clinical, Quality and Regulatory Affairs

Carla Herron, B.Sc., MBA
Director, Logistics

Peter Horsewood, B.Sc., PhD
Director, Scientific Affairs

Corporate Information

CORPORATE HEADQUARTERS

PreMD Inc.
4211 Yonge Street, Suite 615
Toronto, Ontario M2P 2A9
www.premdinc.com
info@premdinc.com

STOCK LISTING

Toronto Stock Exchange: PMD
American Stock Exchange: PME

TRANSFER AGENT AND REGISTRAR

Equity Transfer Services Inc.
120 Adelaide Street West, Suite 420
Toronto, Ontario
www.equitytransfer.com
T: 416.361.0152 ext. 221

AUDITORS

Ernst & Young LLP, Chartered Accountants
Ernst & Young Tower
Toronto-Dominion Centre
Toronto, Ontario

LEGAL COUNSEL

Aird & Berlis LLP
181 Bay Street, Suite 1800
BCE Place
Toronto, Ontario

Mintz, Levin, Cohn, Ferris, Glovsky and Popeo PC
One Financial Center
Boston, Massachusetts

INVESTOR RELATIONS (IR)

Current stock prices, financial reports, recent press releases and annual reports are accessible on PreMD's corporate website. The IR department may be contacted at info@premdinc.com or 416.222.3449.

ANNUAL MEETING AND WEBCAST

Shareholders are invited to attend the Company's annual meeting on Wednesday, May 24, 2006 at 4 p.m. (ET) at the Toronto Stock Exchange Conference Centre, 130 King Street West, Toronto, Ontario. A live audio webcast will be available at www.premdinc.com.

TRADEMARKS

- PREVU (in Canada)
- Cholesterol 1,2,3™
- ColorectAlert™
- LungAlert™
- ColoPath™



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