

## **To Our Shareholders:**

### **President and CEO's Review**

This last financial year was transformative for the Company, with some significant accomplishments for Medgenics, achieved against the powerful tide of the financial storm which has swept the globe.

Through the creative and tenacious efforts of truly dedicated staff, we have managed to navigate the storm while keeping our key operations moving forward, which enabled us to achieve unprecedented results in our EPODURE clinical trial and to complete our first commercial agreement with a major pharmaceutical company.

The demonstration of over 6-12 months of sustained anaemia treatment from a single administration of EPODURE in patients with chronic kidney disease proved that an appropriate dose of EPODURE can provide effective and sustained anaemia therapy and represents an unprecedented duration from a single treatment in patients – replacing scores of EPO injections. Our clinical results build upon the extensive laboratory experience, with more than 5,000 Biopumps successfully produced from more than 150 patients' tissue.

Furthermore, the EPODURE clinical results, taken together with our production of interferon-alpha (IFN $\alpha$ ) by INFRADURE Biopumps, have proven the concept of the Biopump as a platform to provide safe and sustained production and delivery of therapeutic protein on a continuous basis.

This demonstration of the Biopump as a platform technology helped convince our first pharmaceutical partner, a market leader in the field of haemophilia, to pursue with us a new application of the Biopump: to produce blood clotting Factor VIII, which if successful, could revolutionize the treatment of haemophilia. This first deal validated the commercial appeal of the Biopump value proposition, the strength of the Biopump science, brought needed funds to our operations and strengthened our ongoing efforts to raise equity funding.

This first commercial agreement has also spurred a substantial increase in commercial interest in the Biopump platform technology, as we found at the BioEurope conference in November 2009, and continuing in 2010. For Medgenics' more advanced pipeline applications, EPODURE in Phase I/II clinical trials in anaemia, and INFRADURE in preclinical stage, Medgenics will seek during the coming 12-24 months to reach attractive terms with partners along the lines of recent deals for protein therapies, involving milestones for preclinical and early stage clinical applications.

We have now obtained approval to extend our EPODURE Phase I/II trial to an additional major teaching hospital in Israel's largest city, the Tel Aviv Sourasky Medical Center, to continue with the higher dose treatments – implementing an important step in our plan made possible by the recent and ongoing fundraising, and have already commenced patient recruitment.

In addition to EPODURE, we are continuing to advance our pipeline development of other protein therapies on the Biopump platform. In particular, INFRADURE, the Company's Biopump for producing IFN $\alpha$  for treating hepatitis C, has moved forward.

We introduced INFRADURE for the first time at a major clinical conference, when we presented two posters in April 2010 at the leading European conference on liver disease, EASL, generating interest from liver experts, pharmaceutical and hospital product companies. Our Scientific Advisory Board experts on hepatitis C, and numerous of their colleagues at the EASL conference, confirmed the value proposition of INFRADURE in the future treatment of hepatitis C, even with the likely introduction of new direct antiviral agents.

Meanwhile, we are continuing early stage development of a Factor VIII Biopump, with our commercial partner. The haemophilia (Factor VIII) Biopump deal structure potentially provides a model for new applications more generally, including a funding mechanism for proving feasibility of a new Biopump application before commencement of licensing negotiations. Following on this model, Medgenics is exploring opportunities for further commercial interest in new applications using the Biopump platform to provide superior delivery and treatment over existing protein therapies.

In addition to developing new protein applications of the Biopump, the Company has advanced, and continues to advance, its planning for practical scale-up and commercial implementation of its Biopump treatment technology. This includes designing automated Biopump processing technology utilizing low cost single-use sealed cassettes intended for use in regional or local Biopump processing centres capable of producing and storing Biopumps for hundreds or even thousands of patients per year, in a cost-effective manner.

The practical implementation of the Biopump system will take advantage of the robustness and stability of the microorgans and Biopumps for practical logistical transport using standard shipping means. This will enable local implementation of microorgan harvest from patients, and Biopump administration to patients, by their own local physicians.

As the Biopump processing centre model evolves, an additional concept for partnering has emerged and garnered interest from potential partners: the establishment and operation of regional or even local Biopump processing centres. This model can offer pharmaceutical partners the advantages of Biopump therapy in their market applications, building on their existing infrastructure for selling injected therapeutics, while sparing them the need to establish their own Biopump processing centres.

Medgenics believes its unique technology aligns the Company with the objectives and priorities of the recent U.S. healthcare reforms, since the Biopump directly addresses major objectives such as:

- reducing costs while not reducing care – the inherent cost-effectiveness of the Biopump can offer same or superior clinical efficacy at lower cost than standard of care or current alternative treatments
- preventive medicine - Medgenics believes Biopump technology can make a significant contribution in such areas as management of renal anaemia, obesity and diabetes, where control can help prevent deterioration and further health issues.
- personalised medicine – a Biopump produces the patient’s own protein, which extends the concept of personalised medicine from diagnosis to therapy.

These advances have brought Medgenics to what we believe is a new chapter: the pre-revenue commercialization stage, where the Company can now focus major attention on advancing partnering activities towards deals with bio/pharmaceutical or other therapeutic partners for Biopumps producing various proteins and clinical applications and with manufacturing partners to set up Biopump processing centres and produce Biopumps.

We look forward to 2010 with renewed vigour. Against the backdrop of a difficult financial climate, we are now positioned to move forward on many fronts with the aim of developing the Biopump as a commercially viable platform technology, offering substantial advantages to patients, doctors and third-party payers over existing protein therapies. We will continue to update our shareholders as we make further progress in these respects.

Andrew L. Pearlman, PhD.  
President & CEO

## **Chairman's Review**

The Board of Medgenics presents the financial results of the Company and its subsidiary (the "Group") for the 12 months ended 31 December 2009.

I am pleased to be able to report on a period of significant progress for our Company during the past financial year, together with a further update on progress to date. The key points are:

- Signed first commercial agreement concluded with a major pharmaceutical partner, for preclinical development and option fees for Biopumps producing blood clotting Factor VIII, with a market leader in haemophilia.
- Completed the low dose stage of the EPODURE Phase I/II clinical trial and safety review, including attainment of 6-12 months sustained anaemia treatment from a single treatment and received required Israeli Ministry of Health approval and raised sufficient funds to commence higher dose groups.
- Introduced "INFRADURE" at its first major clinical conference, presenting data demonstrating Biopumps producing IFN $\alpha$  intended for use in treatment of hepatitis C, generating significant new partnering interest and also proving the Biopump platform can produce various proteins.
- Obtained issuance of key new patents in USA, Japan and Korea.
- Expanded active partnering discussions with interested pharmaceutical and device companies.
- Raised additional funding, including debentures and warrant exercise, in the UK and the US.

## Operational Review

During the period under review, the financial horizon of the Company provided by the working capital from our initial placing was extended through an additional placing of 4,420,000 shares in October 2009 in consideration for \$0.4 million; through the issuance of \$0.6 million in convertible debentures during June-September 2009; and the exercise of warrants in respect of 11,025,832 Common Shares in consideration for \$0.4 million, which (together with non-dilutive funding from the Israel Office of the Chief Scientist) gave the Company sufficient resources to survive the financial storm of 2009, while advancing and completing negotiations for our first significant commercial deal with a tier one international pharmaceutical company. This provided a further, non-dilutive cash injection of \$1.2 million in 2009 and an additional \$1.4 million in the first quarter of 2010, which has significantly strengthened our financial status, and has given momentum to our ongoing fundraising activities aimed at securing the financial position of the Company and our ongoing development activities through 2011.

Having successfully completed the first low dose group of our Phase I/II study of EPODURE in the treatment of anaemia in patients with renal failure, at the Hadassah Medical Center in Israel, approval has now been received to extend the study to another of Israel's major teaching hospitals, the Tel Aviv Sourasky Medical Center, which we believe should significantly help accelerate recruitment of patients as we proceed with the higher dose groups. EPODURE Biopumps produce erythropoietin ("EPO") which is used to treat anaemia in patients with chronic kidney disease.

The data generated in the seven patients in the trial to date is highly encouraging, with all EPODURE Biopumps producing EPO to an acceptable level before administration and, once implanted in the patients, delivering active EPO into the patients for months, with no material adverse effects, and resulting in haemoglobin elevation and maintenance of an unprecedented 6-12 months from a single administration of EPODURE Biopumps. The primary endpoint for successful treatment was the sustained elevation of haemoglobin level for up to 6 months in each patient following EPODURE

treatment compared to the levels projected for the same period without EPO injections, and without EPODURE treatment. A secondary objective was, for appropriate dose for a given patient, to maintain haemoglobin within the target range for these patients for a sustained period. Both these were attained in most patients, even at the lowest dose of only 20IU/kg/day, with sustained levels of haemoglobin over 6-12 months. In one formerly EPO-dependent patient, whom we have been following over 18 months, the haemoglobin levels have remained in the target range for all of that time, which is a considerable achievement for the technology, both for EPODURE itself and for the Biopump technology platform more generally.

As the low dose was designed to be equivalent to the low end of the FDA approved EPO dosing range (3 weekly injections of 50 IU/kg), which is not normally sufficient to raise haemoglobin to target levels in most patients in routine use, we were not expecting our low dose EPODURE to be sufficient for most patients. Thus, we were very pleased to note that, nonetheless, most patients responded even at this low dose. In accordance with the study protocol, in those cases where the haemoglobin levels remained below target range, those patients exited the study to receive supplementary injections of EPO. In clinical practice, additional Biopumps would be administered to raise the haemoglobin level, but the protocol of the current trial does not allow for that.

I am particularly pleased to be able to report the completion of our first commercial agreement with a tier one international pharmaceutical company. This preclinical development and option agreement is worth up to \$7 million in payments which include funding for preclinical development of Medgenics' Biopump protein technology to produce and deliver clotting protein Factor VIII for the sustained treatment of haemophilia. Under the terms of the agreement, Medgenics will receive \$4 million to work exclusively with this partner for one year to develop a Biopump to test the feasibility of continuous production and delivery of this clotting protein. Additional payments totalling \$3 million are payable upon Medgenics meeting certain technical milestones and upon the partner's exercise of an option to extend the exclusivity through an additional period to negotiate terms to commercialize the Biopump technology for Factor VIII. We anticipate having early in vitro data during the second half of this year, which could lead to the first licensing deal for the technology in 2011.

This haemophilia preclinical development and option deal is extremely important for the Company on a number of levels:

- Commercially, it generates cash inflows.
- As a “new protein” application for our Biopump technology, it validates the Biopump as a true platform technology applicable to a wide range of therapeutic proteins.
- It raises the profile of Medgenics as a partner for companies with significant interest in the biologics arena.
- It offers potential partners the opportunity to enter the biologics market without the necessity of building and approving a protein production plant.
- It circumvents the issues and hurdles to generic biologics in the yet to be resolved debate over biosimilars.

INFRADURE was introduced for the first time at in April 2010 at the leading European conference on liver disease, EASL, with the presentation of two posters, generating interest from liver experts, pharmaceutical and hospital product companies. The value proposition of INFRADURE was confirmed by our Scientific Advisory Board experts on hepatitis C, and many of their colleagues at the EASL conference, as a future treatment of hepatitis C, even with the likely introduction of new direct antiviral agents.

We have now generated extensive in-vitro data on Biopumps that produce EPO, IFN $\alpha$  and other proteins, having produced more than 5,000 Biopumps in vitro. This gives us the confidence that we can look at many of the major biologicals that are being commercialized today and offer a Biopump alternative.

We believe that this places Medgenics at the very core of personalised and cost-effective medicine going forward and that Medgenics' technology directly addresses key goals of the U.S. healthcare reform. We further believe that this supports our commercialisation plans for our Biopump technology as a robust platform from which the Company can grow dramatically in the future.

### Commercialisation Strategy

The Company's active discussions with potential strategic partners have expanded with additional companies expressing interest in one or more therapeutic applications. Furthermore, as the Company has developed its model for Biopump regional processing centres, this model has sparked new interest in the Biopump as a technology platform, particularly in potential partners with expertise in manufacturing and in medical devices. Further updates on these discussions will be given in due course.

### Key Appointments

In December 2009, Dr. Bruce R. Bacon was appointed to the Scientific Advisory Board of the Company. Dr. Bacon is a former President of the American Association for the Study of Liver Diseases (AASLD) and a recognized world expert on hepatitis. Dr. Bacon is the James F. King, MD Endowed Chair in Gastroenterology, Professor of Internal Medicine and Director of the Division of Gastroenterology and Hepatology at Saint Louis University School of Medicine in St. Louis, Missouri. Hepatitis is one of the core areas of treatment that we are seeking to commercialize. Having an expert of Dr. Bacon's calibre is essential as we move into the clinic with the exciting new approach to treatment that our INFRADURE technology offers.

### Other

It was with great sadness that the Company announced the death of Lord Leonard Steinberg, Non-Executive Director, on 2 November 2009. Lord Steinberg had served as a director of the Company since February 2008 and made an invaluable contribution to the continuing development of Medgenics and supported the Company enormously. He will be greatly missed.

### Funding

In parallel with the implementation of significant cost cutting measures to survive the 2009 financial crisis, the directors have focused on raising additional capital for the Company to continue to finance its operations and to realize its strategy of completing the Phase I/II clinical trial of EPODURE, advancing the development of additional products towards clinical trial and commercialization, developing additional Biopump applications, and pursuing strategic alliances with major corporations.

In January and February 2009, warrants over 11,025,832 Common Shares were exercised, raising gross proceeds of \$0.4 million.

In May 2009, Medgenics commenced a private placement to accredited investors of 10% convertible debentures, together with warrants to purchase 35% of the number of shares of Common Shares to be issued upon conversion of such debentures. In a series of closings, the Company raised \$0.6 million in gross proceeds from this private placement.

In October 2009, Medgenics issued a total of 4,420,000 Common Shares in consideration for \$0.4 million in gross proceeds.

In addition, during 2009 Medgenics received non-dilutive funding of \$1.2 million from its Factor VIII Biopump development agreement and an additional \$0.5 million in R&D grants from the Israeli government.

#### Financial Review

Despite significant economies taken in 2009, the Company has incurred significant expenditure in carrying out its ongoing clinical trials, in development of the Biopump platform technology, in maintaining and expanding its intellectual property, in the active pursuit of strategic partnering and in fundraising efforts. As a result, the Company has generated a loss of \$4.4 million for the year. The Company continues to receive grants from the Israeli Office of the Chief Scientist. However, the Board is fully aware that there is still significant further funding required in order to complete the ongoing trial and other programs for 2010. As highlighted above, the Board is constantly looking at ways to raise funds through equity funding, grants and/or strategic partnerships.

Of the funds required for the 2010 program, a total of about \$4m is expected in non-dilutive funding from a combination of the Factor VIII Biopump deal (of which \$1.4m has already been received in 2010) and in funding from the Office of the Chief Scientist in Israel. Furthermore, in March 2010 the Company successfully closed an additional round of equity financing, raising gross proceeds of \$1.1 million.

#### Outlook

With the approval of the Israel Ministry of Health to add an additional clinical site at Tel Aviv Sourasky Medical Center for our Phase I/II EPODURE clinical trial, we look forward to treating additional patients in the higher dose group and receiving further data regarding the efficacy of the technology in the coming months. We also look forward to obtaining early in vitro data on our Factor VIII Biopumps. In addition we will be actively pursuing strategic partnering opportunities that are already in process and seeking additional opportunities.

Finally I would like to thank all of the team at Medgenics for their dedication in what was a difficult but productive year for the Company and I know you will all share in that vote of confidence in the management and advisory boards who have worked hard to bring the Company to this position.

Eugene A. Bauer, MD  
Chairman of the Board of Directors

4 May 2010

**MEDGENICS, INC. AND ITS SUBSIDIARY**  
(A company in the development stage)

**CONSOLIDATED FINANCIAL STATEMENTS**  
**AS OF DECEMBER 31, 2009**

**IN U.S. DOLLARS**

**MEDGENICS, INC. AND ITS SUBSIDIARY**  
(A company in the development stage)

**CONSOLIDATED FINANCIAL STATEMENTS**  
**AS OF DECEMBER 31, 2009**

**IN U. S. DOLLARS**

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**REPORT OF REGISTERED PUBLIC ACCOUNTING FIRM  
TO THE BOARD OF DIRECTORS AND SHAREHOLDERS OF  
MEDGENICS, INC.  
(A company in the development stage)**

We have audited the accompanying consolidated balance sheets of Medgenics, Inc. (a company in the development stage) ("the Company") and its subsidiary as of December 31, 2009 and 2008, and the related consolidated statements of operations, changes in shareholders' equity (deficiency) and cash flows for the years then ended, and for the period from January 27, 2000 (date of inception) through December 31, 2009. 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. The financial statements for the period from January 27, 2000 (date of inception) through December 31, 2000 were audited by other auditors, whose report dated March 7, 2001, expressed an unqualified opinion on those statements. Our opinion on the statements of operations, shareholders' equity (deficiency), and cash flows for the period from January 27, 2000 (date of inception) through December 31, 2009, in so far as it relates to amounts for prior periods through December 31, 2000, is based solely on the report of other auditors.

We conducted our audits in accordance with auditing standards generally accepted in the 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 audits 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, based on our audits and the report of the other auditors the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company and its subsidiary as of December 31, 2009 and 2008, and the consolidated results of their operations, and their cash flows for the years then ended, and for the period from January 27, 2000 (date of inception) through December 31, 2009, in conformity with accounting principles generally accepted in the United States.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As more fully described in Note 1b, the Company is in the development stage, has not yet generated revenues from its operations and is dependent on external sources for financing its operations. These conditions raise substantial doubt about the Company's ability to continue as a going concern. Management's plans in regard to these matters are described in Note 1b. The consolidated financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that may result from the outcome of this uncertainty.

  
Kost Forer Gabbay & Kasierer  
A Member of Ernst & Young Global

Haifa, Israel  
May 4, 2010

**MEDGENICS, INC. AND ITS SUBSIDIARY**  
(A company in the development stage)

**CONSOLIDATED STATEMENTS OF OPERATIONS**

**In US Dollars (except for share data)**

		<b>December 31,</b>	
	<b>Note</b>	<b>2009</b>	<b>2008</b>
<b>ASSETS</b>			
CURRENT ASSETS:			
Cash and cash equivalents	3	\$ 469,928	\$ 1,043,338
Accounts receivable and prepaid expenses	4	11,187	121,794
Total current assets		481,115	1,165,132
LONG TERM ASSETS:			
Restricted lease deposit	8(e)	24,169	22,607
Prepaid lease payments	8(e)	14,742	22,443
Severance pay fund		261,561	171,048
Total long term assets		300,472	216,098
PROPERTY AND EQUIPMENT, NET	5	302,733	400,214
Total Assets		\$ 1,084,320	\$ 1,781,444

**MEDGENICS, INC. AND ITS SUBSIDIARY**  
(A company in the development stage)

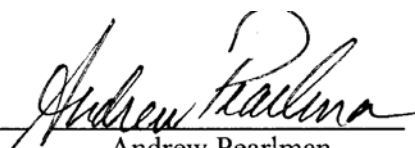
**CONSOLIDATED STATEMENTS OF OPERATIONS**

In US Dollars (except for share data)

		<b>December 31,</b>	
	<b>Note</b>	<b>2009</b>	<b>2008</b>
<b>LIABILITIES AND SHAREHOLDERS' DEFICIENCY</b>			
<b>CURRENT LIABILITIES:</b>			
Short-term bank credit		\$ -	\$ 52,886
Trade payables	6	947,104	889,002
Advance payment for research and development participation	1(c)	667,012	-
Other accounts payable and accrued expenses	7	1,689,518	1,068,518
Total current liabilities		3,303,634	2,010,406
<b>LONG-TERM LIABILITIES:</b>			
Accrued severance pay		990,764	818,639
Convertible debentures	10	1,013,404	-
Total long-term liabilities		2,004,168	818,639
Total liabilities		5,307,802	2,829,045
<b>COMMITMENTS AND CONTINGENCIES</b>			
	8		
<b>SHAREHOLDERS' DEFICIENCY:</b>			
	9		
Common shares - \$0.0001 par value; 500,000,000 shares authorized at December 31, 2009 and 2008; 122,174,027 and 106,728,195 shares issued and outstanding at December 31, 2009 and 2008, respectively		12,217	10,672
Additional paid-in capital		30,327,813	28,968,015
Receipts on account of shares		25,000	150,000
Deficit accumulated during the development stage		(34,588,512)	(30,176,288)
Total Shareholders' Deficiency		(4,223,482)	(1,047,601)
Total Liabilities and Shareholders' Deficiency		\$ 1,084,320	\$ 1,781,444

May 4, 2010

Date of approval



Andrew Pearlman -  
President & CEO



Phyllis Bellin - Director of  
Finance & Administration

**MEDGENICS, INC. AND ITS SUBSIDIARY**  
(A company in the development stage)

**CONSOLIDATED STATEMENTS OF OPERATIONS**

In US Dollars (except for share data)

	Note	Year ended December 31		Period from inception (January 27, 2000) through December 31,
		2009	2008	2009
Research and development expenses		\$ 2,342,304	\$ 3,435,538	\$ 20,536,679
Less - Participation by the Office of the Chief Scientist	2(l)	(488,532)	(1,336,446)	(3,728,239)
Participation of third party	1(c)	(532,988)	-	-
Research and development expenses, net		1,320,784	2,099,092	16,808,440
General and administrative expenses		2,540,452	2,761,008	16,691,319
Loss from disposal of property and equipment		2,860	-	328,702
Operating loss		3,864,096	4,860,100	33,828,461
Financial expenses (income)	12	543,893	(11,457)	1,115,974
Loss before taxes on income		4,407,989	4,848,643	34,944,435
Taxes on income	11	1,043	3,615	71,337
Net loss		<u>\$ 4,409,032</u>	<u>\$ 4,852,258</u>	<u>\$ 35,015,772</u>
Dividend in respect of reduction in exercise price of certain warrants		3,192	6,745	
Net loss attributable to common shareholders		<u>\$ 4,412,224</u>	<u>\$ 4,859,003</u>	
Basic and diluted net loss per share		<u>\$ 0.04</u>	<u>\$ 0.05</u>	
Weighted average number of shares used in computing basic and diluted net loss per share		<u>117,845,867</u>	<u>106,447,604</u>	

**STATEMENTS OF CHANGES IN SHAREHOLDERS' DEFICIENCY**

In US Dollars (except for share data)

	Old Common shares		Preferred shares Series A		Preferred shares Series B		Additional Paid-in Capital	Deferred Stock Compensation	Deficit Accumulated During the Development Stage	Total Shareholders' Equity (Deficiency)
	Number of Shares	Amount	Number of Shares	Amount	Number of Shares	Amount				
Balance as of January 27, 2000 (inception)	-	\$ -	-	\$ -	-	\$ -	\$ -	\$ -	\$ -	\$ -
Issuance of Old Common shares in										
January 2000 at par value	2,000,000	2	-	-	-	-	-	-	-	2
Issuance of Old Common shares in March 2000 at par value	69,677	-	-	-	-	-	-	-	-	-
Issuance of Old Common shares in August 2000 at \$1.14 per share, net	437,936	-	-	-	-	-	499,997	-	-	499,997
Issuance of Old Common shares in respect of license agreement in August 2000 at par value	940,950	1	-	-	-	-	-	-	-	1
Net loss	-	-	-	-	-	-	-	-	(681,216)	(681,216)
Balance as of December 31, 2000	3,448,563	3	-	-	-	-	499,997	-	(681,216)	(181,216)
Stock split effected as stock dividend	-	342	-	-	-	-	(342)	-	-	-
Issuance of Preferred shares in January 2001 at \$1.41 per share, net	-	-	138,502	14	-	-	195,122	-	-	195,136
Issuance of Preferred shares in March and June 2001 at \$1.67 per share, net	-	-	4,085,837	408	-	-	6,805,968	-	-	6,806,376
Deferred stock compensation	-	-	-	-	-	-	248,165	(248,165)	-	-
Amortization of deferred stock compensation	-	-	-	-	-	-	-	40,880	-	40,880
Stock based compensation expense related to options to consultants	-	-	-	-	-	-	510,869	-	-	510,869
Net loss	-	-	-	-	-	-	-	-	(3,243,701)	(3,243,701)
Balance as of December 31, 2001	3,448,563	\$345	4,224,339	\$422	-	\$ -	\$8,259,779	\$(207,285)	\$(3,924,917)	\$4,128,344

**STATEMENTS OF CHANGES IN SHAREHOLDERS' DEFICIENCY**

**In US Dollars (except for share data)**

	Old Common shares		Preferred shares Series A		Preferred shares Series B		Additional Paid-in Capital	Deferred Stock Compensation	Deficit Accumulated During the Development Stage	Total Shareholders' Equity
	Number of Shares	Amount	Number of Shares	Amount	Number of Shares	Amount				
Balance as of December 31, 2001	3,448,563	\$ 345	4,224,339	\$ 422	-	\$ -	\$ 8,259,779	\$ (207,285)	\$ (3,924,917)	\$ 4,128,344
Issuance of Preferred shares In October 2002 at \$1.97 per share, net	-	-	-	-	2,676,674	268	5,264,352	-	-	5,264,620
Deferred stock compensation	-	-	-	-	-	-	63,855	(63,855)	-	-
Amortization of deferred stock compensation	-	-	-	-	-	-	-	66,937	-	66,937
Stock based compensation expenses related to options to consultants	-	-	-	-	-	-	371,560	-	-	371,560
Net loss	-	-	-	-	-	-	-	-	(5,049,391)	(5,049,391)
Balance as of December 31, 2002	<u>3,448,563</u>	<u>\$ 345</u>	<u>4,224,339</u>	<u>\$ 422</u>	<u>2,676,674</u>	<u>\$ 268</u>	<u>\$13,959,546</u>	<u>\$ (204,203)</u>	<u>\$ (8,974,308)</u>	<u>\$ 4,782,070</u>

**STATEMENTS OF CHANGES IN SHAREHOLDERS' DEFICIENCY**

**In US Dollars (except for share data)**

	Old Common shares		Preferred shares Series A		Preferred shares Series B		Additional Paid-in Capital	Deferred Stock Compensation	Deficit Accumulated During the Development Stage	Total Shareholders' Equity
	Number of Shares	Amount	Number of Shares	Amount	Number of Shares	Amount				
	Balance as of December 31, 2002	3,448,563	\$ 345	4,224,339	\$ 422	2,676,674				
Exercise of stock options	19,443	2	-	-	-	-	193	-	-	195
Issuance of Preferred shares in April 2003 at \$ 2.00 per share, net	-	-	-	-	216,507	22	432,994	-	-	433,016
Issuance of Preferred shares in May 2003 at \$ 2.00 per share, net	-	-	-	-	850,490	85	1,603,783	-	-	1,603,868
Deferred stock compensation	-	-	-	-	-	-	440,811	(440,811)	-	-
Amortization of deferred stock compensation	-	-	-	-	-	-	-	105,213	-	105,213
Stock based compensation expenses related to options to consultants	-	-	-	-	-	-	475,469	-	-	475,469
Net loss	-	-	-	-	-	-	-	-	(5,038,272)	(5,038,272)
Balance as of December 31, 2003	<u>3,468,006</u>	<u>\$ 347</u>	<u>4,224,339</u>	<u>\$ 422</u>	<u>3,743,671</u>	<u>\$ 375</u>	<u>\$16,912,796</u>	<u>\$ (539,801)</u>	<u>\$(14,012,580)</u>	<u>\$ 2,361,559</u>

**STATEMENTS OF CHANGES IN SHAREHOLDERS' DEFICIENCY**

In US Dollars (except for share data)

	Old Common shares		Preferred shares Series A		Preferred shares Series B		Additional Paid-in Capital	Deferred Stock Compensation	Deficit Accumulated During the Development Stage	Total Shareholders' Equity (Deficiency)
	Number of Shares	Amount	Number of Shares	Amount	Number of Shares	Amount				
Balance as of December 31, 2003	3,468,006	\$347	4,224,339	\$ 422	3,743,671	\$ 375	\$ 16,912,796	\$ (539,801)	\$(14,012,580)	\$ 2,361,559
Exercise of stock options	12,750	1	-	-	-	-	126	-	-	127
Stock based compensation related to shares to consultants	33,333	3	-	-	-	-	9,997	-	-	10,000
Amortization of deferred stock compensation	-	-	-	-	-	-	-	539,801	-	539,801
Stock based compensation expense related to options to consultants	-	-	-	-	-	-	346,762	-	-	346,762
Net loss	-	-	-	-	-	-	-	-	(4,515,829)	(4,515,829)
Balance as of December 31, 2004	3,514,089	\$351	4,224,339	422	3,743,671	375	\$17,269,681	-	(18,528,409)	\$(1,257,580)
Net loss	-	-	-	-	-	-	-	-	(776,129)	(776,129)
Balance as of December 31, 2005	3,514,089	\$351	4,224,339	\$ 422	3,743,671	\$ 375	\$17,269,681	\$ -	\$(19,304,538)	\$(2,033,709)

**STATEMENTS OF CHANGES IN SHAREHOLDERS' DEFICIENCY**

**In US Dollars (except for share data)**

	<u>Common shares</u>		<u>Old Common shares</u>		<u>Preferred shares Series A</u>		<u>Preferred shares Series B</u>		<u>Additional Paid-in Capital</u>	<u>Deficit Accumulated During the Development Stage</u>	<u>Total Shareholders' Equity (Deficiency)</u>
	<u>Number of Shares</u>	<u>Amount</u>	<u>Number of Shares</u>	<u>Amount</u>	<u>Number of Shares</u>	<u>Amount</u>	<u>Number of Shares</u>	<u>Amount</u>			
	Balance as of December 31, 2005	-	\$ -	3,514,089	\$ 351	4,224,339	\$ 422	3,743,671			
Conversion of Old Common shares, Series A and Series B Preferred shares into Common shares	9,885,842	46	(3,514,089)	(351)	(4,224,339)	(422)	(3,743,671)	(375)	(436,095)	437,197	-
Conversion of convertible Note into Common shares	11,982,914	56	-	-	-	-	-	-	1,795,016	-	1,795,072
Issuance of Common shares in settlement of due debt in March 2006	2,633,228	12	-	-	-	-	-	-	96,004	-	96,016
Issuance of Common shares and warrants in March 2006 at \$0.07 per share and warrant, net	14,110,490	66	-	-	-	-	-	-	828,197	-	828,263
Issuance of Common shares and warrants in April 2006 at \$0.07 per share and warrant, net	513,396	2	-	-	-	-	-	-	30,133	-	30,135
Issuance of Common shares and warrants in June 2006 at \$0.07 per share and warrant, net	1,593,666	8	-	-	-	-	-	-	93,538	-	93,546
Issuance of Common shares and warrants in November 2006 at \$0.12 per share and warrant, net	5,391,725	25	-	-	-	-	-	-	521,752	-	521,777
Issuance of Common shares and warrants in December 2006 at \$0.12 per share and warrant, net	11,294,065	53	-	-	-	-	-	-	1,092,916	-	1,092,969
Stock based compensation expense related to options and warrants granted to consultants and employees	-	-	-	-	-	-	-	-	1,161,287	-	1,161,287
Net loss	-	-	-	-	-	-	-	-	-	(2,598,605)	(2,598,605)
Balance as of December 31, 2006	<u>57,405,326</u>	<u>\$ 268</u>	<u>-</u>	<u>\$ -</u>	<u>-</u>	<u>\$ -</u>	<u>-</u>	<u>\$ -</u>	<u>\$22,452,429</u>	<u>\$(21,465,946)</u>	<u>\$ 986,751</u>

**STATEMENTS OF CHANGES IN SHAREHOLDERS' DEFICIENCY**

In US Dollars (except for share data)

	Common shares		Additional Paid-in Capital	Deficit Accumulated During the Development Stage	Total Shareholders' Equity
	Number of Shares	Amount			
Balance as of December 31, 2006	57,405,326	\$ 268	\$22,452,429	\$ (21,465,946)	\$ 986,751
Issuance of Common shares and warrants in January 2007 at \$0.12 per share and warrant, net	427,402	2	33,318	-	33,320
Issuance of Common shares and warrants in May 2007 at \$0.16 per share and warrant, net	5,347,851	25	583,636	-	583,661
Issuance of Common shares in July 2007 at \$0.16 per share, net	771,612	3	84,211	-	84,214
Exercise of warrants in July 2007	451,939	2	-	-	2
Issuance of Common shares to consultant in August 2007, net	122,232	1	(1)	-	-
Issuance of Common shares and warrants in August 2007 at \$0.16 per share and warrant, net	1,527,973	7	166,753	-	166,760
Stock split effected as stock dividend in December 2007	-	6,297	(6,297)	-	-
Beneficial conversion feature embedded in convertible Note	-	-	511,391	-	511,391
Issuance of Common shares and warrants in December 2007 at \$0.19 - \$0.21 per share and warrant, where applicable, net, in respect to the admission at AIM	38,039,082	3,804	4,493,849	-	4,497,653
Issuance cost due to obligation to issue 142,609 Common shares for consultant, net	-	-	(31,449)	-	(31,449)
Stock based compensation expense related to options granted to consultants and employees	-	-	346,802	-	346,802
Net loss	-	-	-	(3,851,339)	(3,851,339)
Balance as of December 31, 2007	<u>104,093,417</u>	<u>\$ 10,409</u>	<u>\$28,634,642</u>	<u>\$ (25,317,285)</u>	<u>\$ 3,327,766</u>

**STATEMENTS OF CHANGES IN SHAREHOLDERS' DEFICIENCY**

**In US Dollars (except for share data)**

	Common shares		Additional Paid-in Capital	Receipts on account of shares	Deficit Accumulated During the Development Stage	Total Shareholders' Equity (Deficiency)
	Number of Shares	Amount				
Balance as of December 31, 2007	104,093,417	\$ 10,409	\$ 28,634,642	\$ -	\$(25,317,285)	\$ 3,327,766
Cashless exercise of warrants in January 2008	2,462,050	246	(246)	-	-	-
Issuance of Common shares to consultant in April 2008 at \$0.22 per share	142,609	14	31,435	-	-	31,449
Exercise of warrants in December 2008	30,119	3	(3)	-	-	-
Stock based compensation related to options granted to consultants and employees	-	-	295,442	-	-	295,442
Receipts on account of shares in respect to exercise of warrants in January 2009	-	-	-	150,000	-	150,000
Dividend in respect of reduction in exercise price of certain warrants	-	-	6,745	-	(6,745)	-
Net loss	-	-	-	-	(4,852,258)	(4,852,258)
Balance as of December 31, 2008	106,728,195	10,672	28,968,015	150,000	(30,176,288)	(1,047,601)
Exercise of warrants in January and February 2009	11,025,832	1,103	387,821	(150,000)	-	238,924
Stock based compensation related to options granted to consultants and employees	-	-	604,567	-	-	604,567
Issuance of Common Shares in October 2009, net at \$0.10 per Share	4,420,000	442	364,218	-	-	364,660
Receipts on account of shares in respect to exercise of warrants in January 2010	-	-	-	25,000	-	25,000
Dividend in respect of reduction in exercise price of certain warrants	-	-	3,192	-	(3,192)	-
Net loss	-	-	-	-	(4,409,032)	(4,409,032)
Balance as of December 31, 2009	<u>122,174,027</u>	<u>\$ 12,217</u>	<u>\$ 30,327,813</u>	<u>\$ 25,000</u>	<u>\$(34,588,512)</u>	<u>\$(4,223,482)</u>

**MEDGENICS, INC. AND ITS SUBSIDIARY**  
(A company in the development stage)

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

In US Dollars

	<b>Year ended December 31</b>		<b>Period from inception (January 27, 2000) through December 31 2009</b>
	<b>2009</b>	<b>2008</b>	<b>2009</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net loss	\$ (4,409,032)	\$ (4,852,258)	\$ (35,015,772)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation	120,483	96,497	864,447
Exchange differences on a long term loan	-	-	2,950
Loss from disposal of property and equipment	2,860	-	328,702
Issuance of shares in consideration for providing security for letter of credit	-	-	15,748
Stock based compensation related to options and warrants granted to employees and consultants	604,567	295,442	4,875,590
Interest and amortization of beneficial conversion feature of convertible note	-	-	759,197
Change in fair value of convertible debentures	443,404	-	443,404
Accrued severance pay, net	81,612	77,035	729,203
Exchange differences on a restricted lease deposit	(1,562)	-	(1,562)
Increase in trade payables	66,194	439,036	947,104
Decrease (Increase) in accounts receivable and pre-paid expenses	110,607	261,354	(11,187)
Increase in other accounts payable and accrued expenses	1,288,012	564,055	2,452,546
Net cash used in operating activities	<u>(1,692,855)</u>	<u>(3,118,839)</u>	<u>(23,609,630)</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Proceeds from disposal of property and equipment	-	-	172,869
Decrease (Increase) in prepaid lease payments	7,701	(10,939)	(14,742)
Increase in restricted lease deposit	-	(22,607)	(22,607)
Purchase of property and equipment	<u>(33,954)</u>	<u>(371,622)</u>	<u>(1,668,711)</u>
Net cash used in investing activities	<u>(26,253)</u>	<u>(405,168)</u>	<u>(1,533,191)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Proceeds from issuance of shares, net	364,660	(309,741)	22,034,550
Proceeds from exercise of warrants, net	263,924	150,000	413,924
Repayment of a long-term loan	-	-	(73,080)
Proceeds from long term loan	-	-	70,130
Proceeds from a convertible Note	570,000	-	3,167,225
Increase (Decrease) in short-term bank credit	<u>(52,886)</u>	<u>43,172</u>	<u>-</u>
Net cash provided by (used in) financing activities	<u>1,145,698</u>	<u>(116,569)</u>	<u>25,612,749</u>
Increase (Decrease) in cash and cash equivalents	(573,410)	(3,640,576)	469,928
Balance of cash and cash equivalents at the beginning of the period	<u>1,043,338</u>	<u>4,683,914</u>	<u>-</u>
Balance of cash and cash equivalents at the end of the period	<u>\$ 469,928</u>	<u>\$ 1,043,338</u>	<u>\$ 469,928</u>

**MEDGENICS, INC. AND ITS SUBSIDIARY**  
(A company in the development stage)

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**In US Dollars**

	<b>Year ended December 31</b>		<b>Period from inception (January 27, 2000) through December 31 2009</b>
	<u>2009</u>	<u>2008</u>	
<b>Supplemental disclosure of cash flow information:</b>			
Cash paid during the period for:			
Interest	<u>\$ 36,192</u>	<u>\$ 833</u>	<u>\$ 75,451</u>
Taxes	<u>\$ 13,243</u>	<u>\$ 12,420</u>	<u>\$ 83,537</u>
<b>Supplemental disclosure of non cash flow information:</b>			
Issuance expenses	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 309,741</u>
Issuance of Common shares upon conversion of a convertible Note	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 2,845,072</u>
Issuance of shares in settlement of debt	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 96,016</u>
Purchase of property and equipment	<u>\$ -</u>	<u>\$ 8,092</u>	<u>\$ -</u>

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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**In US Dollars**

**NOTE 1:- GENERAL**

- a. Medgenics, Inc. ("the Company") was incorporated in January 2000 in Delaware. The Company has a wholly-owned subsidiary, Medgenics Medical Israel Ltd. (formerly Biogenics Ltd.) ("the subsidiary"), which was incorporated in Israel in March 2000. The Company and its subsidiary are engaged in the research and development of products in the field of biotechnology and associated medical equipment and are thus considered development stage companies as defined in Accounting Standards Codification ("ASC") Topic number 915 "Development Stage Entities" ("ASC 915") (originally issued as "FAS 7").

On December 4, 2007 the Company's Common shares were admitted for trading on the AIM market of the London Stock Exchange (see note 9d (21)).

- b. The Company and its subsidiary are in the development stage. The subsidiary ceased operating in 2004 and in 2006 renewed its research and development activities after having raised additional funds. As reflected in the accompanying financial statements, the Company incurred a loss during the year ended December 31, 2009 of \$ 4,409,032 and has an accumulated deficit since inception in the amount of \$ 34,588,512. The Company and its subsidiary have not yet generated revenues from product sale and have negative cash flows from operations. These conditions raise substantial doubt about the Company's ability to continue as a going concern. Management's plans include seeking additional investments to continue the operations of the Company and its subsidiary. However, there is no assurance that the Company will be successful in its efforts to raise the necessary capital to continue its planned research and development activities. The consolidated financial statements do not include any adjustments with respect to the carrying amounts of assets and liabilities and their classification that might result from the outcome of this uncertainty.
- c. On October 22, 2009 ("Effective Date") the Company signed a preclinical development and option agreement which was amended in December 2009 ("the Agreement"), with a major international healthcare company ("the healthcare company") that is a market leader in the field of hemophilia. The Agreement includes funding for preclinical development of the Company's Biopump protein technology to produce and deliver the clotting protein Factor VIII ("FVIII") for the sustained treatment of hemophilia.

Under the terms of the Agreement, the Company will receive up to \$4.1 million to work exclusively with the healthcare company for one year to develop a Biopump to test the feasibility of continuous production and delivery of this clotting protein. The amount of \$4.1 million will include the following:

- \$1.5 million to work exclusively with the healthcare company (Standstill Payment)
- \$2.6 million as development funding

Additional payments totaling \$3 million are payable upon the Company's meeting certain milestones (\$0.5 million) and upon the healthcare company's exercise of an option to extend the exclusivity through an additional period to negotiate terms to commercialize the Biopump technology for FVIII (\$2.5 million).

If the two parties choose not to proceed to a full commercial agreement, the Company will receive all rights to the jointly developed intellectual property and will pay royalties to the healthcare company on any future proceeds arising from such intellectual property up to a maximum of ten times the total funds paid by the healthcare company.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
**In US Dollars**

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**NOTE 1:- GENERAL (CONT.)**

**c.** (cont.)

According to the above, the Company will recognize income in its statements of operation as follows:

- Standstill Payment – ratably over the expected standstill period, commencing on the Effective Date and expiring on October 22, 2010, taking into consideration the probability of the extension period.
- Development– based on hours incurred assigned to the project and expenses incurred. The excess of the recognized amount received from the healthcare company over the amount of research and development expenses incurred during the period shall be recognized as other income within operating income.
- Milestones – upon the achievement of the specific milestone.

Regarding the option to negotiate a future definitive agreement for the continuation of the development or for a sale, license or other transfer of the FVIII Biopump technology, as of the Balance Sheet date, the Company estimated the value of this Option at the effective date as immaterial.

As of balance sheet date, the Company has recognized an income of \$532,988 related to the Standstill Payment and to the development which is classified as a reduction of research and development expenses in the statement of operations.

A payment of \$1.2 million was received from the healthcare company in November 2009 and an additional payment of \$1.4 million was received subsequent to balance sheet date, in February 2010.

- d.** During 2009 the subsidiary received approval for an additional Research and Development program from the Office of the Chief Scientist in Israel for the period April 2009 through March 2010 (which was extended to August, 2010 subsequent to balance sheet date).

The approval allows for a grant of up to approximately \$1.3 million based on R&D expenses of up to \$2.1 million.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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**In US Dollars**

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES**

The consolidated financial statements are prepared in accordance with United States Generally Accepted Accounting Principles ("U.S. GAAP").

**a. Use of estimates**

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates, judgments and assumptions. The Company's management believes that the estimates, judgments and assumptions used are reasonable based upon information available at the time they are made. These estimates, judgments and assumptions can affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

**b. Financial statements in Dollars**

The majority of the Company and its subsidiary's operations are currently conducted in Israel; however, most of the expenses are denominated in or linked to U.S. Dollars ("Dollars"). Financing activities including loans, equity transactions and cash investments, are made mainly in Dollars. The Company's management believes that the Dollar is the primary currency of the economic environment in which the Company and its subsidiary operate. Thus, the functional and reporting currency of the Company and its subsidiary is the Dollar.

Accordingly, transactions and balances denominated in Dollars are presented at their original amounts. Non-Dollar transactions and balances have been re-measured to Dollars, in accordance with ASC 830 of the Financial Accounting Standards Board ("FASB") (originally issued as FAS 52). All exchange gains and losses from re-measurement of monetary balance sheet items denominated in non-Dollar currencies are reflected in the statements of operations as financial income or expenses, as appropriate.

**c. Consolidated financial statements**

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiary. Inter-company transactions and balances have been eliminated upon consolidation.

**d. Cash equivalents**

The Company and its subsidiary consider all highly liquid investments originally purchased with maturities of three months or less to be cash equivalents.

**e. Property and equipment**

Property and equipment are stated at cost net of accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful lives of the assets. Assets lives are reviewed periodically to determine if appropriate and adjustments are made as necessary. Depreciation begins at the time the asset is placed in service.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**In US Dollars**

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)**

**e. Property and equipment (cont.)**

The annual rates of depreciation are as follows:

	%	
Furniture and office equipment	6 - 15	(mainly 15)
Computers and peripheral equipment	33	
Laboratory equipment	15 - 33	(mainly 15)
Leasehold improvements		The shorter of term of the lease or the useful life of the asset

**f. Impairment of long-lived assets**

Long-lived assets are reviewed for impairment in accordance with ASC 360, "Property, Plant, and Equipment" ("ASC 360") (originally issued as FAS 144), whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of an asset to be held and used is measured by a comparison of the carrying amount of the asset to the future undiscounted cash flows expected to be generated by the asset. If such an asset is considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the asset exceeds the fair value of the asset. During the years ended December 31, 2009 and 2008, no impairment losses have been identified.

**g. Accrued severance pay**

The subsidiary's liability for severance pay is calculated pursuant to the Israeli severance pay law based on the most recent salary for the employees multiplied by the number of years of employment, as of the balance sheet date. Employees are entitled to one month salary for each year of employment or a portion thereof. In addition, several employees are entitled to additional severance compensation as per their employment agreement. The subsidiary's liability for all of its employees is fully provided by an accrual and is mainly funded by monthly deposits with insurance policies. The value of these policies is recorded as an asset in the Company's balance sheet.

The deposited funds may be withdrawn only upon the fulfillment of the obligation pursuant to Israeli severance pay law or labor agreements. The value of the deposited funds is based on the cash surrender value of these policies and includes profits or losses as appropriate.

Severance expenses for the years ended December 31, 2009 and 2008 and for the period from inception (March 27, 2000) through December 31, 2009, amounted to \$172,125, \$155,848 and \$1,401,648, respectively.

**h. Income taxes**

The Company and its subsidiary account for income taxes in accordance with ASC 740, "Income Taxes" ("ASC 740"), (originally issued as FAS 109). ASC 740 prescribes the use of the liability method whereby deferred tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Company and its subsidiary provide a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value. As of December 31, 2009 a full valuation allowance was provided by the Company.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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**In US Dollars**

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)**

**h. Income taxes (cont.)**

On January 1, 2007, the Company adopted ASC 740-10, "Accounting for Uncertainty in Income Taxes", (originally issued as "FIN 48"). ASC 740-10 contains a two-step approach for recognizing and measuring uncertain tax positions accounted for in accordance with ASC 740. The first step is to evaluate the tax position taken or expected to be taken in a tax return by determining if the weight of available evidence indicates that it is more likely than not that, on an evaluation of the technical merits, the tax position will be sustained on audit, including resolution of any related appeals or litigation processes. The second step is to measure the tax benefit as the largest amount that is more than 50% likely to be realized upon ultimate settlement.

**i. Stock based compensation**

On January 1, 2006, the Company adopted ASC 718, "Compensation-Stock Compensation" ("ASC 718"), (originally issued as FAS 123(R)) which requires the measurement and recognition of compensation expense based on estimated fair values for all share-based payment awards made to employees and directors.

ASC 718 requires companies to estimate the fair value of equity-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as an expense over the requisite service periods in the Company's consolidated statement of operations. Prior to the adoption of ASC 718, the Company accounted for equity-based awards to employees and directors using the intrinsic value method in accordance with APB 25.

The Company adopted ASC 718 using the modified prospective transition method, which requires the application of the accounting standard starting from January 1, 2006, the first day of the Company's fiscal year 2006. Under that transition method, compensation cost recognized in the years ended December 31, 2009 and 2008 includes compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of ASC 718. Results for prior periods have not been restated.

The Company recognized compensation expenses for awards granted subsequent to January 1, 2006 based on the straight line method over the requisite service period of each of the grants, net of estimated forfeitures.

The Company estimated the fair value of stock options granted to employees and directors using the Binomial option pricing model.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**In US Dollars**

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)**

**i. Stock based compensation (cont.)**

During 2009 no options were granted to employees or directors of the Company. In 2008 the Company estimated the fair value of stock options granted to employees and directors using the Binominal options pricing model with the following assumptions:

	2008
Dividend yield	0%
Expected volatility	44.4%-111.1%
Risk-free interest rate	1.5%-5.4%
Forfeiture rates	8.2%-10.5%
Suboptimal exercise factor	2.2-2.4
Contractual life (in years)	5

The Company uses historical data of traded companies to estimate pre and post vesting exit rate within the valuation model; separate groups of employees that have similar historical exercise behavior are considered separately for valuation purposes.

The suboptimal exercise factor represents the value of the underlying stock as a multiple of the exercise price of the option which, if achieved, results in exercise of the option.

The risk-free interest rate assumption is based on observed interest rates appropriate for the term of the Company's employee stock options.

The Company has historically not paid dividends and has no foreseeable plans to issue dividends.

The Company applies ASC 718 and ASC 505-50 "Equity- Based Payments to Non –Employees", with respect to options issued to non-employees. ASC 718 requires the use of option valuation models to measure the fair value of the options. The fair value of these options was estimated at grant date and at the end of each reporting period, using the Binomial option pricing model with the following assumptions:

	2009	2008
Dividend yield	0%	0%
Expected volatility	74.6%-122.1%	67.5%-77.5%
Risk-free interest rate	0.4%-2.5%	1.2%-2.2%
Expected life (in years)	1.3-4.9	2.3-4.8

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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**In US Dollars**

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)**

**j. Net loss per share**

Basic net loss per share is computed based on the weighted average number of Common shares outstanding during each year. Diluted net loss per share is computed based on the weighted average number of Common shares outstanding during each year, plus the dilutive effect of options considered to be outstanding during each year, in accordance with ASC 260, "Earnings Per Share" ("ASC 260") (originally issued as "FAS 128").

In 2008 and 2009, all outstanding stock options and warrants have been excluded from the calculation of the diluted net loss per Common share because all such securities were anti-dilutive for the periods presented.

**k. Research and development ("R&D") expenses**

All research and development expenses, net of grants and participations, are charged to the statement of operations as incurred.

**l. Grants and participation**

Royalty-bearing grants from the Office of the Chief Scientist of the Government of Israel for funding approved research and development projects are recognized at the time the subsidiary is entitled to such grants, on the basis of the costs incurred and are presented as a deduction from research and development expenses.

Participation from third party for funding the development of the Company's FVIII Biopump are presented as a deduction from research and development expenses.

The excess of the recognized amount received from the funding party over the amount of research and development expense incurred is recognized as a component of operating income.

**m. Concentrations of credit risks**

Financial instruments that potentially subject the Company and its subsidiary to concentrations of credit risk consist principally of cash and cash equivalents.

Cash and cash equivalents are invested in major banks in Israel, the United Kingdom and the United States. Such deposits in the United States may be in excess of insured limits and are not insured in other jurisdictions. Management believes that the financial institutions that hold the Company's and its subsidiary's investments are institution with high credit standing and accordingly, minimal credit risk exists with respect to these investments.

The Company has no off-balance-sheet concentrations of credit risk such as foreign exchange contracts, option contracts or other foreign hedging arrangements.

**n. Fair value of financial instruments**

The carrying amount of cash and cash equivalents, accounts receivable, short term bank credit, accounts payable and accrued liabilities are generally considered to be representative of their respective fair values because of the short-term nature of those instruments. The convertible debentures are presented based at fair value..

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**In US Dollars**

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)**

**n. Fair value of financial instruments (cont.)**

Effective January 1, 2008, the Company adopted ASC 820 "Fair Value Measurements and disclosures" (formerly issued as Statement of Financial Accounting Standard No. 157, "Fair Value Measurements" ("SFAS 157") and, effective October 10, 2008, adopted FSP 157-3, "Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active". ASC 820 clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants.

As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or a liability. As a basis for considering such assumptions, ASC 820 establishes a three-tier value hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value:

- Level 1 Inputs – Quoted prices for identical instruments in active markets.
- Level 2 Inputs – Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations in which all significant inputs and significant value drivers are observable.
- Level 3 Inputs – Valuation derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable.

The financial instruments carried at fair value on the Company's balance sheet as of December 31, 2009 are convertible debentures. Currently, the convertible debentures are valued using level 3 inputs. The fair value of these convertible debentures was estimated at the measurement date at December 31, 2009 using the Binomial pricing model with the following assumptions:

	2009
Dividend yield	0%
Expected volatility	115.3%
Risk-free interest rate	0.78%
Contractual life (in years)	1.46

**o. Impact of recently issued Accounting Standards**

1. In June 2009, FASB issued ASC Topic No. 105 "Generally Accepted Accounting Principles" ("the Codification"). The Codification was effective for interim and annual periods ended after September 15, 2009 and became the single official source of authoritative, nongovernmental U.S. GAAP, other than guidance issued by the Securities and Exchange Commission. All other literature is non-authoritative. The adoption of the Codification did not have a material impact on the Company's consolidated financial statements and notes thereto. The Company has appropriately updated its disclosures with the appropriate Codification references for the year ended December 31, 2009. As such, all the notes to the consolidated financial statements have been updated with the appropriate Codification references.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**In US Dollars**

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)**

**o. Impact of recently issued Accounting Standards (cont.)**

2. In October 2009, the FASB issued ASU 2009-13, "Revenue Recognition (ASC Topic 605)-Multiple-Deliverable Revenue Arrangements" ("ASU 2009-13"). ASU 2009-13 amends the criteria in ASC Subtopic 605-25, "Revenue Recognition-Multiple-Element Arrangements", for separating consideration in multiple-deliverable arrangements. This update addresses the accounting for multiple-deliverable arrangements to enable vendors to account for products or services (deliverables) separately rather than as a combined unit. ASU 2009-13 modifies the requirements for determining whether a deliverable can be treated as a separate unit of accounting by removing the criteria that verifiable and objective evidence of fair value exists for the undelivered elements. This guidance eliminates the residual method of allocation and requires that arrangement consideration be allocated at the inception of the arrangement to all deliverables using the relative selling price method. This guidance establishes a selling price hierarchy for determining the selling price of a deliverable, which is based on: a) vendor-specific objective evidence; b) third-party evidence; or c) estimates. In addition, this guidance significantly expands required disclosures related to a vendor's multiple-deliverable revenue arrangements. ASU 2009-13 is effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010, with early adoption permitted. The Company has chosen not to early adopt ASU 2009-13. The Company is currently evaluating the potential impact, if any, of the adoption of ASU 2009-13 on its consolidated financial statements.

3. In May 2009, the FASB issued ASC 855 "Subsequent Events" ("ASC 855") (originally issued as "FAS 165").

ASC 855 establishes general standards of accounting for, and disclosure of, events that occur after the balance sheet date but before financial statements are issued or are available to be issued. In particular, this statement sets forth: (1) the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, (2) the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements and (3) the disclosures that an entity should make about events or transactions that occurred after the balance sheet date. ASC 855 is effective for the interim or annual financial periods ending after June 15, 2009.

The adoption of this standard did not have any impact on the consolidated results of operations or financial position of the Company.

**NOTE 3:- CASH AND CASH EQUIVALENTS**

	<b>December 31,</b>	
	<b>2009</b>	<b>2008</b>
In Dollars	\$ 451,480	\$ 258,756
In NIS	18,448	784,582
	\$ 469,928	\$ 1,043,338

**MEDGENICS, INC. AND ITS SUBSIDIARY**  
(A company in the development stage)

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

In US Dollars

**NOTE 4:- ACCOUNTS RECEIVABLE AND PREPAID EXPENSES**

	<b>December 31,</b>	
	<b>2009</b>	<b>2008</b>
Grant receivable	\$ -	\$ 74,568
Government authorities	5,311	30,692
Prepaid expenses and other	5,876	16,534
	<b>\$ 11,187</b>	<b>\$ 121,794</b>

**NOTE 5:- PROPERTY AND EQUIPMENT, NET**

Composition of property and equipment is as follows:

	<b>December 31,</b>	
	<b>2009</b>	<b>2008</b>
<b>Cost:</b>		
Furniture and office equipment	\$ 97,053	\$ 95,452
Computers and peripheral equipment	34,511	42,505
Laboratory equipment	241,936	213,618
Leasehold improvements	169,589	169,589
<b>Total cost</b>	<b>543,089</b>	<b>521,164</b>
<b>Accumulated depreciation:</b>		
Furniture and office equipment	22,180	11,429
Computers and peripheral equipment	25,007	16,596
Laboratory equipment	84,513	45,189
Leasehold improvements	108,656	47,736
<b>Total accumulated depreciation</b>	<b>240,356</b>	<b>120,950</b>
<b>Depreciated cost</b>	<b>\$ 302,733</b>	<b>\$ 400,214</b>

Depreciation expense for the years ended December 31, 2009 and 2008 and for the period from inception (January 27, 2000) through December 31, 2009 amounted to \$120,483, \$96,497 and \$864,447, respectively.

**NOTE 6:- TRADE PAYABLES**

	<b>December 31,</b>	
	<b>2009</b>	<b>2008</b>
Open accounts	\$ 947,104	\$ 830,258
Notes payable	-	58,744
	<b>\$ 947,104</b>	<b>\$ 889,002</b>

**MEDGENICS, INC. AND ITS SUBSIDIARY**  
(A company in the development stage)

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**In US Dollars**

**NOTE 7:- OTHER ACCOUNTS PAYABLE AND ACCRUED EXPENSES**

	<b>December 31,</b>	
	<b>2009</b>	<b>2008</b>
Employees and payroll accruals	\$ 783,299	\$ 641,916
Governmental authorities	96,455	-
Interest payable on debentures	32,703	-
Accrued expenses and others	777,061	426,602
	<b>\$ 1,689,518</b>	<b>\$ 1,068,518</b>

**NOTE 8:- COMMITMENTS AND CONTINGENCIES**

**a. License agreements**

1. On November 23, 2005 the Company signed a new agreement with Yissum Research and Development Company of the Hebrew University of Jerusalem ("Yissum"). According to the agreement, Yissum granted the Company a license of certain patents for commercial development, production, sub-license and marketing of products to be based on its know-how and research results. In consideration, the Company agreed to pay Yissum the following amounts:

- (a) Three fixed installments measured by reference to investment made in the Company, as follows:
- I. 1<sup>st</sup> installment - \$50,000 shall be paid when the cumulative investments in the Company by any third party or parties, from May 23, 2005, amount to at least \$3,000,000.
  - II. 2<sup>nd</sup> installment - \$150,000 shall be paid when the cumulative investments in the Company by any third party or parties, from May 23, 2005, amount to at least \$12,000,000.
  - III. 3<sup>rd</sup> installment - \$200,000 shall be paid when the cumulative investments in the Company by any third party or parties, from May 23, 2005, amount to at least \$18,000,000.

The 1<sup>st</sup> installment of \$50,000 to Yissum was paid on June 5, 2007. As of December 31, 2009 the Company has a full accrual for the 2<sup>nd</sup> installment since the cumulative investment of \$12,000,000 was almost reached. Payments to Yissum are recorded as R&D expenses.

- (b) Royalties at a rate of 5% of net sales of the product.
- (c) Sub-license fees at a rate of 9% of sublicense considerations.

The total aggregate payment of royalties and Sub-license fees by the Company to Yissum shall not exceed \$10,000,000.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
**In US Dollars**

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**NOTE 8:- COMMITMENTS AND CONTINGENCIES**

**a. License agreements (cont.)**

2. Pursuant to an agreement dated January 25, 2007 between Baylor College of Medicine ("Baylor") and the Company, Baylor granted the Company a non exclusive worldwide license of a certain technology ("the Subject Technology"). This agreement modifies collaboration agreements entered into on January 25, 2006 and April 6, 2006.

The license gives the Company a non exclusive right to use, market, sell, lease and import the Subject Technology by way of any product process or service that incorporates, utilizes or is made with the use of the Subject Technology.

The Company has agreed to pay Baylor:

- i a one time, non-refundable license fee of \$25,000 which was paid in 2007;
- ii an annual non-refundable maintenance fee of \$20,000;
- iii a one time milestone payment of \$75,000 upon FDA clearance or equivalent of clearance for therapeutic use. As of the balance sheet date, the Company did not achieve FDA clearance; and
- iiii an installment of \$25,000 upon executing any sub-licenses that the Company executes in respect of the Subject Technology.

The license agreement shall expire (unless terminated earlier for default or by the Company at its discretion) on the first day following the tenth anniversary of the first commercial sale of licensed products by the Company, following which the Company shall have a perpetual, royalty free license to the Subject Technology.

**b. Letter of credit**

Under the terms of an irrevocable Letter of Credit issued on November 26, 2007 an amount of up to \$500,000 was available (subject to certain conditions) for drawdown at any time during an 18-month period which expired on May 25, 2009. The Letter of Credit facility was provided by the Canadian Imperial Bank of Commerce and was procured by CIBC Trust Company (Bahamas) Limited (the "Trust"), one of the Company's shareholders, for the benefit of the Company. One of the beneficiaries of the Trust is a director of the Company.

In consideration for the Trust arranging the issue of the Letter of Credit, the Company paid as follows: (i) \$12,500 in cash in 2007 and (ii) issuance of 76,389 Common shares with a market value of \$15,748. At the 12 month anniversary of the date of issue, the Company should have paid to the Trust an additional fee of \$6,000. As of December 31, 2009, this amount is recorded as accrued expenses.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**In US Dollars**

**NOTE 8:- COMMITMENTS AND CONTINGENCIES (CONT.)**

**c. Chief Scientist**

Under agreements with the Office of the Chief Scientist in Israel regarding research and development projects, the subsidiary is committed to pay royalties to the Office of the Chief Scientist at rates between 3.5% and 5% of the income resulting from this research and development, at an amount not to exceed the amount of the grants received by the subsidiary as participation in the research and development program, plus interest at LIBOR. The obligation to pay these royalties is contingent on actual income and in the absence of such income no payment is required. As of December 31, 2009 the aggregate contingent liability amounted to approximately \$3.7 million.

**d. Clinical trials**

On July 30, 2008 approval was received from the Israel Ministry of Health to conduct a Phase I/II safety and efficacy trial of the EPODURE Biopump for providing sustained treatment of anemia in patients with chronic kidney disease. The subsidiary had agreements with physicians, consultants and Hadasit Medical Research and Development Ltd. ("Hadasit") to operate the trial. The major agreements were entered into in April 2008, with Hadasit to conduct the clinical trial at Hadassah Medical Center ("Hadassah"). The subsidiary paid Hadasit about \$8,400 per month through September 2009 to conduct the trial in addition to an estimated cost of \$9,156 per patient in the trial. The subsidiary also used the lab facilities at a cost of about \$33,000 per month through March 2009.

On April 15, 2010, approval was received from the Israel Ministry of Health to continue the clinical trial at Tel Aviv Medical Center. The subsidiary will continue to use the labs facilities at Hadassah.

**e. Lease Agreement**

1. The facilities of the subsidiary are rented under operating lease agreement for a three year period ending December 2010 with an option to renew the lease for an additional 12 month period. Future minimum lease commitment under the existing non-cancelable operating lease agreement for 2010 is approximately \$54,000.

The subsidiary pledged a bank deposit which is used as a bank guarantee at an amount of \$24,169 to secure its payments under the lease agreement.

2. The subsidiary leases vehicles under standard commercial operating leases. Future minimum lease commitments under various non-cancelable operating lease agreements in respect of motor vehicles are as follows:

<u>Year</u>	
2010	\$ 43,891
2011	25,180
2012	<u>3,663</u>
	<u>\$ 72,734</u>

The subsidiary paid the last three months lease installments in advance which amounted to \$14,742.

**MEDGENICS, INC. AND ITS SUBSIDIARY**  
(A company in the development stage)

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**In US Dollars**

**NOTE 9:- SHAREHOLDERS' EQUITY**

**a. Composition:**

	December 31,		December 31,	
	2009	2008	2009	2008
	Authorized		Issued and Outstanding	
	Number of shares			

Shares of \$0.0001 par value:

Common shares	500,000,000	500,000,000	122,174,027	106,728,195
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**b. Common shares**

The Common shares confer upon the holders the right to receive notice to participate and vote in general and special meetings of the shareholders of the Company and the right to receive dividends, if declared.

**c. Recapitalization of equity capital**

According to a recapitalization agreement signed on March 30, 2006 with the requisite number of the Company's shareholders and Note providers, the convertible note and the outstanding Old Common shares, Series A Preferred shares and Series B Preferred shares were converted into Common shares. The conversion rates were as follows:

1. A total of 11,982,914 Common shares were issued to the holders of the convertible Note upon conversion of the Note.
2. One Common share was issued for 10,578.95 Old Common shares.
3. One Common share was issued for 404.51 Series A Preferred shares.
4. One Common share was issued for 345.69 Series B Preferred shares.

As a result of the recapitalization of the equity, the Company issued a total of 9,885,842 Common shares.

Pursuant to ASC 260-10 "Earnings Per Share" (originally issued as EITF D-42), the Company added the excess of the fair value of the Common shares that would have been issued pursuant to the original conversion terms of the Preferred shares over the fair value of the Common shares issued to the holders of the Preferred shares in the recapitalization in the amount of \$437,197 to deficit accumulated during the development stage with a corresponding reduction in share capital and additional paid in capital.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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**In US Dollars**

**NOTE 9:- SHAREHOLDERS' EQUITY (CONT.)**

**d. Issuance of shares and warrants to investors**

1. In January and March 2000, the Company issued a total of 2,069,677 Old Common shares at par value.
2. In August 2000, the Company issued 437,936 Old Common shares in consideration of \$499,997.
3. In August 2000, in respect of the earlier license agreement with Yissum, the Company issued 940,950 Old Common shares at par value.
4. In January 2001, the Company issued 138,502 Series A Preferred shares in consideration of \$200,000. The issuance costs amounted to \$4,864.
5. On March 19, 2001, the Board of Directors authorized a 10 to 1 stock split and 1000 to 1 stock split effected as stock dividend. As a result, 3,445,113 additional shares were issued and the par value of each share was reduced from \$0.001 to \$0.0001.
6. In March and June 2001, the Company issued a total of 4,085,837 Series A Preferred shares in consideration of \$6,998,355. The issuance costs amounted to \$191,979.
7. In October 2002, the Company issued a total of 2,676,674 Series B Preferred shares in consideration of \$5,353,348. The issuance costs amounted to \$88,728.
8. In February, September and November 2003, the Company issued a total of 19,443 Old Common shares in consideration of \$195, upon exercise of stock options.
9. In April and May 2003, the Company issued a total of 1,066,997 Series B Preferred shares in consideration of \$2,133,996. The issuance costs amounted to \$97,112.
10. In January and February 2004, the Company issued a total of 46,083 Old Common shares in consideration of \$127 in cash upon exercise of stock options and \$10,000 in consideration for services.
11. In March 2006, the Company issued 2,633,228 Common shares in settlement of a debt.
12. In March 2006, as part of the recapitalization, warrants to purchase 2,139,106 Common shares at an exercise price per share of \$0.0001 with a term of 5 years were issued by the Company to existing holders of Old Common shares.
13. In March, April and June 2006, the Company issued a total of 16,217,552 Common shares and warrants to purchase 32,435,103 Common shares at an exercise price per share of \$0.071 and a term of 5 years in consideration for \$1,149,266. The issuance costs amounted to \$197,322.
14. In November and December 2006, the Company issued a total of 16,685,790 Common shares and warrants to purchase 20,857,259 Common shares at an exercise price of \$0.117 and a term of 5 years in consideration for \$1,949,467. The issuance costs amounted to \$334,721.
15. In January 2007, the Company issued a total of 427,402 Common shares and warrants to purchase 534,252 Common shares at an exercise price per share of \$0.117 and a term of 5 years, in consideration for \$49,952. The issuance costs amounted to \$16,632.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**In US Dollars**

**NOTE 9:- SHAREHOLDERS' EQUITY (CONT.)**

**d. Issuance of shares and warrants to investors (cont.)**

16. In May, July, and August 2007, the Company issued a total of 7,647,436 Common shares and warrants to purchase 1,634,909 Common shares at an exercise price per share of \$0.164 and a term of 5 years in consideration for \$1,251,252. The issuance costs amounted to \$416,617.
17. In July 2007, 451,939 warrants were exercised into 451,939 Common shares, in consideration of \$2.
18. In August 2007, the Company issued 122,232 Common shares at fair value of \$18,387 to an advisor in consideration for consulting services related to the issuance of shares. The fair value of the shares was recorded as issuance costs.
19. Based on a resolution approved by shareholders in November 22, 2007, a stock split was effectuated on December 4, 2007 such that each existing Common share was converted to 21.39149 Common shares. In addition all existing warrants and options were automatically adjusted so that each warrant or option to purchase one Common share was converted to a warrant or option to purchase 21.39149 Common shares. Data regarding share and per share data in these financial statements has been retroactively adjusted to reflect this stock split.
20. On August 13, 2007, the Company issued a \$1.05 million convertible unsecured promissory note ("Note"). In addition, the Company issued to the Note holder warrants for the purchase of up to 3,208,724 Common shares at an exercise price per share of \$0.164 and a term of 5 years. In respect of the Note and warrants, the Company recorded financial expenses relating to the beneficial conversion feature in accordance with the provisions of ASC 470-20 "Debt with Conversion and Other Options" ("ASC 470-20") (originally issued as "EITF 98-5" and "EITF 00-27") in the amount of \$469,500 with a corresponding credit to additional paid in capital in shareholders' equity. The Company computed the value of the warrants using the Black & Scholes option pricing model with the following assumptions: a risk-free interest rate of 4.72%, zero dividends, volatility of 66%, and an expected term of 5 years. On November 14, 2007, the Note term was extended to December 15, 2007. In respect of this change, the Company recorded additional financial costs of \$41,891 in the statement of operations with a corresponding credit to additional paid-in capital in shareholders' equity. On December 4, 2007, the Note was converted into 6,417,447 Common shares.
21. On December 4, 2007, the Company's Common shares were admitted for trading on the London Stock Exchange's Alternative Investment Market (AIM). Concurrently, the Company placed 9,640,000 Common shares at a per share price of GBP 0.10 (\$0.21), issued 18,897,213 Common shares and 3,084,422 Common shares to investors and consultants, respectively, and issued additional 6,417,447 Common shares resulting from the conversion of a convertible Note (see note 9d (20)), for a total gross consideration of GBP 3,276,985 (\$6,719,075). The issuance costs amounted to \$2,221,422. In addition the Company issued warrants to purchase 971,075 Common shares at an exercise price per share of \$0.164, and additional warrants to purchase 5,799,553 Common shares at an exercise price per share of \$0.194, each with a term of 5 years.
22. In January 2008, a total of 3,560,314 warrants were exercised in a cashless conversion to 2,414,326 Common shares by consultants of the Company. In addition 47,724 warrants were exercised and resulted in the issuance of 47,724 Common shares. The cash consideration received was immaterial.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**In US Dollars**

**NOTE 9:- SHAREHOLDERS' EQUITY (CONT.)**

**d. Issuance of shares and warrants to investors (cont.)**

23. In April 2008, the Company issued a total of 142,609 Common shares to an advisor in consideration for assistance with the Company's fund raising in relation to the placing of the Common shares on December 4, 2007.
24. In December 2008, 30,119 warrants were exercised and resulted in the issuance of 30,119 Common shares. The cash consideration received upon exercise of the warrants was immaterial.
25. On December 17, 2008, the Company announced that it was implementing a warrant repricing program ("program") to encourage the exercise of existing warrants provided that such exercise be completed by January 30, 2009. During February 2009, the Company extended the date to February 13, 2009. To encourage existing warrant holders to exercise their warrants for cash before the closing date as aforesaid, the following terms were offered:
  - a) Reduced Exercise Price: \$0.0375/share (2.5 pence/share) or the current exercise price, whichever is lower;
  - b) Bonus Warrants: for every one dollar (\$1.00) or 0.667 GBP paid for exercise of warrants during this program, a new bonus warrant will be issued to purchase three Common Shares, which will be immediately exercisable for three years at an exercise price of \$0.25 per share.

The exercise price of any warrants that were not exercised before the expiration of the program revert to the original price as stated in the warrant prior to this program.

26. Pursuant to the warrant repricing program mentioned above, during January and February 2009, 11,025,832 warrants were exercised into 11,025,832 Common shares in consideration for a reduced price of \$ 406,048 and the issuance of 1,218,144 new warrants as a bonus. The issuance costs were \$17,124. The bonus warrants were exercisable immediately for a period of three years from the issuance date at an exercise price of \$0.25 per share. The consideration was paid partly in the year ended December 31, 2008 (\$150,000) and the balance was paid in 2009. According to ASC 815 the benefit resulted to the warrant holders from the reduction of the exercise price and the bonus warrants in the amount of \$6,745 and \$3,192 as of December 31, 2008 and December 31, 2009, respectively, was recorded as a dividend to the warrant holders.
27. On October 6, 2009, the Company issued a total of 4,420,000 Common shares in consideration for GBP 265,200 (\$423,475). The issuance costs were \$58,815.

**e. Stock options and warrants to employees and directors**

1. On March 30, 2006, the Company adopted a stock option plan ("the stock option plan") according to which up to 21,327,380 options to purchase 21,327,380 Common shares of the Company may be granted to directors, employees and consultants (non-employees) of the Company and its subsidiary, as determined by the Company's Board of Directors from time to time. The options outstanding are exercisable within a period of 5 years from the date of grant at an exercise price as determined by the Company's Board of Directors. The options outstanding to employees, directors and consultants will vest over a period of three or four years from the date of grant. Any option which is canceled or forfeited before expiration becomes available for future grants.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**In US Dollars**

**NOTE 9:- SHAREHOLDERS' EQUITY (CONT.)**

**e. Stock options and warrants to employees and directors (cont.)**

2. On June 12, 2008, the Company granted to the Company's employees 3,188,370 options exercisable at a price of \$0.146 per share. The options vest in four equal annual tranches of 797,092. The options were granted under the stock option plan terms. The fair value of these options at the grant date was \$0.036 per option.
3. On December 1, 2008, the Company granted to a Company's director 1,711,319 options exercisable at a price of \$0.042 per share. Upon the death of the director in November 2009, 570,440 options were vested, and are exercisable until November 2010. The fair value of these options at the grant date was \$0.0261 per option.
4. No options or warrants were granted to employees or directors during the year ended December 31, 2009.
5. A summary of the Company's activity for options and warrants granted to employees and directors is as follows:

	<b>Year ended December 31, 2009</b>			
	<b>Number of options and warrants</b>	<b>Weighted average exercise price</b>	<b>Weighted average remaining contractual terms (in years)</b>	<b>Aggregate intrinsic value price</b>
Options and warrants outstanding at the beginning of the year	85,853,410	\$ 0.081		
Changes during the year:				
Forfeited	(2,595,501)	0.109		
Options and warrants outstanding at the end of the year	83,257,909	\$ 0.081	1.56	\$ 4,342,931
Options and warrants exercisable at the end of the year	74,023,902	\$ 0.071	1.45	\$ 4,223,830
Options and warrants vested and expected to vest	82,456,683	\$ 0.080	1.55	\$ 4,332,986

As of December 31, 2009, there was \$434,529 of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted to employees. That cost is expected to be recognized over a weighted-average period of 0.8 years.

Calculation of aggregate intrinsic value is based on the share price of the Company's Common shares as of December 31, 2009 (\$0.1234 / 0.075 GBP, per share).

**MEDGENICS, INC. AND ITS SUBSIDIARY**  
(A company in the development stage)

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**In US Dollars**

**NOTE 9:- SHAREHOLDERS' EQUITY (CONT.)**

**e. Stock options and warrants to employees and directors (cont.)**

6. The Company's outstanding options and warrants under the Company's stock option plan to employees and directors as of December 31, 2009 have been separated into ranges of exercise prices as follows:

<u>Issuance date</u>	<u>Options and warrants outstanding</u>	<u>Exercise price</u>	<u>Options and warrants exercisable</u>	<u>Weighed average remaining contractual term</u>
March 2006	14,480,755	\$ 0.0001	14,480,755	1.25
March 2006	46,478,702	\$ 0.071	44,879,148	1.25
April 2006	1,599,549	\$ 0.071	1,599,549	1.28
May 2006	3,419,430	\$ 0.071	2,564,572	1.36
September 2006	1,599,549	\$ 0.071	1,599,549	1.72
August 2007	1,497,404	\$ 0.120	748,702	2.65
November 2007	11,878,332	\$ 0.210	7,147,750	2.87
June 2008	1,733,748	\$ 0.146	433,437	3.45
December 2008	570,440	\$ 0.042	570,440	0.92
Total	<u>83,257,909</u>		<u>74,023,902</u>	

7. Compensation expenses related to options granted to employees and directors were recorded, in the statements of operations in the following line items:

	<u>Year ended December 31,</u>		<u>Period from inception through</u>
	<u>2009</u>	<u>2008</u>	<u>December 31, 2009</u>
Research and development expenses	\$ 102,683	\$ 98,072	\$ 268,646
General and administrative expenses	<u>309,218</u>	<u>343,916</u>	<u>1,813,000</u>
	<u>\$ 411,901</u>	<u>\$ 441,988</u>	<u>\$ 2,081,646</u>

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**In US Dollars**

**NOTE 9:- SHAREHOLDERS' EQUITY (CONT.)**

**f. Warrants and options to-non-employees**

1. On October 16, 2008, the Company granted to a consultant 677,397 warrants exercisable at a price of \$0.146 per share and having a 5 year term. 33.3% of the warrants vested immediately at the grant date and the remaining portion of the warrants vest in two equal annual tranches starting from the grant date of 225,799. The warrants were granted under the stock option plan terms. The fair value of these warrants at the grant date was \$0.00511. The fair value was estimated using Binomial model with the following weighted-average assumptions: expected stock price volatility range of 62%, risk-free interest rate of 4.2%, expected dividend yield of 0% and a contractual life of the options of five years.
2. On December 1, 2008, the Company granted to a consultant 2,353,064 warrants exercisable at a price of \$0.194 per share and having a 5 year term. The warrants vest immediately at the grant date. The warrants were granted under the stock option plan terms. The fair value of these warrants at the grant date was \$0.00934 per warrant.
3. On December 7, 2009, the Company granted to a consultant 677,397 options exercisable at a price of \$0.12 per share and having a 5 year term. The options vest in three equal annual tranches of 225,799. The options were granted under the stock option plan terms. The fair value of these options at the grant date was \$0.08768 per warrant. The fair value was estimated using Binomial model with the following weighted-average assumptions: expected stock price volatility range of 74.9%, risk-free interest rate of 2.4%, expected dividend yield of 0% and a contractual life of the options of five years.
4. A summary of the Company's stock option activity for warrants and options granted to consultants under the stock option plan is as follows:

	<b>Year ended December 31, 2009</b>			
	<b>Number of Warrants and options</b>	<b>Weighted average exercise price</b>	<b>Weighted average remaining contractua l terms (in years)</b>	<b>Aggregate intrinsic value price</b>
Warrants and options outstanding at the beginning of the year	19,795,892	\$ 0.115		
Changes during the year:				
Granted	677,397	0.12		
Warrants and options outstanding at the end of the year	20,473,289	\$ 0.116	2.21	\$ 607,399
Warrants and options exercisable at the end of the year	18,389,796	\$ 0.114	2.09	\$ 580,220

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**In US Dollars**

**NOTE 9:- SHAREHOLDERS' EQUITY (CONT.)**

**f. Warrants and options to non-employees (cont.)**

4. (cont.)

The weighted-average grant-date fair value of warrants and options granted to consultants during the year ended December 31, 2009 and 2008 was \$0.09 and \$0.01, respectively. As of December 31, 2009, there was \$65,071 of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted to consultants under the Company's stock option plan. That cost is expected to be recognized over a weighted-average period of 1.2 years.

Calculation of aggregate intrinsic value is based on the share price of the Company's Common shares as of December 31, 2009 (\$0.1234 / 0.075 GBP, per share).

5. The Company's outstanding warrants and options under the Company's stock option plan to consultants as of December 31, 2009 were as follows:

<u>Issuance date</u>	<u>warrants and options outstanding</u>	<u>Exercise price per share</u>	<u>Warrants and options exercisable</u>	<u>Weighed average remaining contractual term</u>
March 2006	1,200,063	\$0.000	1,200,063	1.25
March 2006	6,011,543	\$0.071	6,011,543	1.25
April 2006	106,957	\$0.071	80,218	1.28
May 2006	2,132,732	\$0.071	1,599,549	1.36
June 2006	1,283,490	\$0.071	1,283,490	1.50
October 2006	1,040,397	\$0.117	1,040,397	1.81
August 2007	1,024,011	\$0.164	1,024,011	2.62
November 2007	1,861,125	\$0.210	1,240,750	2.87
December 2007	288,785	\$0.164	288,785	2.93
December 2007	1,222,153	\$0.194	1,222,153	2.93
December 2007	594,175	\$0.159	594,175	2.93
October 2008	677,397	\$0.159	451,598	3.79
December 2008	2,353,064	\$0.194	2,353,064	3.92
December 2009	677,397	\$0.120	-	4.92
Total	<u>20,473,289</u>		<u>18,389,796</u>	

**MEDGENICS, INC. AND ITS SUBSIDIARY**  
(A company in the development stage)

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**In US Dollars**

**NOTE 9:- SHAREHOLDERS' EQUITY (CONT.)**

**f. Warrants and options to non-employees (cont.)**

6. Compensation expense related to warrants and options granted to consultants was recorded in the statement of operations in the following line items:

	<b>Year ended December 31,</b>		<b>Period from inception through December 31,</b>
	<b>2009</b>	<b>2008</b>	<b>2009</b>
Research and development expenses (income)	\$ 164,769	\$ (113,004)	\$ 181,255
General and administrative expenses (income)	27,897	(33,542)	145,197
	\$ 192,666	\$ (146,546)	\$ 326,452

**NOTE 10:- CONVERTIBLE DEBENTURES**

In May 2009, the Company offered to accredited investors only, through a private placement, convertible debentures (the "Debentures"), together with warrants (the "Warrants") to purchase a number of Common shares, par value \$0.0001 per share, of the Company (the "Common Share"), equal to 35% of the number of Common shares issued upon conversion of the Debentures. Warrants shall not be issued unless and until the conversion of the Debentures. The Debentures will mature two years after the date of issuance and will bear interest at an annual rate of 10%, paid on a quarterly basis. The Debentures will automatically be converted into Common shares upon the closing of a Qualified Transaction, as defined in the Debenture.

In a series of closings from June 16 through September 15, 2009, the Company raised \$570,000 in gross proceeds through the issuance of Debentures.

In the event of default, the interest rate shall increase 2% per month for every month the Debentures are in default to a maximum of 18% per annum paid on a quarterly basis. The Company shall repay the principal and any accrued interest at the two-year anniversary of the date the Debentures were issued. The Debentures are unsecured and the Company has no right to redeem the Debentures. If the Company is liquidated, the holders of the Debentures will participate pari passu with all general creditors of the Company with no seniority or preference.

The interest due on June 30, 2009 had been paid. The interest due on September 30 and December 31, 2009, including default interest, has been accrued.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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**In US Dollars**

**NOTE 10:- CONVERTIBLE DEBENTURES (CONT.)**

Until such time the Debentures are repaid, the Debentures (including any accrued interest) shall automatically convert into Common shares at the closing of a Qualified Transaction at the following valuation:

- In the event that the per share price paid in the Qualified Transaction (or per share value of merger consideration in a Merger Transaction (as defined in the Debenture)) (the "Qualified Transaction Price") is \$0.12 per share or greater, the conversion price shall be the lesser of \$0.12 per share or a 40% discount from the Qualified Transaction Price.
- In the event that the Qualified Transaction Price is at least \$0.07 but less than \$0.12 per share, the conversion price shall be \$0.07 per share.
- In the event that the Qualified Transaction Price is less than \$0.07 per share, the conversion price shall be the Qualified Transaction Price; provided, however, that the holder of the Debenture shall receive 100% more Warrants than such holder would have otherwise been entitled to receive upon conversion.

The share prices referenced above shall be adjusted to reflect any stock splits, stock combinations, stock dividends, reorganizations and the like.

The Warrants are exercisable for a number of Common shares equal to 35% of the number of Common shares issued upon the conversion of the Debentures. The Warrants shall be immediately exercisable upon issuance and shall expire five years from the date of issuance. The exercise price shall be 110% of the Qualified Transaction Price.

The Company irrevocably elected to initially and subsequently measure the Debentures entirely at fair value (with changes in fair value recognized in earnings) in accordance with ASC 815-15-25 (originally issued as par. 16 of FAS 133) thus the Company will not separate the embedded derivative instrument from the host contract and account for it as a derivative instrument pursuant to ASC 815.

This election was made only in respect to the Debentures, as permitted by ASC 815-15-25, which states that this election may be made on an instrument-by-instrument basis.

As of the balance sheet date, the fair value of the Debentures amounted to \$1,013,404. In 2009, the Company recorded financial expenses in the amount of \$443,404 as a result of the change in fair value of the Debentures.

**NOTE 11:- TAXES ON INCOME**

a. Tax laws applicable to the companies:

1. The Company is taxed under U.S. tax laws.
2. The subsidiary is taxed under the Israeli income Tax Ordinance and the Income Tax (Inflationary Adjustments) Law, 1985: ("the law").

Results of the subsidiary for tax purposes are measured and reflected in real terms in accordance with the changes in the CPI. The financial statements are presented in U.S. dollars.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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**In US Dollars**

**NOTE 11:- TAXES ON INCOME (CONT.)**

- a. Tax laws applicable to the companies (cont.):

The difference between the rate of change in Israeli CPI and the rate of change in the NIS/U.S. dollar exchange rate causes a difference between taxable income or loss and the income or loss before taxes reflected in the financial statements. In accordance with ASC 740-10 (or paragraph 9(f) of FAS 109), the Company has not provided deferred income taxes on this difference between the reporting currency and the tax bases of assets and liabilities.

In February 2008, the "Knesset" (Israeli parliament) passed an amendment to the Income Tax (Inflationary Adjustments) Law, 1985, which limits the scope of the law starting 2008 and thereafter. Starting 2008, the results for tax purposes are measured in nominal values, excluding certain adjustments for changes in the Israeli CPI carried out in the period up to December 31, 2007. The amendment to the law includes, inter alia, the elimination of the inflationary additions and deductions and the additional deduction for depreciation starting 2008.

- b. Tax assessments:

The Company files income tax returns in the U.S. federal jurisdiction and state jurisdiction. The U.S. tax authorities have not conducted an examination in respect of the Company's U.S. federal income tax returns since inception. The Israeli subsidiary has not yet received final tax assessments since its inception. The subsidiary has tax assessments, deemed final under the law, up to and including the year 2004.

- c. Tax rates applicable to the Company and the subsidiary:

1. The subsidiary:

The rate of the Israeli corporate tax is as follows: 2008 - 27%, 2009 - 26%, 2010 - 25%. In July 2009, the "Knesset" (Israeli Parliament) passed the Law for Economic Efficiency (Amended Legislation for Implementing the Economic Plan for 2009 and 2010), 2009, which prescribes, among others, an additional gradual reduction in the rates of the Israeli corporate tax and real capital gains tax starting 2011 to the following tax rates: 2011 - 24%, 2012 - 23%, 2013 - 22%, 2014 - 21%, 2015 - 20%, 2016 and thereafter - 18%. The effect of the abovementioned change on the financial statements is immaterial.

Israeli companies are generally subject to capital gains tax at rate of 25% for capital gains (other than gains deriving from the sale of listed securities) derived after January 1, 2003.

2. The Company:

The tax rates applicable to the Company whose place of incorporation is the U.S. are corporate (progressive) tax at the rate of up to 35%, excluding state tax, which rates depend on the state in which the Company will conduct its business.

According to the tax laws applicable to Israeli residents, dividend received from a foreign resident company is subject to tax in Israel at the rate of 25% in the hands of its recipient. According to the tax laws applicable in the U.S., tax at the rate of 30% is withheld and based on the treaty for the avoidance of double taxation of Israel and the U.S., it may be reduced to either 25% or 12.5% (dependent on the identity of the shareholder). To enjoy the benefits of the tax treaty, certain procedural requirements need to be satisfied.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**In US Dollars**

**NOTE 11:- TAXES ON INCOME (CONT.)**

- d. Carryforward losses for tax purposes:

As of December 31, 2009, the Company had U.S. federal net operating loss carryforward for income tax purposes in the amount of approximately \$23.1 million. Net operating loss carryforward arising in taxable years beginning after January 2000 (inception date) can be carried forward and offset against taxable income for 20 years and expiring between 2020 and 2029. As of December 31, 2009 the Company had net operating loss carryforward for state franchise tax purposes of approximately \$21.6 million which will begin to expire in 2011.

Utilization of U.S. net operating losses may be subject to substantial annual limitations due to the "change in ownership" provisions of the Internal Revenue Code of 1986 and similar state provisions. The annual limitation may result in the expiration of net operating losses before utilization.

The Company's subsidiary in Israel has accumulated losses for tax purposes as of December 31, 2009, in the amount of approximately \$5 million, which may be carried forward and offset against taxable income and capital gain in the future for an indefinite period.

- e. Deferred income taxes:

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's deferred tax assets are as follows:

	<b>December 31,</b>	
	<b>2009</b>	<b>2008</b>
Deferred tax assets:		
Net operating loss carryforward	\$ 4,941,779	\$ 3,476,589
Allowances and reserves	325,136	262,191
Total deferred tax assets before valuation allowance	5,266,915	3,738,780
Valuation allowance	(5,266,915)	(3,738,780)
Net deferred tax asset	\$ -	\$ -

As of December 31, 2009, the Company and its subsidiary have provided valuation allowances in respect of deferred tax assets resulting from tax loss carryforward and other temporary differences, since they have a history of operating losses and current uncertainty concerning its ability to realize these deferred tax assets in the future. Management currently believes that it is more likely than not that the deferred tax regarding the loss carryforward and other temporary differences will not be realized in the foreseeable future.

In 2008 and 2009, the main reconciling item of the statutory tax rate of the Company and its subsidiary (27% to 35% in 2008 and 26% to 35% in 2009) to the effective tax rate (0%) is tax loss carryforwards and other deferred tax assets for which a full valuation allowance was provided.

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**NOTE 12: - FINANCIAL EXPENSE (INCOME)**

	<b>Year ended December 31,</b>		<b>Period from inception (January 27, 2000) through December 31, 2009</b>
	<b>2009</b>	<b>2008</b>	
Financial expense (income) , net:			
Financial income:			
Foreign currency translation adjustments	\$ (6,471)	\$ (87,868)	\$ (255,316)
Interest on cash equivalents, short-term bank deposits and others	(2,578)	(62,477)	(209,434)
Others	-	(14,963)	(49,294)
	<u>(9,049)</u>	<u>(165,308)</u>	<u>(514,044)</u>
Financial expenses:			
Bank charges	15,593	26,603	58,115
Interest expenses	42,053	2,437	604,834
Convertible debentures valuation	443,404	-	443,404
Foreign currency translation adjustments	51,892	121,771	514,319
Others	-	3,040	9,346
	<u>552,942</u>	<u>153,851</u>	<u>1,630,018</u>
	<u>\$ 543,893</u>	<u>\$ (11,457)</u>	<u>\$ 1,115,974</u>

**NOTE 13:- SUBSEQUENT EVENTS**

1. In March 2010, the Company issued a total of 14,465,591 Common shares in consideration for GBP 726,168 (\$1,096,845). The issuance costs amounted to \$110,297.
2. In February 2010, the Company issued 1,275,000 Common shares as compensation for services rendered to the Company by a consultant.

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