

EUPRAXIA PHARMACEUTICALS INC.

CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2021 and 2020

(Expressed in Canadian Dollars)

EUPRAXIA PHARMACEUTICALS INC.
CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2021 and 2020
(Expressed in Canadian Dollars)

CONTENTS

MANAGEMENT’S RESPONSIBILITY.....3

INDEPENDENT AUDITOR’S REPORT.....4-7

CONSOLIDATED STATEMENTS OF FINANCIAL POSITION.....8

CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS.....9

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS’ EQUITY (DEFICIT).....10

CONSOLIDATED STATEMENTS OF CASH FLOWS.....11

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS.....12-45

MANAGEMENT’S RESPONSIBILITY

The management of Eupraxia Pharmaceuticals Inc. is responsible for the preparation of the accompanying consolidated financial statements. The consolidated financial statements have been prepared in accordance with accounting principles generally accepted under International Financial Reporting Standards, and are considered by management to present fairly the financial position and operating results of the Company.

The Company maintains various systems of internal control to provide reasonable assurance that transactions are appropriately authorized and recorded, that assets are safeguarded, and that financial reports are properly maintained to provide accurate reliable financial statements.

The Company’s audit committee is comprised entirely of independent directors and is appointed by the Board of Directors annually. The committee meets annually with the Company’s management and independent auditors to review the consolidated financial statements and the independent auditors report. The audit committee has approved the consolidated financial statements and reported its findings to the Board of Directors.

The Company’s independent auditors, Baker Tilly WM LLP, have performed an audit of the consolidated financial statements and their report follows.

“James Helliwell”
Chief Executive Officer
March 29, 2022

“Bruce Cousins”
Chief Financial Officer
March 29, 2022



Baker Tilly WM LLP
900 – 400 Burrard Street Vancouver,
British Columbia
Canada V6C 3B7
T: +1 604.684.6212
F: +1 604.688.3497

vancouver@bakertilly.ca
www.bakertilly.ca

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of Eupraxia Pharmaceuticals Inc.

Opinion

We have audited the consolidated financial statements of Eupraxia Pharmaceuticals Inc. and its subsidiaries (together the "Company"), which comprise the consolidated statements of financial position as at December 31, 2021 and December 31, 2020, and the consolidated statements of operations and comprehensive loss, consolidated statements of changes in shareholders' equity (deficit) and consolidated statements of cash flows for the years then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying consolidated financial statements present fairly, in all material respects, the consolidated financial position of the Company as at December 31, 2021 and December 31, 2020, and its consolidated financial performance and its consolidated cash flows for the years then ended in accordance with International Financial Reporting Standards.

Basis for Opinion

We conducted our audits in accordance with Canadian generally accepted auditing standards. Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Consolidated Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audits of the consolidated financial statements in Canada, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our opinion.

Material Uncertainty Related to Going Concern

We draw attention to Note 1 in the consolidated financial statements, which describes events and conditions indicating that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. Our opinion is not modified in respect of this matter.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the consolidated financial statements for the year ended December 31, 2021. These matters were addressed in the context of our audit of the consolidated financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

Key audit matter**How our audit addressed the key audit matter**

Share Purchase Warrants - Measurement and Presentation

Refer to Note 14

During the year ended December 31, 2021, the Company completed an Initial Public Offering (“IPO”). Prior to the IPO, certain share purchase warrants issued by the Company met the conditions for classification as financial liabilities and were required to be measured at fair value at each period end. Upon completion of the IPO, certain terms of the warrants were revised, resulting in the reclassification of the warrants to equity. Management made judgments in determining the presentation of the warrants and was also required to estimate their fair value as at the date of reclassification.

Conversion of Debt Instruments to Equity Instruments - Measurement and Presentation

Refer to Notes 9, 10, 11, and 16

The IPO triggered the conversion of various debt instruments, resulting in numerous issuances of common shares. Management was required to calculate the carrying amount of the debt instruments as at the date of their conversion and determine the number of common shares to be issued according to the terms of the applicable agreements. The Company recognized losses on the conversions due to the differences between the fair values of the common shares issued and the carrying amounts of the debt instruments.

Other Information

Management is responsible for the other information. The other information comprises the information included in the Management’s Discussion and Analysis filed with the relevant Canadian securities commissions.

Our opinion on the consolidated financial statements does not cover the other information and we do not express any form of assurance conclusion thereon

Our approach to addressing the matter included the following procedures, among others:

- Agreed the terms of the share purchase warrants to the underlying documents.
- Assessed the mathematical accuracy of management’s valuation model and assessed the appropriateness of the assumptions used in the model.
- Assessed the appropriateness of the related disclosures.

Our approach to addressing the matter included the following procedures, among others:

- Agreed the conversion terms of the various debt instruments to the underlying documents.
- Assessed the mathematical accuracy of management’s calculations for the outstanding debt instruments as at the date of conversion, the expected number of common shares to be issued, the fair value of common shares issued and the resulting loss on conversion.
- Confirmed the number of common shares issued with the Company’s transfer agent.
- Assessed the appropriateness of the related disclosures.

In connection with our audit of the consolidated financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the consolidated financial statements or our knowledge obtained in the audits and remain alert for indications that the other information appears to be materially misstated. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact in this auditor's report. We have nothing to report in this regard.

Responsibilities of Management and Those Charged with Governance for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of the consolidated financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the consolidated financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with Canadian generally accepted auditing standards will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these consolidated financial statements.

As part of an audit in accordance with Canadian generally accepted auditing standards, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.

- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the consolidated financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the consolidated financial statements, including the disclosures, and whether the consolidated financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the consolidated financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

The engagement partner on the audit resulting in this independent auditor's report is Anna C. Moreton.

Baker Tilly WM LLP

CHARTERED PROFESSIONAL ACCOUNTANTS

Vancouver, B.C.
March 29, 2022

EUPRAXIA PHARMACEUTICALS INC.
CONSOLIDATED STATEMENTS OF FINANCIAL POSITION
(Expressed in Canadian Dollars)

	December 31, 2021	December 31, 2020
ASSETS		
Current assets		
Cash and cash equivalents	\$ 20,892,069	\$ 150,126
Short term investments	9,008,855	-
Prepaid expenses and deposits	270,986	367,523
Amounts receivable (Note 5)	429,718	620,606
Total current assets	30,601,628	1,138,255
Non-current assets		
Prepaid expenses	31,371	-
Equipment (Note 6)	444,736	68,314
Right-of-use asset (Note 7)	144,332	247,023
Total assets	\$ 31,222,067	\$ 1,453,592
LIABILITIES AND SHAREHOLDERS' EQUITY (DEFICIT)		
Current liabilities		
Accounts payable and accrued liabilities (Note 8)	\$ 2,112,989	\$ 3,200,812
Convertible notes payable (Note 9)	-	8,592,751
Special warrants (Note 10)	-	1,715,000
Loans payable – current portion (Note 11)	94,916	3,924,698
Lease liability – current portion (Note 12)	59,883	52,529
Payable to Auritec Pharmaceuticals Inc. (Note 13)	-	5,056,482
Total current liabilities	2,267,788	22,542,272
Non-current liabilities		
Loans payable (Note 11)	180,189	-
Lease liability (Note 12)	137,751	198,665
Derivative warrant liability (Note 14)	-	376,308
Convertible debt (Note 15)	9,083,403	-
Total liabilities	11,669,131	23,117,245
Shareholders' Deficit		
Share capital (Note 16(b))	80,713,131	23,797,507
Contributed surplus (Notes 15 and 16(c))	13,860,404	6,189,888
Deficit	(74,186,763)	(51,197,157)
Equity (deficit) attributable to the owners of the Company	20,386,772	(21,209,762)
Non-controlling interest	(833,836)	(453,891)
Total shareholders' equity (deficit)	19,552,936	(21,663,653)
Total liabilities and shareholders' deficit (equity)	\$ 31,222,067	\$ 1,453,592

Nature of business and going concern (Note 1)

Approved and authorized for issue on behalf of the Board of Directors on March 29, 2022:

“John Montalbano”
Director

“James Helliwell”
Director

The accompanying notes are an integral part of these consolidated financial statements.

EUPRAXIA PHARMACEUTICALS INC.
CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS
(Expressed in Canadian Dollars)

	Year ended December 31, 2021	Year ended December 31, 2020
Expenses		
Depreciation of equipment (Note 6)	\$ 55,251	\$ 42,517
Amortization of right-of-use asset (Note 7)	56,278	74,292
General and administrative (Note 19)	724,284	238,159
Professional fees	1,113,454	120,528
Public company costs	478,014	-
Research and development, net (Notes 17 and 18)	9,678,807	859,781
Salaries and benefits, net (Notes 18 and 19)	2,356,938	682,236
Stock-based compensation (Notes 16(c) and 19)	4,214,651	228,680
Total expenses	18,677,677	2,246,193
Other income/(expenses)		
Interest income	65,728	427
Interest expense (Note 23)	(1,296,688)	(1,881,633)
Loss on sale of equipment (Note 6)	-	(132,759)
Foreign exchange gain	72,784	127,673
Loss on conversion of notes, special warrants and loans (Notes 9, 10 and 11)	(2,260,477)	-
Change in fair value of warrant liability (Note 14)	(1,273,221)	121,847
	(4,691,874)	(1,764,445)
Net loss and comprehensive loss for the year	\$ (23,369,551)	\$ (4,010,638)
Loss and comprehensive loss attributable to:		
Owners of the Company	\$ (22,989,606)	\$ (3,997,202)
Non-controlling interest	(379,945)	(13,436)
Net loss and comprehensive loss for the year	\$ (23,369,551)	\$ (4,010,638)
Loss per share – basic and diluted (Owners of the Company)	\$ (1.85)	\$ (0.65)
Loss per share – basic and diluted (Non-controlling interest)	\$ (0.03)	\$ (0.00)
Loss per share – basic and diluted	\$ (1.88)	\$ (0.65)
Weighted average shares outstanding – basic and diluted	12,405,838	6,118,673

The accompanying notes are an integral part of these consolidated financial statements.

EUPRAXIA PHARMACEUTICALS INC.
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (DEFICIT)
(Expressed in Canadian Dollars)

	Number of Shares	Amount	Contributed Surplus	Deficit	Non-controlling Interest	Total
Balance, December 31, 2019	6,118,002	\$ 23,548,357	\$ 5,961,208	\$ (47,199,955)	\$ (440,455)	\$ (18,130,845)
Stock-based compensation	-	-	228,680	-	-	228,680
Conversion of promissory note	62,288	249,150	-	-	-	249,150
Total loss and comprehensive loss for the year	-	-	-	(3,997,202)	(13,436)	(4,010,638)
Balance, December 31, 2020	6,180,290	\$ 23,797,507	\$ 6,189,888	\$ (51,197,157)	\$ (453,891)	\$ (21,663,653)
Conversion of notes (Note 9)	1,261,387	10,089,835	-	-	-	10,089,835
Conversion of special warrants (Note 10)	298,798	2,390,085	-	-	-	2,390,085
Conversion of loans (Note 11)	1,298,664	5,987,642	-	-	-	5,987,642
Warrant reclassification (Note 14)	-	-	2,175,688	-	-	2,175,688
Equity component of convertible debt (Note 15)	-	-	1,280,177	-	-	1,280,177
Initial public offering (Note 16 (b))	5,125,000	37,833,462	-	-	-	37,833,462
Issuance of shares for services (Note 16 (b))	78,456	614,600	-	-	-	614,600
Stock-based compensation (Note 16 (c))	-	-	4,214,651	-	-	4,214,651
Total loss and comprehensive loss for the year	-	-	-	(22,989,606)	(379,945)	(23,369,551)
Balance, December 31, 2021	14,242,595	\$ 80,713,131	\$ 13,860,404	\$ (74,186,763)	\$ (833,836)	\$ 19,552,936

The accompanying notes are an integral part of these consolidated financial statements.

EUPRAXIA PHARMACEUTICALS INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Expressed in Canadian Dollars)

	Year ended December 31, 2021	Year ended December 31, 2020
CASH FLOWS FROM OPERATING ACTIVITIES		
Total loss and comprehensive loss	\$ (23,369,551)	\$ (4,010,638)
Items not affecting cash		
Accrued interest on convertible notes (Note 9)	136,253	707,090
Accrued interest on loans (Note 11)	408,352	705,177
Accrued interest on SVB debt facility (Note 15)	548,896	-
Accrued interest on payable to Auritec Pharmaceuticals Inc. (Note 23)	28,515 (8,855)	284,255 -
Accrued interest on short term investments	-	57,611
Other accrued interest and accretion		
Depreciation of equipment (Note 6)	55,251	42,517
Depreciation of right-of-use asset (Note 7)	56,278	74,292
Interest – lease liability (Note 12)	35,167	42,648
Loss on conversion of notes, specials warrants and loans (Notes 9, 10 and 11)	2,260,477	-
Loss on sale of equipment (Note 6)	-	132,759
Stock-based compensation (Note 16(c))	4,214,651	228,680
Change in fair value of warrant liabilities (Note 14)	1,273,221	(121,847)
Unrealized foreign exchange	(68,854)	(128,932)
	<u>(14,430,199)</u>	<u>(1,986,388)</u>
Changes in non-cash working capital balances		
Accounts payable and accrued liabilities	(467,485)	852,010
Prepaid expenses	65,166	2,905
Amounts receivable	190,888	727,689
Cash used in operating activities	<u>(14,641,630)</u>	<u>(403,784)</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Acquisition of equipment (Note 6)	(431,673)	-
Proceeds from sale of equipment (Note 6)	-	81,305
Receipt of tenant improvement allowance (Notes 7 and 12)	45,382	-
Purchase of short term investments	(9,000,000)	-
Payable to Auritec Pharmaceuticals Inc. (Note 13)	(5,063,528)	(56,687)
Cash provided by (used in) investing activities	<u>(14,449,819)</u>	<u>24,618</u>
CASH FLOWS FROM FINANCING ACTIVITIES		
Receipt (repayment) of loans (Note 11)	2,753,299	(1,000,000)
Repayment of loans (Note 11)	(498,730)	-
Receipt of convertible debt from SVB (Note 15)	9,814,684	-
Issuance of convertible notes for cash (Note 9)	100,000	710,000
IPO shares issued for cash (net of transaction costs) (Note 16(b))	37,833,462	-
Financing costs related to Initial Public Offering (Note 16(b))	-	(235,949)
Lease payments (Note 12)	(87,696)	(100,695)
Cash provided by (used in) financing activities	<u>49,915,019</u>	<u>(626,644)</u>
Increase (decrease) in cash and cash equivalents	20,823,570	(1,005,810)
Foreign exchange effect on cash and cash equivalents	(81,627)	(143)
Cash and cash equivalents, beginning of year	150,126	1,156,079
Cash and cash equivalents, end of year	<u>\$ 20,892,069</u>	<u>\$ 150,126</u>

Supplemental disclosure with respect to cash flows (Note 24)

The accompanying notes are an integral part of these consolidated financial statements

EUPRAXIA PHARMACEUTICALS INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2021 and 2020
(Expressed in Canadian Dollars)

1. NATURE OF BUSINESS AND GOING CONCERN

Eupraxia Pharmaceuticals Inc. (the “Company”) was incorporated under the laws of the province of Alberta on May 12, 2011 under the name Plaza Capital Partners Inc. On May 11, 2012, the Company changed its name to Eupraxia Pharmaceuticals Inc. and continued from the province of Alberta to the province of British Columbia.

On October 10, 2012, a wholly-owned subsidiary, Eupraxia Holdings, Inc. (“Holdings”) was incorporated under the laws of the State of Delaware, USA. On November 16, 2012, Holdings was registered as an extra-provincial corporation under the laws of the province of British Columbia, Canada. On October 10, 2012, Eupraxia Pharmaceuticals USA, LLC (“Eupraxia USA”) was incorporated under the laws of the State of Delaware. On November 16, 2012, Eupraxia USA was registered as an extra-provincial corporation under the laws of the province of British Columbia. On January 7, 2021, Eupraxia Pharma, Inc. (“Eupraxia Pharma”) was incorporated under the laws of the State of Delaware.

On March 9, 2021, the Company completed an initial public offering on the Toronto Stock Exchange (“TSX”) with the listing of both common shares and warrants under the symbols “EPRX” and “EPRX.WT”, respectively. The Company completed a four-for-one share consolidation of its common stock as part of the Company’s initial public offering on the TSX. All share and earnings per share information has been retroactively adjusted to reflect the share consolidation.

The Company’s principal business is the development of locally-delivered, extended-release alternatives to existing pharmaceuticals. The address of the Company’s corporate office and principal place of business is 201 –2067 Cadboro Bay Road, Victoria, British Columbia, Canada.

On March 11, 2020, the World Health Organization declared COVID-19 a pandemic. In response to the pandemic, the Company has modified its business practices with a focus on the health and safety of our employees, partners, service providers, and communities. At the onset of the outbreak of COVID-19, the Company implemented appropriate measures to allow the offices to remain open and operational while allowing employees to work from home where possible. However, several of the Company’s partners were impacted by COVID-19 (including shutdown of some of their offices), which resulted in project delays. The effect of COVID-19 on other aspects of the results of operations and financial performance remains uncertain and may only be known in future periods.

These consolidated financial statements have been prepared on a going concern basis with the assumption that the Company will be able to realize its assets and discharge its liabilities and commitments in the normal course of business. At December 31, 2021, the Company had cash and cash equivalents of \$20,892,069, short term investments of \$9,008,855 and working capital of \$28,333,840 and the Company has not yet generated revenue from operations. The Company incurred a net loss of \$23,369,551 during the year ended December 31, 2021 and, as of that date, the Company’s accumulated deficit was \$74,186,763. In addition, the Company is required to raise an additional \$10,000,000 of net new capital by June 30, 2022 (see Note 15 – Convertible Debt). As the Company is in the research and development stage, the recoverability of the costs incurred to date is dependent upon the ability of the Company to obtain the necessary financing to complete the research and development of its projects and upon future profitable production or proceeds from the monetization of research activities to date. The Company will periodically have to raise funds to continue operations and, although it has been successful in doing so in the past, there is no assurance it will be able to do so in the future, especially with recent developments in Russia and Ukraine affecting the global capital markets in addition to the ongoing impact of COVID-19. These events and conditions indicate a material uncertainty which may cast significant doubt about its ability to continue as a going concern. These consolidated financial statements do not include any adjustments to the amounts and classification of assets and liabilities that might be necessary should the Company be unable to continue in business.

EUPRAXIA PHARMACEUTICALS INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2021 and 2020
(Expressed in Canadian Dollars)

1. NATURE OF BUSINESS AND GOING CONCERN (continued)

The continued operations of the Company are dependent on its ability to generate future cash flows or obtain additional financing. The Company is active in its pursuit of additional funding through partnering, and other strategic activities, as well as via grants, to fund future research and development activities. There is a risk that in the future, additional financing will not be available on a timely basis or on terms acceptable to the Company.

2. BASIS OF PRESENTATION

Statement of Compliance

These consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (“IFRS”) using accounting policies consistent with IFRS as issued by the International Accounting Standards Board (“IASB”) and interpretations of the IFRS Interpretations Committee (“IFRIC”), effective for the Company’s reporting for the year ended December 31, 2021.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Measurement

The consolidated financial statements have been prepared on a historical cost basis, except for certain financial instruments which are measured at fair value. The consolidated financial statements are presented in Canadian dollars, which is also the Company’s functional currency.

The preparation of consolidated financial statements in compliance with IFRS requires management to make certain critical accounting estimates. It also requires management to exercise judgment in applying the Company’s accounting policies. The areas involving a higher degree of judgment or complexity, or areas where assumptions and estimates are significant to the consolidated financial statements are disclosed in Note 4 – Significant Accounting Estimates and Judgements.

Consolidation

These consolidated financial statements include the accounts of the Company and the accounts of its subsidiaries. The financial statements of subsidiaries are included in the consolidated financial statements from the date that control commences until the date that control ceases. Control exists when an entity is exposed to or has rights to variable returns from its involvement with the entity and has the ability to affect these returns through its power over the entity. All significant intercompany transactions and balances have been eliminated.

Non-controlling interest in the net assets of consolidated subsidiaries are identified separately from the Company’s equity. Non-controlling interest consists of the non-controlling interest as at the date of the original transaction plus the non-controlling interest’s share of changes in equity since that date.

Company Entity	Jurisdiction of Incorporation	Effective Interest (Note 16(e))
Eupraxia Pharma, Inc.	Delaware, USA	95%
Eupraxia Holdings Inc.	Delaware, USA	95%
Eupraxia Pharmaceuticals USA, LLC	Delaware, USA	95%
AMDM Holdings Inc.	Washington, USA	100%

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Loss per Share

The Company applies the "Treasury Stock Method" to calculate loss per common share. Under this method, the basic loss per share is calculated based on the weighted average aggregate number of common shares outstanding during each period. The diluted loss per share assumes that the outstanding stock options and share purchase warrants had been exercised at the beginning of the period, or date of issuance if issued during the period, and proceeds from dilutive instruments are used to purchase common shares at the average market price during the period. Since the Company was in a loss position for the years ended December 31, 2021 and 2020, the assumed conversion of outstanding common share warrants and options has an anti-dilutive impact, therefore the diluted loss per share is equal to basic loss per share.

Equipment

Equipment is recorded at historical cost less accumulated depreciation and accumulated impairment losses. Depreciation is provided over the estimated useful lives of the assets as follows:

Computer equipment	45% declining balance
Office equipment	20% declining balance
Leasehold improvements	straight-line over the term of the lease
Lab equipment	20% declining balance

The useful lives and depreciation methods applied to each category of equipment are assessed on an annual basis by management and adjusted where necessary to reflect the recoverability of equipment.

Research and Development Expenditures

The Company expenses all research costs as they are incurred. Development costs are also expensed unless they meet all of the specific capitalization criteria established in IAS 38, Intangible Assets. Capitalized development costs are stated at cost, net of investment tax credits and government assistance, and net of accumulated amortization and accumulated impairment losses, if any.

Investment Tax Credits

Investment tax credits ("ITCs") arising from research and development activities are deducted from the related costs and are included in profit or loss when there is reasonable assurance that the credits will be realized. ITCs arising from the acquisition or development of equipment and capitalized development costs are deducted from the cost of those assets with amortization calculated on the net amount.

Government Grants

Government grants related to research and development activities are recognized in profit or loss as a deduction from the related expenditure when there is reasonable assurance that the grant will be received. Grants that compensate the Company for the cost of an asset are recognized in profit or loss on a systematic basis over the useful life of the asset.

Government Assistance

Government contributions are recognized and deducted from the related costs when there is reasonable assurance that the contribution will be received and all attached conditions have been complied with by the Company. Government contributions arising from the acquisition or development of equipment and capitalized development costs are deducted from the cost of those assets with amortization calculated on the net amount.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Income Taxes

Current tax is the expected tax payable or recoverable on the taxable profit or loss for the year using tax rates enacted or substantively enacted at the reporting date and any adjustment to tax payable from previous years.

Deferred income tax is recorded using the liability method, providing for temporary differences, between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. Temporary differences are not provided for if they relate to goodwill not deductible for tax purposes, the initial recognition of assets or liabilities that affect neither accounting nor taxable loss, or differences relating to investments in subsidiaries to the extent that they will probably not reverse in the foreseeable future. The amount of deferred tax provided is based on the expected manner of realization or settlement of the carrying amount of assets and liabilities, using tax rates enacted or substantively enacted at the reporting date. A deferred tax asset is recognized only to the extent that it is probable that future taxable profits will be available against which the asset can be utilized.

Stock-based Compensation

Where equity-settled stock options are awarded to employees, officers or directors, the fair value of the options at the date of grant, as measured using the Black-Scholes option pricing model, is charged to profit or loss over the vesting period. Performance vesting conditions are taken into account by adjusting the number of equity instruments expected to vest at each reporting date so that, ultimately, the cumulative amount recognized over the vesting period is based on the number of options that eventually vest. Non-vesting conditions and market vesting conditions are factored into the fair value of the options granted. As long as all other vesting conditions are satisfied, a charge is made irrespective of whether these vesting conditions are satisfied. The cumulative expense is not adjusted for failure to achieve a market vesting condition or where a non-vesting condition is not satisfied.

Where the terms and conditions of options are modified, the increase in the fair value of the options, measured immediately before and after the modification, is also charged to profit or loss over the remaining vesting period, if applicable.

Where equity instruments are granted to non-employees, they are recorded at the fair value of the goods or services received in profit or loss, unless they are related to the issuance of shares or assets. Amounts related to the issuance of shares are recorded as a reduction of share capital, amounts related to assets are capitalized.

When the value of goods or services received in exchange for the stock-based payment cannot be reliably estimated, the fair value is measured using the Black-Scholes option pricing model. The expected life used in the model is adjusted, based on management's best estimate, for the effects of non-transferability, exercise restrictions, and behavioral considerations.

All equity-settled stock-based payments are reflected in contributed surplus, until exercised. Upon exercise, shares are issued from treasury and the amount reflected in contributed surplus is credited to share capital, in addition to any consideration paid.

Where a grant of options is cancelled or settled during the vesting period, excluding forfeitures when vesting conditions are not satisfied, the Company immediately accounts for the cancellation as an acceleration of vesting and recognizes the amount that otherwise would have been recognized for services received over the remainder of the vesting period. Any payment made to the employee on the cancellation is accounted for as the repurchase of an equity interest except to the extent the payment exceeds the fair value of the equity instrument granted, measured at the repurchase date. Any such excess is recognized in profit or loss.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Share Capital and Warrants

The Company records proceeds from share issuances net of issue costs and any related tax effects. Common shares issued for consideration other than cash are valued based on their market value at the date the agreement to issue shares was concluded. When units are issued during a private placement, which include both common shares and share purchase warrants, the warrants are valued by comparing the total unit price to the fair value of the shares on the day of the announcement of the private placement. Any premium above the fair value of the shares issued is allocated to the warrants and credited to contributed surplus.

Classification as debt or equity

Debt and equity instruments are classified as either financial liabilities or as equity in accordance with the substance of the contractual arrangements and the definitions of a financial liability and an equity instrument.

Equity instruments

An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities. Equity instruments issued by the Company are recognised at the proceeds received, net of direct issue costs.

Deferred Financing Costs

Financing costs related to the Company's Initial Public Offering (Note 16(b)(i)) were recorded as deferred financing costs. These costs were deferred until the financing was completed, at which time the costs were allocated between the proceeds received and profit or loss.

Foreign Currency Translation

The functional currency for each of the Company and the Company's subsidiaries is the currency of the primary economic environment in which each entity operates. Determination of functional currency may involve certain judgments to determine the primary economic environment. The Company reconsiders the functional currency of its entities if there is a change in events and conditions which determine the primary economic environment. Transactions in foreign currencies are translated to the functional currency of the entity at the exchange rate at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies at the reporting date are retranslated at the period end date exchange rates.

The functional currency of Eupraxia Pharmaceuticals Inc., the parent entity, is the Canadian dollar, which is also the presentation currency of the consolidated financial statements. The functional currency of each of the Company's subsidiaries is also the Canadian dollar.

Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rate at the date of the transaction. Non-monetary assets and liabilities denominated in foreign currencies that are measured at fair value are re-translated to the functional currency at the exchange rate at the date that the fair value was determined. Foreign currency differences arising on re-translation are recognized in profit or loss.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Impairment of Long-Lived Assets

At the end of each reporting period, the Company's long-lived assets which include equipment, are reviewed to determine whether there is any indication that those assets may be impaired. If such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of the impairment, if any. The recoverable amount is the higher of fair value less cost of disposal and value in use. Fair value is determined as the amount that would be obtained from the sale of the asset in an arm's length transaction between knowledgeable and willing parties. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. If the recoverable amount of an asset is estimated to be less than its carrying amount, the carrying amount of the asset is reduced to its recoverable amount and the impairment loss is recognized in profit or loss for the period. For an asset that does not generate largely independent cash inflows, the recoverable amount is determined for the cash generating unit to which the asset belongs.

Where an impairment loss subsequently reverses, the carrying amount of the asset (or cash-generating unit) is increased to the revised estimate of its recoverable amount, but to an amount that does not exceed the carrying amount that would have been determined had no impairment loss been recognized for the asset (or cash-generating unit) in prior years. A reversal of an impairment loss is recognized immediately in profit or loss.

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand, bank deposits and short-term, highly liquid investments that are readily convertible to known amounts of cash and subject to insignificant risk of changes in value. The Company held cash equivalents of \$5,005,856 as at December 31, 2021 and \$nil as at December 31, 2020 in addition to cash being held of \$15,886,213 and \$150,126 as at December 31, 2021 and December 31, 2020 respectively.

Short Term Investments

Short term investments include highly liquid investments with a maturity date greater than 180 days and which cannot be redeemed prior to maturity without incurring a penalty. The Company held short term investments of \$9,008,855 as at December 31, 2021 and \$nil as at December 31, 2020.

Financial Instruments

a) Recognition

The Company recognizes a financial asset or financial liability on the consolidated statement of financial position when it becomes party to the contractual provisions of the financial instrument. Financial assets are initially measured at fair value, and are derecognized either when the Company has transferred substantially all the risks and rewards of ownership of the financial asset, or when cash flows expire. Financial liabilities are initially measured at fair value and are derecognized when the obligation specified in the contract is discharged, cancelled or expired.

A write-off of a financial asset (or a portion thereof) constitutes a derecognition event. Write-off occurs when the Company has no reasonable expectation of recovering the contractual cash flows of a financial asset.

b) Classification and measurement

The Company determines the classification of its financial instruments at initial recognition. Financial instruments are classified according to the following measurement categories:

- i) those to be measured subsequently at fair value, either through profit or loss ("FVTPL") or through other comprehensive income ("FVTOCI"); and
- ii) those to be measured subsequently at amortized cost.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

The classification and measurement of financial assets after initial recognition at fair value depends on the business model for managing the financial asset and the contractual terms of the cash flows. Financial assets that are held within a business model whose objective is to collect the contractual cash flows, and that have contractual cash flows that are solely payments of principal and interest on the principal outstanding, are measured at amortized cost at each subsequent reporting period using the effective interest rate method. The “effective interest rate” is the rate that discounts estimated future cash flows over the expected life of the financial instrument, or where appropriate, a shorter period. All other financial assets are measured at their fair values at each subsequent reporting period, with any changes recorded through profit or loss or through other comprehensive income (which designation is made as an irrevocable election at the time of recognition).

After initial recognition at fair value, financial liabilities are classified and measured at either:

- i) Amortized cost;
- ii) FVTPL, if the Company has made an irrevocable election at the time of recognition, or when required (for items such as derivatives); or
- iii) FVTOCI, when the change in fair value is attributable to changes in the Company’s credit risk.

Financial liabilities classified as FVTPL are measured at fair value, with any changes in fair value on re-measurement recognized in profit or loss.

The Company reclassifies financial assets when and only when its business model for managing those assets changes. Financial liabilities are not reclassified.

Transaction costs that are directly attributable to the acquisition or issuance of a financial asset or financial liability classified as subsequently measured at amortized cost or FVTOCI are included in the fair value of the instrument on initial recognition. Transaction costs for financial assets and financial liabilities classified at FVTPL are expensed in profit or loss.

The Company has classified its financial assets and liabilities as follows:

Financial assets/liabilities	Classification
Cash and cash equivalents	Amortized cost
Short term investments	Amortized cost
Rent and other receivables	Amortized cost
Accounts payable and accrued liabilities	Amortized cost
Payable to Auritec Pharmaceuticals Inc.	Amortized cost
Convertible debt	Amortized cost
Convertible notes payable	FVTPL
Special warrants	FVTPL
Loans payable	Amortized cost
Derivative warrant liability	FVTPL

c) Impairment

The Company assesses all information available, including on a forward-looking basis the expected credit losses associated with any financial assets carried at amortized cost. The impairment methodology applied depends on whether there has been a significant increase in credit risk. To assess whether there is a significant increase in credit risk, the Company compares the risk of a default occurring on the asset as at the reporting date with the risk of default as at the date of initial recognition based on all information available, and reasonable and supportable forward-looking information.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Leases

Right-of-use assets

The Company recognizes right-of-use assets at the commencement date of the lease. Right-of-use assets are measured at cost, less any accumulated depreciation and impairment losses, and adjusted for any remeasurement of lease liabilities. The cost of right-of-use assets is equal to the lease liabilities recognized. Unless the Company is reasonably certain to obtain ownership of the leased asset at the end of the lease term, right-of-use assets are depreciated on a straight-line basis over the shorter of its estimated useful life and the lease term.

As such, the Company's right-of-use assets are depreciated over the following:

Property	1.25 to 5 years
----------	-----------------

Right-of-use assets are subject to impairment assessment consistent with other long-lived assets.

Lease Liabilities

The Company recognizes lease liabilities at the commencement date of the lease measured at the present value of lease payments to be made over the term of the lease. The lease payments are fixed. Other variable lease payments that do not depend on an index or rate are recognized as rent expense in the period the expense is incurred. In calculating the present value of lease payments, the Company uses its incremental borrowing rate at the lease commencement date if the interest rate implicit in the lease is not readily determinable. After the commencement date, the amount of lease liabilities is increased to reflect the accretion of interest and reduced for the lease payments made. In addition, the carrying amount of lease liabilities is remeasured if there is a modification, a change in the lease term, a change in the in-substance fixed lease payments or a change in the assessment to purchase the underlying asset.

Upcoming Accounting Standards and Interpretations

The Company has not yet adopted certain new standards, amendments and interpretations to existing standards, which have been published but are only effective for accounting periods beginning on or after January 1, 2022 or later periods. The new and amended standards are not expected to have a material impact on the Company.

4. SIGNIFICANT ACCOUNTING ESTIMATES AND JUDGMENTS

The preparation of the consolidated financial statements requires management to make certain estimates, judgments and assumptions that affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and reported amounts of expenses during the reporting year, which, by their nature, are uncertain. Actual outcomes could differ from these estimates. The impacts of such estimates are pervasive throughout the consolidated financial statements, and may require accounting adjustments based on future events. Revisions to accounting estimates are recognized in the year in which the estimate is revised and future periods if the revision affects both current and future years. These estimates are based on historical experience, current and future economic conditions and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

Critical accounting estimates

Significant assumptions about the future and other sources of estimation uncertainty that management has made at the end of the reporting period, that could result in a material adjustment to the carrying amounts of assets and liabilities in the event that actual results differ from assumptions made, relate to, but are not limited to, the following:

EUPRAXIA PHARMACEUTICALS INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2021 and 2020
(Expressed in Canadian Dollars)

4. SIGNIFICANT ACCOUNTING ESTIMATES AND JUDGMENTS (continued)

Critical accounting judgments (continued)

- i) The valuation of stock-based compensation and other non-cash stock-based payments; and
- ii) The determination of the amount allocated to the liability and equity components (for those financial instruments that are comprised of both). This requires management to estimate various components and characteristics of present value calculations used in determining the fair value of the instrument, including the market interest rates of non-convertible debentures.

Critical accounting judgments

Critical accounting judgments are accounting policies that have been identified as being complex or involving subjective judgments or assessments. The Company's management made the following critical accounting judgments:

- i) The determination of whether the Company is in the "research" or "development" stage of operations. During the research stage of operations, all expenditures associated with the advancement of the technology are expensed in the period they are incurred;
- ii) The determination of the functional currency of the Company and its subsidiaries; and
- iii) Assessment of the appropriateness of the going concern assertion and events and conditions that indicate a material uncertainty that may cast significant doubt thereon.

5. AMOUNTS RECEIVABLE

	December 31, 2021	December 31, 2020
Government grants (Note 18)	\$ 102,952	\$ 179,750
Scientific research and development ITCs (Note 17)	298,564	379,000
GST/HST recoverable	28,202	22,415
Rent receivable	-	33,590
Other	-	5,851
Total	\$ 429,718	\$ 620,606

EUPRAXIA PHARMACEUTICALS INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2021 and 2020
(Expressed in Canadian Dollars)

6. EQUIPMENT

	Computers	Office	Leasehold Improvements	Lab	Total
<u>Cost</u>					
As at December 31, 2019	\$ 90,719	\$ 95,710	\$ 106,464	\$ 424,891	\$ 717,784
Disposals	-	(11,193)	-	(378,948)	(390,141)
As at December 31, 2020	90,719	84,517	106,464	45,943	327,643
Additions	38,284	8,371	63,844	321,174	431,673
As at December 31, 2021	\$ 129,003	\$ 92,888	\$ 170,308	\$ 367,117	\$ 759,316
<u>Accumulated depreciation</u>					
As at December 31, 2019	\$ 66,254	\$ 49,667	\$ 98,905	\$ 178,063	\$ 392,889
Depreciation	11,011	7,710	7,559	16,237	42,517
Disposals	-	(4,747)	-	(171,330)	(176,077)
As at December 31, 2020	77,265	52,630	106,464	22,970	259,329
Depreciation	12,989	6,913	9,343	26,006	55,251
As at December 31, 2021	\$ 90,254	\$ 59,543	\$ 115,807	\$ 48,976	\$ 314,580
<u>Carrying amount</u>					
As at December 31, 2020	\$ 13,454	\$ 31,887	\$ -	\$ 22,973	\$ 68,314
As at December 31, 2021	\$ 38,749	\$ 33,345	\$ 54,501	\$ 318,141	\$ 444,736

7. RIGHT-OF-USE ASSET

The following table presents details of movement in the carrying value of the right-of-use asset:

	December 31, 2021	December 31, 2020
Beginning Balance	\$ 247,023	\$ 321,315
Less: Tenant improvement allowance received	(46,413)	-
Amortization	(56,278)	(74,292)
Ending Balance	\$ 144,332	\$ 247,023

EUPRAXIA PHARMACEUTICALS INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2021 and 2020
(Expressed in Canadian Dollars)

8. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

	December 31, 2021	December 31, 2020
Research and development	\$ 1,046,037	\$ 620,951
General and administrative	318,424	1,491,969
Wages and payroll remittances	5,011	163,984
Bonus ⁽¹⁾	743,517	-
Deferred salaries ⁽²⁾	-	923,908
Total	\$2,112,989	\$ 3,200,812

(1) Bonus relates to FY21 corporate bonus which was paid out to employees in early 2022.

(2) The Company entered into a salary deferral agreement with various employees. Contingent upon the Company closing an institutional financing of at least USD25 million, the Company was to pay the employees a bonus of 20% of the deferred salary as of that date. Upon completion of the initial public offering on the TSX the Company paid the deferred salaries and associated bonus.

9. CONVERTIBLE NOTES PAYABLE

On May 25, 2018, the Company approved the issuance of unsecured convertible notes (the “Notes”) with up to an aggregate principal amount of \$3,000,000. The aggregate principal amount was subsequently increased to \$8,000,000 on April 1, 2019.

The Notes carried an annual interest rate of 10% and originally matured on June 30, 2020, subsequently extended to December 31, 2020.

In the event of a Qualified Financing of greater than USD15,000,000, the principal and any accrued interest would convert into the same class of securities issued in the Qualified Financing at a 10% discount to the price paid per share. If the Company did not consummate a Qualified Financing prior to maturity, the principal and any accrued interest would convert into common shares at a conversion price of \$8.00 per share.

On March 10, 2020, the directors of the Company approved a reduction in the conversion price from \$8.00 to \$4.00 per share.

On April 30, 2020, the Company approved the issue of unsecured convertible notes (the “2020 Notes”) up to an aggregate principal amount of \$2,000,000. The terms of these convertible notes were identical to the notes outlined above with the exception that they converted at a 30% discount in the event of a Qualified Financing.

On December 18, 2020, the Company offered the convertible note holders the opportunity to extend the maturity date of their convertible notes to December 31, 2021. The majority of convertible note holders extended their maturity dates. A convertible note totaling \$249,150 of principal and accrued interest converted into common shares on December 31, 2020 as a result of the convertible note holder not electing to extend the maturity date. In accordance with the terms of the convertible note agreement, 62,288 common shares were issued at \$4.00 per share.

The settlement of the convertible notes required a variable number of shares; therefore, the contract was treated as a financial liability even though it involved settlement by the delivery of common shares.

EUPRAXIA PHARMACEUTICALS INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2021 and 2020
(Expressed in Canadian Dollars)

9. CONVERTIBLE NOTES PAYABLE (continued)

On March 9, 2021, both the Notes and 2020 Notes were converted into common shares as a result of the Company's initial public offering on the TSX which constituted a Qualified Financing. Principal and interest totaling \$8,829,004 was converted into 1,261,387 common shares. These shares had a fair market value of \$10,089,835 as of the conversion date, which was reflected in the Company's share capital balance. The difference of \$1,260,831 between the carrying value of the liability and the fair market value was recorded in other income (expense) as a loss on conversion of notes.

As at December 31, 2021 and December 31, 2020, the following convertible notes were outstanding:

	December 31, 2021	December 31, 2020
Convertible notes ⁽¹⁾ issued June 19, 2018	\$ 2,150,000	\$ 2,150,000
Convertible notes ⁽¹⁾ issued November 13, 2018	975,000	975,000
Convertible notes ⁽¹⁾ issued December 20, 2018	350,000	350,000
Convertible notes ⁽¹⁾ issued April 1, 2019	1,500,000	1,500,000
Convertible notes ⁽¹⁾ issued April 30, 2019	700,000	700,000
Convertible notes ⁽¹⁾ issued May 23, 2019	815,000	815,000
Convertible notes ⁽²⁾ issued June 1, 2020	500,000	500,000
Convertible notes ⁽²⁾ issued July 22, 2020	121,000	121,000
Convertible notes ⁽²⁾ issued November 27, 2020	110,000	110,000
Convertible notes ⁽²⁾ issued January 5, 2021	100,000	-
Accrued interest	1,508,004	1,371,751
Loss on conversion	1,260,831	-
Conversion into common shares on March 9, 2021	(10,089,835)	-
Total	\$ -	\$ 8,592,751

(1) Converted at 10% discount as a result of qualified financing

(2) Converted at 30% discount as a result of qualified financing

10. SPECIAL WARRANTS

On June 23, 2018, the Company approved the issue of up to 1,000,000 special warrants with a subscription price of \$2.00 per warrant for aggregate proceeds of \$2,000,000.

The warrants originally had an expiry date of June 30, 2020 which was subsequently extended to December 31, 2021.

Under the terms of the Special Warrants, if the Company had not completed a Qualified Financing before December 31, 2021 (the "Final Conversion Date") then the Special Warrants would be deemed to be exercised for such number of common shares of the Company determined in accordance with the following formula:

$$[SW*2 + (0.1 \times SW*2) (D / 365)] \times [1/4]$$

Where:

SW = Number of Special Warrants.

D = the number of days between the date the Special Warrants were issued and the Final Conversion Date.

If the Company completed a Qualified Financing before the Final Conversion Date, then the Special Warrants would be deemed to be exercised, by the Holder on the date of the completion of the Qualified Financing into the class of shares issued and sold in the Qualified Financing and the number of shares issued and sold in the Qualified Financing in accordance with the following formula:

$$(SW \times \$2.00) / (PP \times 0.9) + 0.1 \times [(SW \times \$2.00) / (PP \times 0.9)] (D / 365)$$

Where:

SW = Number of Special Warrants.

D = the number of days between the date the Special Warrants were issued and the date of the Qualified Financing.

PP = the per share purchase price of the equity securities issued and sold in the Qualified Financing.

The settlement of the special warrants required a variable number of shares, therefore the contract was treated as a financial liability even though it involved settlement by the delivery of common shares.

On March 9, 2021, the special warrants were converted into common shares as a result of the Company's initial public offering on the TSX which constituted a Qualified Financing. The special warrants were converted into 298,798 common shares according to the terms outlined above. These shares had a fair market value of \$2,390,085 as of the conversion date, which was reflected in the Company's share capital balance. The difference of \$675,085 between the carrying value of the liability and the fair market value was recorded in other income (expense) as a loss on conversion of special warrants.

EUPRAXIA PHARMACEUTICALS INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2021 and 2020
(Expressed in Canadian Dollars)

10. SPECIAL WARRANTS (continued)

As at December 31, 2021 and December 31, 2020, the following special warrants were outstanding:

	December 31, 2021	December 31, 2020
Special warrants issued July 18, 2018 (590,000)	\$ 1,180,000	\$ 1,180,000
Special warrants issued November 13, 2018 (267,500)	535,000	535,000
Loss on conversion	675,085	-
Conversion into common shares on March 9, 2021	(2,390,085)	-
Total	\$ -	\$ 1,715,000

11. LOANS PAYABLE

On January 4, 2021 and January 8, 2021, the Company borrowed an aggregate of USD1,700,000 (\$2,355,795) from certain shareholders and a director of the Company. The loans were unsecured, incurred interest at a rate of 10% per annum and matured on December 31, 2021. Under the terms of the loans and following completion of an equity financing exceeding USD15,000,000, each lender had the right to convert the principal and accrued interest under their respective loan into common shares at a 30% discount to the per share purchase price of the common shares issued and sold in the equity financing. As consideration for providing such loans, the lenders were issued an aggregate of 270,957 common share purchase warrants, with each warrant exercisable for one common share for a period of three years from the date of issuance at an exercise price of \$4.00 per share provided that upon completion of an equity financing, the exercise price of such warrants will be adjusted to equal a 30% discount to the equity financing price. Upon completion of the Company's initial public offering, the exercise price of these warrants was adjusted to \$5.5993.

On January 4, 2021, the Company borrowed USD250,000 from a director of the Company. The loan was unsecured, incurred interest at a rate of 15% per annum and matured on December 31, 2021. The Company intended to repay the loan using the proceeds of the Scientific Research and Experimental Development Tax Incentive Program (SR&ED) tax credits and/or refunds received by the Company relating to the 2020 calendar year. As consideration for providing the loan, the lender was issued a total of 39,846 common share purchase warrants, with each warrant exercisable for one Common Share for a period of three years at an exercise price of \$4.00 per share, provided that upon completion of an equity financing, the exercise price of such warrants will be adjusted to equal a 10% discount to the equity financing price. Upon completion of the Company's initial public offering, the exercise price of these warrants was adjusted to \$7.1991. On June 2, 2021, upon receipt of the Company's 2020 SR&ED refund, principal and interest owing on the loan totaling USD265,000 was repaid to the director of the Company.

On May 18, 2021, the Company offered existing lenders the opportunity to convert their outstanding principal and accrued interest into common shares at a conversion price equal to \$4.6106 per common share. Principal and interest totaling \$5,987,642 was subsequently converted into 1,298,664 common shares of the Company on June 8, 2021. The difference of \$324,561 between the carrying value of the liability and the fair market value was recorded in other income (expense) as a loss on conversion of loans.

On June 10, 2021, accrued interest totaling \$180,197 was paid to a lender.

EUPRAXIA PHARMACEUTICALS INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2021 and 2020
(Expressed in Canadian Dollars)

11. LOANS PAYABLE (continued)

On September 10, 2021, the Company entered into a Master Loan and Security Agreement (“Loan Agreement”) whereby the Company borrowed USD235,000 to purchase production and test equipment (see Note 6 – Equipment).

The Loan Agreement has a term of 36 months commencing September 13, 2021. The Loan Agreement accrues interest at 5.84% per annum with monthly payments (principal and interest) being made on the 1st of each month, beginning October 1, 2021. As part of the agreement, the Company granted the lender first priority interest on the equipment it purchased.

Below is a breakdown of loan balance as at December 31, 2021 and December 31, 2020:

	December 31, 2021	December 31, 2020
Balance, beginning	\$ 3,924,698	\$ 4,249,105
Receipt of cash loans	2,653,062	-
Transaction costs	(526,161)	-
Loan repayment	(521,386)	(1,029,584)
Interest accrued	206,752	328,673
Financing cost accreted	201,600	376,504
Conversion to common shares	(5,987,642)	-
Loss on conversion	324,561	-
Foreign exchange adjustment	(379)	-
Balance, ending	\$ 275,105	\$ 3,924,698
Current portion	\$ 94,916	\$ 3,924,698
Non-current portion	\$ 180,189	\$ -

EUPRAXIA PHARMACEUTICALS INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2021 and 2020
(Expressed in Canadian Dollars)

12. LEASES

The Company entered into a lease agreement for its Victoria, BC facility (of approximately 4,900 square feet of office space) which expires on November 30, 2024.

	December 31, 2021	December 31, 2020
Opening balance	\$ 251,194	\$ 309,241
Interest expense	35,167	42,648
Tenant improvement allowance (net of \$41,046 cash received)	(1,031)	-
Payments	(87,696)	(100,695)
Ending balance	\$ 197,634	\$ 251,194
Current portion	\$ 59,883	\$ 52,529
Non-current portion	\$ 137,751	\$ 198,665

The incremental borrowing rate on lease liabilities is 14%. Variable lease payments comprised of operating, maintenance and property tax fees totaling \$79,050 for the year ended December 31, 2021 are included in general and administrative expenses (year ended December 31, 2020 – \$61,425).

During the year ended December 31, 2021, the Company subleased a portion of its office space with amounts totaling \$24,572 for the year ended December 31, 2021 (\$21,990 – year ended December 31, 2020) being recorded as a reduction to general and administrative expenses.

The Company’s lease payments for office space over the remaining term of the lease are as follows:

	2022	2023	2024
Office	\$87,696	\$87,696	\$80,388

The following is a reconciliation of undiscounted lease commitments and lease liabilities at December 31, 2021:

Total undiscounted lease commitments	\$ 255,780
Balance remaining of tenant allowance to be repaid	(1,031)
Discount using incremental borrowing rate	(57,115)
Total lease liabilities at December 31, 2021	\$ 197,634

13. AURITEC LICENSE AGREEMENT

Eupraxia USA entered into an amended and restated license agreement with Auritec Pharmaceuticals Inc. (“Auritec”) on October 9, 2018 (as further amended, the “Amended and Restated License Agreement”). Under the terms of the Amended and Restated License Agreement, Auritec has granted Eupraxia USA an exclusive license (including the right to sublicense to its affiliates and third parties) under the licensed patents held by Auritec and for all the technical information and know-how relating to the technology claimed in the licensed patents held by Auritec with respect to the use of Auritec’s “Plexis Platform” for the delivery of fluticasone in all medical fields (except for otolaryngology and the prevention, treatment and control of all diseases, disorders and conditions of the eye and its adnexa (collectively, the “Excluded Fields”)), to develop, make, have made, manufacture, use, commercialize, sell, sub-license, offer for sale, import, and have imported products for the delivery of fluticasone drug products using the Plexis Platform in all medical fields except the Excluded Fields (“Licensed Products”).

Pursuant to the terms of the Amended and Restated License Agreement, Eupraxia USA was to pay USD5,000,000 to Auritec (the “Upfront Fee”). In addition, Eupraxia USA has agreed to pay Auritec up to USD30 million upon achievement of certain regulatory and commercial milestones related to products licensed under the Amended and Restated License Agreement (“Licensed Products”) as well as a royalty of 4% of net sales of Licensed Products by Eupraxia USA or its affiliates, subject to certain reductions. Eupraxia USA also agreed to pay to Auritec 20% of sublicensing royalties or other consideration based on net sales of Licensed Products. Eupraxia USA further agreed to pay Auritec a percentage of Non-Royalty Monetization Revenue (as defined in the Amended and Restated License Agreement), which includes payments received for a sale of Eupraxia USA or sale or sublicense of a Licensed Product, which percentage ranges from 30% to 15% depending on the development stage of the most-advanced Licensed Product, up to a maximum of USD100 million.

Eupraxia USA had made a partial payment of USD1,200,000 towards the Upfront Fee as of December 31, 2020. On January 6, 2021, Eupraxia USA and Auritec entered into the seventh amendment to the Amended and Restated License Agreement, pursuant to which the parties agreed to extend the deadline for the USD3,800,000 balance of the Upfront Fee such that USD1,650,000 would be paid on or prior to January 8, 2021. Eupraxia USA paid such amount on January 6, 2021. The deadline for the remaining USD2,150,000 balance plus outstanding interest was due on or prior to the earlier of December 31, 2021 or three days after which Eupraxia received aggregate proceeds of debt and/or equity financing of USD12,000,000 or more. The remaining balance, including principal and accrued interest totaling USD2,343,999, was paid to Auritec on March 9, 2021 following completion of the Company’s initial public offering.

EUPRAXIA PHARMACEUTICALS INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2021 and 2020
(Expressed in Canadian Dollars)

13. AURITEC LICENSE AGREEMENT (continued)

The following table summarizes the payments made with respect to the Upfront Fee in US dollars and Canadian dollars:

Upfront Fee payable	USD	5,000,000	\$ 6,480,500
Principal repayments		(1,200,000)	(1,604,151)
Monthly interest accrued		303,119	402,210
Monthly interest paid		(303,119)	(402,210)
Foreign exchange		-	59,091
Balance payable at December 31, 2019		3,800,000	4,935,440
Monthly interest accrued		214,225	284,255
Monthly interest paid		(42,750)	(56,687)
Foreign exchange		-	(106,526)
Balance payable December 31, 2020		3,971,475	5,056,482
Monthly interest accrued		22,524	28,515
Monthly interest paid		(193,999)	(245,739)
Principal repayments		(3,800,000)	(4,817,789)
Foreign exchange		-	(21,469)
Balance payable December 31, 2021	USD	-	\$ -

14. DERIVATIVE WARRANT LIABILITY

On July 19, 2019, the directors of the Company approved a new loan structure which offered lenders interest at 8% and warrants to acquire common shares in an amount equal to one warrant for every \$10.00 of principal and interest loaned. The warrants would vest immediately and allow the investor to purchase common shares anytime up to 3 years from the date of issue. The exercise price of the warrants was \$4.00 per share or if a Qualified Financing has closed any time prior to or including the expiry date then the exercise price is the per share purchase price of equity securities issued and sold in the Qualified Financing. Upon completion of the Company's initial public offering, the exercise price of these warrants was adjusted to \$7.999.

Existing loans with a total principal of \$1,500,000 and accrued interest of \$141,733 previously bearing interest at 14% were converted to the new structure on July 13, 2019 and November 19, 2019.

A total of 289,172 warrants were issued in relation to the loans. The fair value of warrants issued were recorded against the principal balance at the issuance dates.

On January 4, 2021 and January 8, 2021, a further 310,803 warrants were issued in connection with the loans outlined in Note 11.

Accretion of loan financing costs of \$201,600 was included in interest expense for the year ended December 31, 2021 (\$376,504 for the year ended December 31, 2020).

EUPRAXIA PHARMACEUTICALS INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2021 and 2020
(Expressed in Canadian Dollars)

14. DERIVATIVE WARRANT LIABILITY (continued)

At issuance the warrants issued as part of the loan financings were a derivative liability given that the warrant exercise price was subject to change if a Qualified Financing occurred. The derivative warrant liability was measured at fair value at each reporting period with any gain or loss resulting from re-measurement recognized in profit or loss. Upon completion of the Company's initial public offering, the exercise price was set and the fair value of warrants (measured on March 9, 2021) was reclassified to equity. The Company recognized \$1,273,221 as a change in the fair value of the derivative warrant liability once the exercise price was set. The fair value of the warrants at each measurement date was estimated using the Black-Scholes option pricing model and based on the following weighted average assumptions:

	At March 9, 2021	At Issuance dates (Jan. 4, 2021 to Jan. 8, 2021)	At December 31, 2020
Annual volatility ⁽¹⁾	72.50%	71.35%	71.35%
Risk free interest rate	0.39%	0.25%	0.20%
Warrant life	2.22 years	3 years	1.53 – 1.96 years
Share price	\$8.00	\$3.77	\$3.76
Exercise price ⁽²⁾	\$6.86	\$4.00	\$4.00
Number of warrants issued	599,975	310,803	289,172

(1) Estimated annual volatility is based on the historical stock prices of comparable public companies.

(2) The initial public offering closed on March 9, 2021 constitutes a qualified financing so the exercise price has been modified to \$7.999 to reflect the purchase price of equity securities issued and sold in the Qualified Financing.

Details related to the warrant liability are as follows:

	December 31, 2021	December 31, 2020
Fair value of warrants issued on July 13, 2019	\$ 67,306	\$ 31,285
Fair value of warrants issued on July 22, 2019	264,117	122,708
Fair value of warrants issued on August 30, 2019	68,341	31,703
Fair value of warrants issued on December 16, 2019	412,123	190,612
Fair value of warrants issued on January 4, 2021	1,221,587	-
Fair value of warrants issued on January 8, 2021	142,214	-
Fair value of warrants reclassified to contributed surplus on March 9, 2021	(2,175,688)	-
Total fair value of warrants	\$ -	\$ 376,308

15. CONVERTIBLE DEBT

On June 21, 2021, the Company entered into a contingent convertible debt agreement (the "Debt Agreement") with Silicon Valley Bank ("SVB") and concurrently drew down, in full, the \$10 million principal amount under the Agreement.

The Debt Agreement has a term of 36 months or 48 months at SVB's election. The Debt Agreement accrues interest at the greater of 2.45% and the Canadian prime rate, requiring monthly interest payments. An additional payment in kind will accrue at a rate of 7% per annum, which will be settled at maturity or on conversion.

EUPRAXIA PHARMACEUTICALS INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2021 and 2020
(Expressed in Canadian Dollars)

15. CONVERTIBLE DEBT (continued)

Subject to the terms and conditions of the Debt Agreement, SVB may elect to convert the principal amount of the convertible debt and the accrued and unpaid interest thereon into Common Shares at a conversion price equal to \$5.68 per Common Share. The conversion price of the accrued and unpaid interest will be subject to the minimum pricing requirements of the TSX, to the extent applicable, at the time of conversion.

The Company will have the right (the "Call Right") to call the convertible debt by paying to SVB an amount equal to:

- i. 125% of the principal amount of the convertible debt (less principal amounts previously repaid), if the Call Right is exercised on or before the 18 month anniversary of the date of the Debt Agreement; and
- ii. 150% of the principal amount of the convertible debt (less principal amounts previously repaid), if the Call Right is exercised after the 18 month anniversary of the date of the Debt Agreement,

in either case together with all accrued and unpaid interest on the principal balance of the convertible debt. If the Call Right is exercised by the Company, SVB will retain certain lookback rights in the event the Company subsequently announces its topline data from its Phase 2 clinical study or the Company enters into an agreement to be acquired in the 12 months following the exercise of the Call Right. The Company has agreed to grant SVB a security interest in all of its assets, excluding its patents and other intellectual property, and the testing and product equipment by way of the loan agreement it entered into on September 10, 2021 (Note 11 – Loans Payable) as security for its obligations under the Debt Agreement.

The Company is required, on or prior to June 30, 2022, to raise additional net new capital, as defined in the Debt Agreement, in the aggregate amount of \$10 million. This net new capital can originate from, but is not restricted to, a variety of sources as outlined in the Debt Agreement and can include up to \$5 million in reduced project expenses.

The fair value of the liability component of the convertible debt at the time of issue was calculated as the discounted cash flows assuming a 15% discount rate, which was the estimated rate for a similar instrument without a conversion feature. The fair value of the equity component (the conversion feature) was determined at the time of issue as the difference between the face value and the fair value of the liability component. The liability component will be accreted over the life of the instrument.

As at December 31, 2021, the loan balance is comprised of the following:

	Liability component	Equity component	Total
Principal drawdown	\$ 8,695,652	\$ 1,304,348	\$ 10,000,000
Transaction costs	(161,145)	(24,171)	(185,316)
Accrued interest	506,625	-	506,625
Interest paid	(110,250)	-	(110,250)
Accretion expense	152,521	-	152,521
Total, December 31, 2021	\$ 9,083,403	\$ 1,280,177	\$ 10,363,580

16. SHARE CAPITAL and CONTRIBUTED SURPLUS

- a) Authorized
- An unlimited number of Common shares, with no par value, with one vote per share.
 - An unlimited number of Preferred shares, with no par value (none have been issued to date).
- b) Issued

Capital transactions which took place during the prior year are as follows:

- i) On December 31, 2020, the Company issued 62,288 common shares at \$4.00 per share on the conversion of convertible notes totaling \$249,150 of principal and accrued interest at maturity.

Capital transactions which took place during the current year are as follows:

- i) On March 9, 2021, the Company closed an Initial Public Offering (the “Offering”) of 5,125,000 units of the Company (the “Units”) at a price of \$8.00 per Unit (the “Offering Price”) for gross proceeds of \$41,000,000. Each Unit consisted of one common share in the Company and one-half of one common share purchase warrant of the Company (each whole common share purchase warrant, a “Warrant”). Each Warrant is exercisable into one common share of the Company (each, a “Warrant Share”) at an exercise price of \$11.20 per Warrant Share for a period of five years following the closing of the Offering, subject to adjustment in certain events. The Warrants include an acceleration provision, exercisable at the Company’s option, if the Company’s daily volume weighted average share price is greater than \$22.40 for five consecutive trading days. As consideration for the services rendered by the Underwriters in connection with the Offering, the Company paid the Underwriters a cash commission of \$2,460,000 which is equal to 6% of the gross proceeds raised under the Offering. An additional \$215,832 in legal and agents’ expenses were paid to the Underwriters. The Company incurred an additional \$447,512 in share issue costs associated with the Offering. The Company granted the Agents an over- allotment option (the “Over-Allotment Option”), exercisable in whole or in part, at the sole discretion of the Agents, at any time up to 30 days following the closing of the Offering, to purchase up to an additional number of Units equal to 15% of the Units sold pursuant to the Offering (the “Agents’ Option Units”) at a price of \$8.00 per Agents’ Option Unit to cover the Agents’ over-allocation position, if any, and for market stabilization purposes. On March 23, 2021, the Agents partially exercised the Over-Allotment Option pursuant to which the Company issued 263,775 Warrants to the Agents at a price of \$0.002 per Warrant for gross proceeds of \$528.
- ii) On March 9, 2021, the Company converted outstanding Convertible Notes into 1,261,387 common shares as outlined in Note 9.
- iii) On March 9, 2021, the Company converted outstanding Special Warrants into 298,798 common shares as outlined in Note 10.
- iv) On April 29, 2021, the Company issued 78,456 units comprised of one common share and one-half of one common share purchase warrant to Nordic Bioscience Clinical Development (“NBCD”). This investment was in exchange for a \$614,600 (USD500,000) reduction in services fees otherwise payable to NBCD as a contract research organization conducting the Company’s Phase 2 clinical trial. Each warrant is exercisable into one common share of the Company at an exercise price of \$11.20 per warrant at any time prior to April 14, 2026, subject to adjustment in certain events. These units were issued at the same price as the Units issued as part of the Offering.

EUPRAXIA PHARMACEUTICALS INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2021 and 2020
(Expressed in Canadian Dollars)

16. SHARE CAPITAL and CONTRIBUTED SURPLUS (continued)

b) Issued (continued)

- v) On June 8, 2021, the Company converted outstanding loans totaling \$5,987,642 into 1,298,664 common shares as outlined in Note 11 – Loans Payable.

c) Options

Under the Stock Option Plan (the “Plan”), approved by the Board of Directors on September 27, 2015, the Board of Directors may grant stock options to directors, officers, employees and consultants of the Company up to an aggregate of 12.5% of the Company’s then issued and outstanding common shares. On March 9, 2021, the Board of Directors amended and restated the Plan (the “Amended Plan”) to comply with the applicable requirements of the TSX and to ensure the terms and conditions of the Amended Plan are consistent with those of other public companies. On December 3, 2021, shareholders at the Company’s Annual General Meeting voted to further amend the Amended Plan. The number of shares available for directors, officers, employees and consultants to acquire pursuant to stock options granted under the Amended Plan was increased to 18.5% of the aggregate of the Company’s issued and outstanding shares. As well, the 15% limit on Common Shares reserved for issuance in combination with the aggregate number of Common Shares issuable under any security-based compensation arrangement was removed.

Options granted under the Plan have lives of up to ten years from the date of grant. The vesting schedule of all granted options is determined at the discretion of the Board. Unless otherwise determined by the Board, in its sole discretion, all grants of options will vest over a three-year period, with the first twenty-five percent (25%) of the Options vesting on the date of grant, and the remaining options vesting over the following thirty-six-month period in three equal instalments on an annual basis.

The following table summarizes the Company’s option transactions:

	Number of options	Weighted average exercise price
Outstanding, December 31, 2019	766,000	\$ 8.00
Cancelled	(32,500)	(8.00)
Outstanding December 31, 2020	733,500	8.00
Issued	1,400,750	7.74
Outstanding December 31, 2021	2,134,250	\$ 7.83

EUPRAXIA PHARMACEUTICALS INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2021 and 2020
(Expressed in Canadian Dollars)

16. SHARE CAPITAL and CONTRIBUTED SURPLUS (continued)

c) Options (continued)

As at December 31, 2021, the following options were outstanding:

Grant date	Options outstanding	Options exercisable	Exercise price	Expiry date	Remaining contractual life (years)
Sep 27, 2015	118,750	118,750	\$8.00 ⁽³⁾	Mar 31, 2025	3.25
Sep 27, 2015	67,500	67,500	\$8.00 ⁽³⁾	Mar 31, 2025	3.25
Nov 2, 2015	62,500	62,500	\$8.00 ⁽³⁾	Nov 2, 2025	3.84
Nov 2, 2015	32,500	32,500	\$8.00 ⁽³⁾	Nov 2, 2025	3.84
Mar 5, 2018	198,750	198,750	\$8.00 ⁽³⁾	Mar 5, 2028	6.18
Mar 5, 2018	253,500	253,500	\$8.00 ⁽³⁾	Mar 5, 2028	6.18
Mar 9, 2021	756,950	189,237 ⁽¹⁾	\$8.00	Mar 9, 2031	9.19
Mar 9, 2021	326,800	326,800 ⁽²⁾	\$8.00	Mar 9, 2031	9.19
May 3, 2021	257,000	64,250 ⁽¹⁾⁽⁴⁾	\$8.00	May 3, 2031	9.34
Dec 9, 2021	60,000	52,500 ⁽⁵⁾⁽⁶⁾	\$2.02	Dec 9, 2031	9.95
	2,134,250	1,366,287	\$7.83		7.84

- (1) Options granted to employees and board members of the Company vesting as follows: 25% vest immediately, 25% vest on the first anniversary of the grant date, 25% vest on the second anniversary of the grant date, and 25% vest on the third anniversary of the grant date.
(2) Options granted to employees and board members of the Company vesting 100% as of the grant date.
(3) On March 9, 2021 the exercise price of these options was modified from \$10.00 per share to \$8.00 per share.
(4) These options were granted to the Company's CFO on May 3, 2021 but were not approved until the Company's AGM on December 3, 2021.
(5) 50,000 options granted to board members of the Company vesting 100% as of the grant date.
(6) 10,000 options granted vesting as follows: 25% vest immediately, 25% vest on the first anniversary of the grant date, 25% vest on the second anniversary of the grant date, and 25% vest on the third anniversary of the grant date.

The stock-based compensation expense was determined based on the fair value of options at the date of measurement and those modified on March 9, 2021 using the Black-Scholes option pricing model with the following weighted-average assumptions.

Options granted during the period/year ended	December 31, 2021	December 31, 2018	December 31, 2015
Expected dividend yield	0.00%	0.00%	0.00%
Expected forfeiture rate	0.00%	0.00%	0.00%
Weighted average annual volatility	72.50%	71.35%	78.90%
Weighted average risk-free interest rate	1.01%	0.97%	0.66%
Weighted average expected option life	5.45 years	7.01 years	4.61 years
Weighted average share price	\$6.64	\$8.00	\$8.00
Weighted average exercise price	\$7.74	\$8.00	\$8.00
Weighted average fair value of options granted	\$3.97	\$5.33	\$4.87

EUPRAXIA PHARMACEUTICALS INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2021 and 2020
(Expressed in Canadian Dollars)

16. SHARE CAPITAL and CONTRIBUTED SURPLUS (continued)

c) Options (continued)

The total cost of the option modification is \$174,352 which has been included in stock-based compensation expense for the year ended December 31, 2021. Stock-based compensation of \$3,608,583 which was based on the fair value of the options prior to the modification was expensed in previous periods. Stock option expense for the year ended December 31, 2021 was \$4,214,651 (\$228,680 for the year ended December 31, 2020).

d) Warrants

The following table summarizes the Company's warrant transactions:

	Number of warrants	Weighted average exercise price
Outstanding December 31, 2019 and 2020	985,593	\$ 1.63
Issued	3,176,306	10.67
Outstanding December 31, 2021	4,161,899	\$ 8.81

As at December 31, 2021, the following warrants were outstanding:

Expiry date	Exercise price	Remaining contractual life (years)	Warrants outstanding and exercisable
120 days after holder or common-law partner ceases to be a Director/ Officer or consultant	\$ 0.7572	N/A	380,921
120 days after holder ceases to be a Director/ Officer or consultant	0.4984	N/A	315,500
July 13, 2022 to December 16, 2022	7.999 ⁽¹⁾	0.53-0.96	289,172
January 4, 2024	5.5993	2.01	239,080
January 4, 2024	7.1991	2.01	39,846
January 8, 2024	5.5993	2.02	31,877
March 9, 2026	11.20	4.19	2,826,275
April 29, 2026	11.20	4.33	39,228
	\$ 8.81		4,161,899

(1) Upon completion of the Company's initial public offering, the exercise price of these warrants was adjusted pursuant to the terms of the warrant agreements.

16. SHARE CAPITAL and CONTRIBUTED SURPLUS (continued)

e) Class B Non-Voting shares

On January 31, 2021, the Company entered into a contribution agreement with the Chief Scientific Officer of the Company, and certain of the Company's subsidiaries (the "Contribution Agreement"). Pursuant to the Contribution Agreement, the Company acquired AMDM Holdings Inc., a corporation wholly-owned by the Chief Scientific Officer, which held 5% of the equity interest in the Company's subsidiary, Eupraxia USA. In exchange, the Company issued to the Chief Scientific Officer 225 non-voting Class B shares (the "Class B Shares") in Eupraxia Pharmaceuticals Inc. ("Eupraxia Pharma"), representing 5% of the outstanding securities of Eupraxia Pharma. The Company holds the remaining 95% of such securities, which consists of 4,275 voting Class A shares.

Each Class B Share is exchangeable into common shares based on an exchange rate of 2,500 common shares for each Class B Share, subject to adjustments upon the occurrence of certain events, for a total of 562,500 common shares. The Class B Shares are exchangeable by the Chief Scientific Officer at her election, provided that the Company may force the exchange of the Class B Shares into common shares at any time on or after January 31, 2031, or on or after January 31, 2026 if the Company is listed on a stock exchange and is a reporting issuer in Canada at such time. The Company may also force the exchange of the Class B Shares into common shares if there is a change of control transaction involving the Company, a change in law which makes the exchange necessary or desirable or if there are a *de minimis* number of Class B Shares outstanding. If the Company is listed on a stock exchange at the time of the applicable exchange, the Company may elect to pay the Chief Scientific Officer cash in lieu of issuing common shares, with such cash amount to be determined based on the then current market price of the common shares.

EUPRAXIA PHARMACEUTICALS INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2021 and 2020
(Expressed in Canadian Dollars)

17. RESEARCH AND DEVELOPMENT EXPENSES

Research and development expenses are comprised of the following:

Research and development expenses	December 31, 2021	December 31, 2020
Arthritis Program (EP-104IAR)		
Preclinical	\$ 650,034	\$ 2,167
Clinical	5,906,888	(11,630)
Manufacturing & analytical	806,983	214,222
Regulatory	221,022	10,131
Consulting	13,967	53,837
	7,598,894	268,727
Pipeline Development	7,628	(3,008)
Other research and development	363,778	116,100
Salaries and benefits	2,286,132	1,171,984
Government grants (Note 18)	(266,786)	(222,796)
SRED refund current year	(298,564)	(379,000)
SRED adjustment prior years	(12,275)	(92,226)
Total expenses during the year	\$ 9,678,807	\$ 859,781

18. GOVERNMENT GRANTS AND ASSISTANCE

National Research Council – Industrial Research Assistance Program (“NRC-IRAP”)

On February 1, 2019, the Company entered into an agreement with NRC-IRAP for funding support of specified research and development activities during a project phase, commencing on February 1, 2019 and ending on July 31, 2020. Under the agreement, NRC-IRAP reimbursed up to 80% of supported salary costs, and 50% of supported contractor fees to a maximum of \$999,000. The project was completed on January 15, 2020.

On April 1, 2020, the Company entered into an agreement with NRC-IRAP for funding support from the Innovation Assistance Program (IAP) commencing April 1, 2020 and ending June 24, 2020. On June 25, 2020, the Company entered into a subsequent agreement with NRC-IRAP for funding support from the IAP commencing June 25, 2020 and ending December 19, 2020. On March 12, 2021, the Company entered into a third agreement for funding support from the IAP commencing December 20, 2020 and ending March 13, 2021. Under the agreements, NRC-IRAP provided a payroll subsidy to assist innovative, early-stage, small and medium sized enterprises that are unable to access existing COVID-19 business support. During the year ended December 31, 2021, the Company claimed \$65,030 pertaining to this agreement (year ended December 31, 2020 - \$312,767).

On April 15, 2021, the Company entered into an agreement with NRC-IRAP for funding support from the Youth Internship Program commencing April 15, 2021 and ending on December 31, 2021. Under the agreement, the NRC agrees to contribute up to a maximum of \$36,000 for internal graduate salary costs. During the year ended December 31, 2021, the Company claimed \$36,000 pertaining to this agreement (year ended December 31, 2020 - \$nil).

On October 1, 2021, the Company entered into an agreement with NRC-IRAP for funding support of specified research and development activities during a project phase, commencing on September 1, 2021 and ending on December 15, 2023. Under the agreement, NRC-IRAP would reimburse up to 80% of supported salary costs, and 50% of supported contractor fees to a maximum of \$700,000. During the year ended December 31, 2021, the Company claimed \$177,278 pertaining to this agreement (year ended December 31, 2020 - \$nil).

At December 31, 2021 there was \$102,952 (December 31, 2020 - \$179,750) of government grants recorded in amounts receivable and collected subsequent to year end.

Government of Canada Assistance - 10% Temporary Wage Subsidy

On March 18, 2020, the Company applied for and received the 10% Temporary Wage Subsidy for Employers (“TWS”) from the Government of Canada. The TWS is a 3-month measure that allows eligible employers to reduce the amount of payroll deductions they remit to the Canada Revenue Agency (“CRA”). The subsidy is equal to 10% of the remuneration paid from March 18 to June 19, 2020, up to \$1,375 for each eligible employee, with a maximum total of \$25,000 per employer.

There were \$nil amounts of government assistance recorded in amounts receivable as at December 31, 2021 and 2020.

The following table summarizes the government grants and assistance the Company received or accrued during the year.

EUPRAXIA PHARMACEUTICALS INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2021 and 2020
(Expressed in Canadian Dollars)

18. GOVERNMENT GRANTS (continued)

	2021	2020
NRC-IRAP	\$ 278,308	\$ 330,382
Biotalent Canada	15,574	5,273
Temporary wage subsidy	-	20,625
Total	\$ 293,882	\$ 356,280

Government assistance of \$266,786 (2020 - \$222,796) relating to research and development activities has been offset against research and development expense, and \$27,096 (2020 - \$133,484) relating to general and administrative costs has been offset against salaries and benefits expense.

19. RELATED PARTIES

Due to/from Related Parties

Related parties include directors and companies controlled by Key Management Personnel (which includes directors and senior management comprising the CEO, CFO, and CSO).

As at December 31, 2021, \$404,167 (December 31, 2020 - \$725,486) is due to Key Management Personnel (as defined above) representing accrued salaries and bonuses and the reimbursement of expenses.

As at December 31, 2021, a loan payable of \$nil (December 31, 2020 - \$238,121) was due to a Director of the Company representing principal and interest as outlined in Note 11. On June 2, 2021, \$318,533 representing loan principal and interest, was repaid to a Director of the Company as outlined in Note 11.

On June 8, 2021, \$244,110 representing loan principal and interest, was converted into 52,945 common shares of the Company and \$250,226 representing loan principal and interest, was converted into 54,271 common shares of the Company as outlined in Note 11. Both loans were from Directors of the Company.

As at December 31, 2021, convertible notes of \$nil (December 31, 2020 - \$869,534) were held by a director of the Company representing principal and interest as outlined in Note 9. On March 9, 2021, \$882,575 of convertible notes held by the Director representing principal and interest as outlined in Note 9 were converted into 122,595 common shares.

As at December 31, 2021, \$nil (December 31, 2020 - \$5,851) is due from a company controlled by common directors. This amount is included in amounts receivable.

EUPRAXIA PHARMACEUTICALS INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2021 and 2020
(Expressed in Canadian Dollars)

19. RELATED PARTIES (continued)

Compensation for Key Management Personnel

The aggregate value of compensation for Key Management Personnel was as follows:

Compensation, during the year ended	December 31, 2021	December 31, 2020
Short-term compensation	\$ 2,185,490	\$ 620,000
Share-based payments	3,650,123	158,137
Total	\$ 5,835,613	\$ 778,137

Included in short-term compensation during the year ended December 31, 2021 was \$696,282 related to a retroactive salary adjustment and deferred compensation bonus to senior management which was paid out during fiscal 2021. As well, a fiscal 2021 performance bonus of \$404,167 was accrued as at December 31, 2021 and subsequently paid out in early 2022.

20. INCOME TAXES

Income tax recovery varies from the amount that would be computed from applying the combined federal and provincial income tax rates to loss before taxes as follows:

Year ended December 31,	2021	2020
Loss before taxes	\$ (23,369,551)	\$ (4,010,638)
Statutory Canadian corporate tax rate	27%	27%
Anticipated tax recovery	(6,309,800)	(1,082,900)
Difference resulting from:		
Items not deductible for tax purposes and other	1,728,500	66,900
Share issue costs	(855,100)	-
Change in unrecognized deferred tax assets	5,385,000	997,000
Change in estimate and other	51,400	19,000
Income tax expense	\$ -	\$ -

The deferred tax assets have not been recognized in these consolidated financial statements, as management does not consider it probable that those assets will be realized in the carry forward period.

EUPRAXIA PHARMACEUTICALS INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2021 and 2020
(Expressed in Canadian Dollars)

20. INCOME TAXES (continued)

The composition of the Company's deferred tax assets not recognized are as follows:

	December 31, 2021	December 31, 2020
Deferred tax assets in relation to:		
Convertible debt	\$ 92,000	\$ -
Equipment and license	1,124,000	1,190,000
Investment tax credits ("ITCs")	465,000	-
Lease obligation	14,000	1,000
Non-capital loss carry forwards	14,045,000	10,436,000
Share issue costs	720,000	12,000
SR&ED pool	564,000	-
Deferred tax assets not recognized	\$ 17,024,000	\$ 11,639,000

The Company and its foreign subsidiaries have available non-capital losses for Canadian and US income tax purposes which may be carried forward to reduce taxable income in future years. If not utilized, the non-capital losses of \$47,357,000 for Canadian income tax purposes will expire beginning December 31, 2032 as follows:

Expiry date	Non-capital loss
2032	\$ 372,000
2033	761,000
2034	3,282,000
2035	3,883,000
2036	3,262,000
2037	5,023,000
2038	9,648,000
2039	5,653,000
2040	2,227,000
2041	13,246,000
	\$ 47,357,000

The Company also has approximately \$2,089,000 of scientific research and experimental development expenditures ("SR&ED") that may be carried forward indefinitely to be deducted against future Canadian taxable income. It also has federal investment tax credits of approximately \$313,000 available to offset future Canadian federal income taxes payable as well as provincial investment tax credits of approximately \$152,000. These tax credits are available to be carried forward 10 years to offset future Canadian federal income taxes payable. The benefit of the investment tax credits has not been recognized as their realization is not reasonably assured.

As well, the Company has Undepreciated Capital Cost ("UCC") amounts of approximately \$1.1 million dollars which can be carried forward indefinitely.

The Company has non-capital losses of \$4,660,000 for US income tax purposes. Losses incurred prior to December 31, 2018 (\$3,309,000) expire beginning December 31, 2032, while losses incurred during the year ended December 31, 2018 and after (\$1,351,000) can be carried forward indefinitely.

21. FINANCIAL INSTRUMENTS

The Company's financial instruments consist of cash and cash equivalents, short term investments, rent and other receivables, accounts payable and accrued liabilities, loans payable and convertible debt. Unless otherwise noted, it is management's opinion that the Company is not exposed to significant interest, currency or credit risks arising from these financial instruments.

The Company's risk exposures and the impact on the Company's financial instruments are summarized below:

Credit risk

Credit risk is the risk of loss associated with counterparty's inability to fulfill its payment obligations. The Company believes it has no significant credit risk, as its cash and cash equivalents and short term investments, being its primary exposure to credit risk, is with a large Canadian bank. The Company's maximum exposure to credit risk is the carrying value of its financial assets.

Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations when they become due. The Company's approach to managing liquidity risk is to ensure that it will have sufficient liquidity to meet liabilities when due. As at December 31, 2021, the Company had cash and cash equivalents of \$20,892,069 in addition to short term investments of \$9,088,855 (December 31, 2020 - \$150,126) and current liabilities of \$2,267,788 (December 31, 2020 - \$22,542,272). Management is currently working on certain strategic alternatives including, but not limited to, financing arrangements. There is no assurance, however, that any or all of these alternatives will materialize or that additional funding will be available, if and when needed.

Market risk

Market risk is the risk of fluctuations in fair values or future cash flows that may arise from changes in market factors such as interest rates, foreign exchange rates, and commodity and equity prices.

Price risk

The Company is not exposed to significant price risk with respect to commodity or equity prices.

Interest rate risk

Interest rate risk consists of two components; to the extent that payments are made or received on the Company's monetary assets or liabilities are affected by changes in the prevailing market interest rates, the Company is exposed to interest rate cash flow risk; and to the extent that the prevailing market interest rates differ from the interest rate on the Company's monetary assets and liabilities, the Company is exposed to interest rate price risk. At December 31, 2021, the Company maintains a Convertible Debt facility totaling \$10,000,000 (the "Debt") (see Note 15 – Convertible Debt) as well as having a loan of USD235,000 (the "Loan") (see Note 11 – Loans Payable). The Loan accrues interest at 5.84%.

21. FINANCIAL INSTRUMENTS (continued)

The Debt accrues interest at the greater of 2.45% and the Canadian prime rate, requiring monthly interest payments. An additional payment in kind accrues at a rate of 7% per annum, which will be settled at maturity or on conversion.

As at December 31, 2021, management has determined the effect on the future results of operations due to increased interest expense paid on the Convertible Debt Facility of the Company if the Canadian prime rate were to increase by 1%. An impact of a 1% increase in the Canadian prime rate would increase the amount of interest to be paid over the remaining term of the Convertible Debt facility by approximately \$262,000. There would be no impact with a 1% decrease in the prime rate.

Foreign currency risk

Foreign currency risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates. The Company is exposed to foreign currency risk due to its frequency of transactions in US dollars. The Company does not use derivatives to hedge against this risk however, it has purchased sufficient US dollars to cover the majority of anticipated costs of the Company's Phase 2 clinical trial. At December 31, 2021, the Company held cash of USD5,179,699 (December 31, 2020 - USD473) had accounts payable of USD623,478 (December 31, 2020 - USD839,212), loan payable of USD216,994 (December 31, 2020 - USD nil) and had an amount owing to Auritec of USD nil (December 31, 2020 - USD3,971,475) which were translated to Canadian dollars at 1.2678 (December 31, 2020 - 1.2732). The impact of a 10% change in the exchange rates would have an impact of approximately \$550,100 (2020 - \$612,400) on profit or loss.

Fair Value Measurement

The Company categorizes its financial instruments measured at fair value into one of three different levels depending on the observation of inputs used in the measurement.

Level 1: Fair value is based on unadjusted quoted prices for identical assets or liabilities in active markets

Level 2: Fair value is based on inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly

Level 3: Fair value is based on valuation techniques that require one or more significant unobservable inputs

The Company's financial instruments consist of cash and cash equivalents, short term investments, rent and other receivables, accounts payable and accrued liabilities, loans payable and convertible debt. With the exception of convertible debt, the carrying value of the Company's financial instruments approximate their fair values due to their short-term maturities. The fair value of convertible debt approximates its carrying value due to minimal changes in interest rates and the Company's credit risk since issuance of the instruments.

22. CAPITAL DISCLOSURES

The Company's principal source of capital is from the issuance of common shares, although other initiatives such as warrants, convertible notes payable, special warrants and debt have been utilized. The Company's capital management objective is to obtain sufficient capital to develop scientific programs that can be added to the product portfolio using the Company's novel drug delivery platform. To meet these objectives, management monitors the Company's ongoing capital requirements whilst examining each scientific program for its ability to meet patient's medical needs, address a large market and novel drug kinetics. The capital structure of the Company consists of equity attributable to common shareholders, including issued share capital, contributed surplus and deficit. During the year, the Company entered into a Convertible Debt Agreement (Note 15 – Convertible Debt) that includes a requirement to raise an additional \$10,000,000 in net new capital prior to June 30, 2022.

23. INTEREST EXPENSE

Interest expense is comprised of the following:

	Year ended December 31, 2021	Year ended December 31, 2020
Interest on convertible notes payable (Note 9)	\$ 136,253	\$ 707,090
Interest and accretion on loans payable (Note 11)	408,352	705,177
Interest and accretion on convertible debt (Note 15)	659,146	-
Interest on lease liabilities (Note 12)	35,167	42,648
Interest on amount payable to Auritec Pharmaceuticals Inc. (Note 13)	28,515	284,255
Other interest and accretion	29,255	142,463
Total	\$ 1,296,688	\$ 1,881,633

24. SUPPLEMENTAL DISCLOSURE WITH RESPECT TO CASH FLOWS

The Company paid interest of \$578,485 during the year ended December 31, 2021 (\$116,056 paid during the year ended December 31, 2020).

The Company received interest of \$50,868 during the year ended December 31, 2021 (\$425 received during the year ended December 31, 2020).

The Company had the following significant non-cash transactions for the year ended December 31, 2021:

- 1,261,387 common shares were issued at \$7.999 per share on the conversion of convertible notes on March 9, 2021, valued at \$10,089,835.

24. SUPPLEMENTAL DISCLOSURE WITH RESPECT TO CASH FLOWS (continued)

- 298,798 common shares were issued at \$7.999 per share on the conversion of special warrants on March 9, 2021, valued at \$2,390,085.
- Warrants with a fair value of \$2,175,688 as at March 9, 2021 were reclassified from a financial liability to equity as outlined in Note 12.
- 78,456 units consisting of one common share and one half of one common share purchase warrant were issued on April 29, 2021 in exchange for \$614,600 (USD500,000) in services from a vendor.
- 1,298,664 common shares were issued at \$4.61 per share on the conversion of a total of \$5,987,642 of loan principal and interest on June 8, 2021.

The Company had the following significant non-cash transactions for the year ended December 31, 2020:

- A convertible note was issued to a vendor to settle \$21,000 of amounts payable.
- 62,288 common shares were issued at \$4.00 per share on the conversion of convertible notes at maturity on December 31, 2020.