

Consolidated Financial Statements of

PARAGON PHARMACIES LIMITED

August 31, 2009 and 2008



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AUDITORS' REPORT

To the Shareholders of Paragon Pharmacies Limited

We have audited the consolidated balance sheet of Paragon Pharmacies Limited as at August 31, 2009 and the consolidated statements of operations, comprehensive loss and deficit and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at August 31, 2009 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

The consolidated financial statements as at August 31, 2008 and for the year then ended were audited by other auditors, who expressed an opinion without reservation on those statements in their report, dated November 27, 2008.

Signed "**KPMG LLP**"

Chartered Accountants

Winnipeg, Canada

December 8, 2009

PARAGON PHARMACIES LIMITED**Consolidated Statements of Operations, Comprehensive Loss and Deficit**
Years Ended August 31, 2009 and 2008
(Thousands of dollars)

	2009	2008
	\$	\$
Revenue	86,134	83,718
Cost of sales	54,715	55,567
Operating expenses	22,779	22,273
	8,640	5,878
Corporate and other costs	4,639	4,485
Income before undernoted items	4,001	1,393
Interest and accretion expense (Note 14)	6,676	7,936
Amortization (Notes 7 and 8)	4,409	3,690
Stock-based compensation (Note 13)	68	121
Other items (Note 15)	29	(229)
	11,182	11,518
Loss and comprehensive loss for the year	(7,181)	(10,125)
Deficit, beginning of year	(18,330)	(8,475)
Impact of adoption of financial instruments (Note 2)	-	270
Deficit, end of year	(25,511)	(18,330)
Loss per share (Note 17)		
Basic and diluted	(0.08)	(0.24)

PARAGON PHARMACIES LIMITED

Consolidated Balance Sheets

August 31, 2009 and 2008

(Thousands of dollars)

	2009	2008
	\$	\$
ASSETS		
CURRENT		
Cash and cash equivalents	14,980	541
Restricted cash (Note 11)	-	13,728
Accounts receivable	3,845	5,042
Inventory	8,114	10,012
Prepaid expenses and deposits	434	691
	27,373	30,014
Deferred transaction costs	-	41
Investment in and advances to private companies (Note 6)	-	954
Capital assets (Note 7)	5,958	5,031
Intangible assets (Note 8)	8,770	11,694
Goodwill (Note 9)	15,103	15,103
	57,204	62,837
LIABILITIES		
CURRENT		
Bank indebtedness (Note 10)	-	921
Accounts payable and accrued liabilities	9,093	10,012
Deferred rent inducements	273	-
Current portion of long-term debt (Note 12)	10,612	2,427
Current portion of capital leases	28	32
	20,006	13,392
Convertible debenture (Note 11)	-	17,233
Long-term debt (Note 12)	3,521	13,848
Capital leases	29	51
	23,556	44,524
SHAREHOLDERS' EQUITY		
Share capital (Note 13)	56,589	26,617
Contributed surplus (Note 13)	2,570	2,502
Convertible debenture (Note 11)	-	7,524
Deficit	(25,511)	(18,330)
	33,648	18,313
	57,204	62,837
Commitments and contingencies (Note 21)		
Subsequent events (Note 24)		

APPROVED BY THE BOARD OF DIRECTORS

(signed) *“Denis Taillieu”, Director*

(signed) *“Randy Henderson”, Director*

PARAGON PHARMACIES LIMITED

Consolidated Statement of Cash Flows

Years Ended August 31, 2009 and 2008

(Thousands of dollars)

	2009	2008
	\$	\$
CASH FLOWS RELATED TO THE FOLLOWING ACTIVITIES:		
OPERATING		
Loss for the year	(7,181)	(10,125)
Adjustments for:		
Interest and accretion expense (Note 14)	5,584	7,585
Amortization	4,409	3,690
Write off deferred transaction costs	41	242
Loss on disposal of capital and intangible assets (Note 15)	61	(506)
Stock-based compensation	68	121
(Income)/loss on equity investments	(32)	277
	<u>2,950</u>	<u>1,284</u>
Net change in non-cash working capital (Note 20)	3,493	2,244
	<u>6,443</u>	<u>3,528</u>
FINANCING		
Reduction in advances to related parties	(393)	(352)
Issuance of share capital, net of issuance costs	8,568	17
Financing costs	(135)	(1,034)
Proceeds on issuance of long-term debt	-	6,803
Repayment of long term debt	(2,494)	(2,415)
Repayment of convertible debenture (Note 11)	(8,450)	-
Increase (decrease) in bank indebtedness	(921)	921
Repayment of capital leases, net	(72)	(35)
Net change in non-cash working capital (Note 20)	(633)	633
	<u>(4,530)</u>	<u>4,538</u>
INVESTING		
Restricted cash	13,830	6,383
Interest paid into restricted cash	(102)	-
Acquisition of remaining interest in private companies (Note 5)	241	-
Acquisitions (Note 5)	-	(14,173)
Addition to intangible assets	(72)	-
Proceeds on disposal of capital and intangible assets	12	600
Purchase of capital assets	(1,835)	(2,717)
Net change in non-cash working capital (Note 20)	452	(452)
	<u>12,526</u>	<u>(10,359)</u>
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	14,439	(2,293)
CASH AND CASH EQUIVALENTS BEGINNING OF YEAR	541	2,834
CASH AND CASH EQUIVALENTS END OF YEAR	14,980	541
Supplemental cash flow disclosure:		
Interest paid	1,245	1,019
Income taxes paid	-	-

PARAGON PHARMACIES LIMITED

Notes to Consolidated Financial Statements

Years Ended August 31, 2009 and 2008

(tabular amounts in thousands, except per share amounts)

1. NATURE OF OPERATIONS

Paragon Pharmacies Ltd. (the “Company” or “Paragon”) was incorporated on August 1, 2002 under the Alberta Business Corporations Act and commenced active operations in March 2003. On October 31, 2006, the Company completed a reverse takeover transaction to create a new company, Paragon Pharmacies Limited. On August 29, 2008 the Company amalgamated with 1405257 Alberta Ltd. (Note 4). The Company is comprised of a single operating segment, pharmacy operations, providing retail and institutional prescription drug services and retail front store operations including supplemental services such as Canada Post outlets.

With respect to the reverse takeover and amalgamation, for accounting purposes the consolidated financial statements reflect a continuity of interest basis of accounting that recognizes Paragon as the successor to the amalgamated companies.

2. SIGNIFICANT ACCOUNTING POLICIES

Basis of accounting

The Company’s accounting policies and standards of financial disclosure are in accordance with Canadian generally accepted accounting principles (“GAAP”).

Consolidation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries which include Black Mountain Pharmacy (1979) Ltd., Paragon Central Fill (2007) Ltd., Paragon Glenpark Pharmacy Ltd., Paragon Medical Supplies Ltd., Paragon Payless Pharmacy Ltd., Paragon Crestview Pharmacy Ltd., Paragon Lake Country Pharmacy Ltd., Paragon Mission Pharmacy (B.C.) Ltd., Paragon Columbia Pharmacy Ltd., Canadian Medical Supplies Ltd., Paragon Nordic Pharmacy Ltd., Duncan Pharmacy Ltd., 1036985 Alberta Ltd., and ACO Super Drug Mart Ltd.

Use of estimates

The preparation of the consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Estimates are used when accounting for items such as inventory provisions, income and other taxes and evaluating goodwill, intangible assets and long-lived assets for impairment. Changes in those estimates could materially affect the consolidated financial statements

PARAGON PHARMACIES LIMITED

Notes to Consolidated Financial Statements

Years Ended August 31, 2009 and 2008

(tabular amounts in thousands, except per share amounts)

2. SIGNIFICANT ACCOUNTING POLICIES *(continued)*

Revenue recognition

The Company recognizes revenue at the time goods are sold, net of returns.

Cash and cash equivalents

Cash and cash equivalents are defined as cash and highly liquid investments, which have maturities of less than three months at the date of acquisition.

Restricted cash

This amount represents funds on deposit that are restricted in their use (Note 11).

Inventory

Inventory is valued at the lower of cost and net realizable value with cost being determined on a weighted average cost basis.

Capital assets

Capital assets are recorded at cost and are amortized using the declining-balance method at the following annual rates:

Building	4%
Furniture and fixtures	20%
Automotive	30%
Equipment	30%
Computer equipment	30%
Computer software	50% - 100%

Assets under capital lease are amortized over the term of their respective leases.

Leasehold improvements are recorded at cost and are amortized over the shorter of their estimated useful life or a straight-line basis over the non-cancellable term of the lease.

Deferred rent inducements

The Company leases its store locations and office space. Landlord inducements are deferred and amortized as reductions to rent expense on a straight-line basis over the term of the lease.

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Notes to Consolidated Financial Statements

Years Ended August 31, 2009 and 2008

(tabular amounts in thousands, except per share amounts)

2. SIGNIFICANT ACCOUNTING POLICIES *(continued)*

Intangible assets

Intangible assets are recorded at cost and are amortized using the straight-line method over the following periods:

Prescription files	5 years
Customer relationships	5 years
Pre-operating costs	5 years
Rebranding costs	3 - 5 years

Operating leases are amortized using the straight-line method over the remaining terms of the corresponding leases, ranging from four to forty-seven months.

Deferred transaction costs

Deferred transaction costs are incurred in the acquisition of new stores, and include legal fees and other direct costs associated with potential acquisitions. These costs are deferred until an acquisition is completed and are included in the purchase price of the acquisition. Costs associated with acquisitions that are not completed are expensed when a determination is made that the acquisition will not occur.

Goodwill

Goodwill represents the excess of the acquisition cost of companies over the estimated fair value of the identifiable net assets acquired.

Goodwill is not amortized but is evaluated for impairment at August 31 or more frequently if there are indications of impairment. In the event of impairment, the excess of the carrying amount over the estimated fair value of the assets would be expensed.

Long-lived assets

The carrying value of the Company's long-lived assets, including intangible assets, is evaluated for recoverability whenever events or circumstances indicate that the carrying value exceeds the estimated fair value, being the sum of the estimated undiscounted cash flows expected from their use and eventual disposal. An impairment loss is measured as the amount by which the long-lived assets' carrying value exceeds the estimated fair value.

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Notes to Consolidated Financial Statements

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(tabular amounts in thousands, except per share amounts)

2. SIGNIFICANT ACCOUNTING POLICIES *(continued)*

Future income taxes

Income taxes are accounted for by the liability method. Under this method, future income tax assets and liabilities are determined based on temporary differences between the carrying amount of balance sheet items and their tax basis. Future income tax assets and liabilities are measured under this method by using substantively enacted tax rates that are expected to apply when such tax assets or liabilities are either settled or realized. To the extent that the Company does not consider it to be more likely than not that a future tax asset will be recovered, it provides a valuation allowance against the excess.

Stock-based compensation

The Company has a stock option plan (Note 13). The Company accounts for grants under this plan in accordance with the fair value based method of accounting for stock-based compensation using the Black-Scholes option pricing model. Compensation expense is recognized over the period in which the option vests, with a corresponding increase to contributed surplus. Upon exercise of options, an amount is allocated from contributed surplus to share capital together with the proceeds of exercise. In the event that vested options expire without being exercised, previously recognized compensation costs associated with such options are not reversed.

Per share amounts

Earnings (loss) per share are computed based on the weighted average number of shares outstanding during the period. Diluted per share amounts are calculated giving effect to the potential dilution that would occur if options and warrants to purchase common shares were exercised and other convertible instruments were converted. The Company uses the treasury stock method to determine the dilutive effect of stock options and warrants and used the “if converted” method to assess the dilutive effect of the convertible debenture.

Comprehensive income

Comprehensive income is comprised of net earnings or loss and other comprehensive income (“OCI”). OCI represents the change in equity for a period that arises from items such as unrealized gains and losses on available-for-sale securities and changes in the fair market value of derivative instruments designated as cash flow hedges. The Company does not currently have any transactions that give rise to OCI; therefore the Company’s loss for the year and comprehensive loss are the same amount.

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(tabular amounts in thousands, except per share amounts)

2. SIGNIFICANT ACCOUNTING POLICIES *(continued)*

Financial instruments

A financial asset is cash or a contractual right to receive cash or another financial asset, including equity instruments, from another party. A financial liability is the contractual obligation to deliver cash or another financial asset to another party.

A derivative is a financial instrument whose value changes in response to a specified variable, requires little or no net investment and is settled at a future date. An embedded derivative is a derivative that is a part of a non-derivative contract and not directly related to that contract. Embedded derivatives that are not closely related to the host contract are accounted for as a separate financial instrument. A non-financial derivative is a contract that can be settled net in cash or another financial instrument.

The Company records all financial instruments initially at fair-value and subsequently accounts for the financial instruments based on one of five classifications: held for trading, held-to maturity, other liabilities, loans and receivables or available-for-sale. The classification of a financial instrument depends on its characteristics and the purpose for which it was acquired.

A) Held for trading

Held for trading financial instruments are financial assets or financial liabilities that are purchased with the intention of selling or repurchasing in the near term. Any financial instrument can be designated as held for trading as long as its fair value can be reliably measured. A derivative is classified as held for trading unless designated as and considered an effective hedge. Held for trading instruments are recorded at fair value with any subsequent gains or losses from changes in the fair value included in earnings.

All of the Company's cash and cash equivalents, restricted cash and bank indebtedness are designated as held for trading financial instruments.

B) Held-to-maturity

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and a fixed maturity that the Company has the intent and ability to hold to maturity.

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(tabular amounts in thousands, except per share amounts)

2. SIGNIFICANT ACCOUNTING POLICIES *(continued)*

These financial assets are measured at amortized cost using the effective interest method. Any gains or losses arising from the sale of a held-to-maturity investment are included in earnings.

The Company has no assets designated as held-to-maturity.

C) Other liabilities

Accounts payable and accrued liabilities, long-term debt and convertible debenture are accounted for at amortized cost using the effective interest method. Any gains or losses in the realization of such other liabilities are included in earnings.

D) Loans and receivables

Account receivable and amounts due from related parties are accounted for at amortized cost using the effective interest method. Any gains or losses on the realization of such loans and receivables are included in earnings.

E) Available-for-sale

Available-for-sale assets are those financial assets that are not classified as held for trading, held-to-maturity or loans and receivables. Available-for-sale instruments are recorded at fair value. Any gains or losses arising from the change in fair value are recorded in OCI and upon the sale of the instrument or other-than-temporary impairment, the cumulative gain or loss is included in earnings.

The Company has not designated any financial instruments as available-for-sale assets.

Fair values are based upon quoted market prices available from active markets or are otherwise determined using a variety of valuation techniques and models.

The financial instrument standards require that costs related to obtaining debt financing be expensed as incurred or deducted from the related debt and accreted over the term of the debt as interest expense using the effective interest rate method. The Company has elected to deduct these expenses from the related debt.

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Notes to Consolidated Financial Statements

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(tabular amounts in thousands, except per share amounts)

2. SIGNIFICANT ACCOUNTING POLICIES *(continued)*

In summary, the following table outlines the Company's accounting for financial instruments:

Asset / Liability	Category	Subsequent Measurement
Cash and cash equivalents	Held for trading	Fair value
Accounts receivable	Loans and receivables	Amortized cost
Due from related parties	Loans and receivables	Amortized cost
Restricted cash	Held for trading	Fair value
Bank indebtedness	Held for trading	Fair value
Accounts payable and accrued liabilities	Other liabilities	Amortized cost
Long-term debt	Other liabilities	Amortized cost
Convertible debenture	Other liabilities	Amortized cost

The adoption of the financial instrument standards in fiscal 2008 resulted in a decrease to the deficit and convertible debenture of \$0.27 million at September 1, 2007 resulting from a change to the effective interest rate method.

Hedge accounting is optional and the Company may designate any qualifying hedging instrument as a hedge for accounting purposes. The Company has no qualifying hedging instruments.

3. CHANGE IN ACCOUNTING POLICIES – ADOPTION OF NEW ACCOUNTING STANDARDS AND FUTURE ACCOUNTING PRONOUNCEMENTS

Capital Management

The Company's primary objectives when managing capital are to profitably grow its business while maintaining adequate financing flexibility to fund new investment opportunities and other unanticipated requirements or opportunities that may arise. Profitable growth is defined as earnings growth commensurate with the additional capital being invested in the business in order that the Company earns an appropriate rate of return on that capital. The primary investments undertaken by the Company to drive profitable growth include additions to the selling square footage of its store network via the construction of new, relocated and expanded stores, including related leasehold improvements and features, as well as through the acquisition of independent drug stores or their prescription files. In addition, the Company makes capital investments in information technology. The Company largely relies on its cash flow from operations to fund its capital investment program supplemented by debt and equity offerings. No changes were made to these objectives during the year.

PARAGON PHARMACIES LIMITED

Notes to Consolidated Financial Statements

Years Ended August 31, 2009 and 2008

(tabular amounts in thousands, except per share amounts)

3. CHANGE IN ACCOUNTING POLICIES *(continued)*

The Company considers its total capitalization to be bank indebtedness, long-term debt (including the current portion thereof) and shareholders' equity, net of cash. The Company also gives consideration to its obligations under operating leases when assessing its total capitalization. During the current year, the Company and its debenture holder reached agreement whereby the debenture was converted into equity and funds previously held in escrow of approximately \$13.8 million were released to the Company. This transaction also resulted in amendments to the Company's lending agreements with its principal bank. As a result, the Company has available cash resources to make necessary capital investments and to fund acquisitions. The Company will require additional debt and/or equity capital to fund any significant opportunities.

The Company monitors its capital structure principally through measuring its net debt to shareholders' equity and net debt to capitalization ratios, and manages its ability to service its debt and meet other fixed obligations by tracking its interest and other fixed charges coverage ratios.

As part of its lending agreement, the Company monitors its net senior debt to EBITDA ratio as defined in its lending agreement. At August 31, 2009 the Company's cash on deposit exceeded senior debt and the Company was in compliance with its bank covenants.

The following table provides a summary of certain information with respect to the Company's capital structure and financial position at the end of the year.

	2009	2008
	\$	\$
Cash and cash in escrow	(14,980)	(14,269)
Bank indebtedness	-	921
Current portion of long-term debt and capital leases	10,640	2,459
Convertible debenture	-	17,233
Long-term debt and capital leases	3,550	13,899
Net debt	(790)	20,243
Shareholders' equity	33,648	18,313
Total capitalization	32,858	38,556
Net debt: Shareholders' equity	(0.02)	1.11
Net debt: Total capitalization	(0.02)	0.52
EBITDA: Cash interest expense ⁽¹⁾⁽²⁾	5.16	3.97

PARAGON PHARMACIES LIMITED

Notes to Consolidated Financial Statements

Years Ended August 31, 2009 and 2008

(tabular amounts in thousands, except per share amounts)

3. CHANGE IN ACCOUNTING POLICIES (*continued*)

- (1) For purposes of calculating the ratios, EBITDA is for each of the fiscal years then ended. EBITDA (earnings before interest expense, income taxes, depreciation and amortization, stock based compensation and other items as defined.) is a non-GAAP financial measure. Non-GAAP financial measures do not have standardized meanings prescribed by GAAP and therefore may not be comparable to similar measures presented by other reporting issuers.
- (2) Cash interest expense is also a non-GAAP measure and is comprised of interest expense excluding interest on the convertible debenture not paid in cash for each of the fiscal years then ended and also excludes the amortization of deferred financing costs and accretion expense net of interest income.

Financial Instruments

The Company adopted new accounting standards concerning financial instruments: CICA Handbook section 3862 “Financial Instruments – Disclosures” (“Section 3862”) and CICA Handbook Section 3863 “Financial Instruments – Presentation” (“Section 3863”). These standards were issued in December 2006 and replaced Section 3861, “Financial Instruments – Disclosure and Presentation”. The new disclosure standard increased the emphasis on the risk associated with financial instruments and how those risks are managed. The new presentation standard carried forward the former presentation requirements under the replaced Section 3861.

The Company applied the new accounting standards at the beginning of its current fiscal year and its implementation did not have an impact on the Company’s results of operations or financial position; the resulting disclosures from implementation are presented in Note 22.

Future Accounting Standards

Goodwill and intangible assets, financial statement concepts

In February 2008, the CICA issued a new accounting standard Handbook Section 3064 “Goodwill and Intangible Assets”. The new section replaces the existing guidance on goodwill and other intangible assets and research and development costs. The new section provides additional guidance on measuring the cost of goodwill and intangible assets. Section 1000, “Financial Statement Concepts”, was also amended to provide consistency with this new standard to clarify the criteria for recognition of an asset and the timing of expense recognition. The standards are effective for interim and annual financial statements for fiscal years beginning on or after October 1, 2008. As a result of adopting these policies effective September 1, 2009, the Company will write off deferred pre-operating costs which will be charged against the deficit (Note 8).

PARAGON PHARMACIES LIMITED

Notes to Consolidated Financial Statements

Years Ended August 31, 2009 and 2008

(tabular amounts in thousands, except per share amounts)

3. CHANGE IN ACCOUNTING POLICIES *(continued)*

Business combinations and consolidated financial statements

In January 2009, the CICA issued new accounting standards concerning Business Combinations and Consolidated Financial Statements which are based on International Financial Reporting Standards “IFRS” 3 and 27. The new section replaces existing guidance on accounting for business combinations, the preparation of consolidated financial statements and accounting for non-controlling interests. The standards are effective for fiscal years beginning on or after January 1, 2011. The Company currently anticipates applying the new accounting standards at the beginning of its 2011 fiscal year. The Company expects to assess the impact of the new standard as part of its overall review of its convergence to IFRS.

International Financial Reporting Standards (IFRS)

In January 2006, the CICA Accounting Standards Board adopted a strategic plan for the direction of accounting standards in Canada. As part of that plan, accounting standards in Canada for public companies will converge with International Financial Reporting Standards (“IFRS”) by the end of 2011. The Company continues to assess the impact of conversion of Canadian GAAP and IFRS.

4. AMALGAMATION WITH 1405257 ALBERTA LTD.

Paragon and a third party pharmaceutical supplier entered into a Debt Purchase Agreement on December 19, 2007 whereby the Company agreed to acquire from the third party pharmaceutical supplier a loan in the principal amount of \$7,139,000 owing by Autonomy Pharma Inc. ("Autonomy") to the third party pharmaceutical supplier (the "Autonomy Loan"). The purchase price pursuant to the Debt Purchase Agreement was \$4,139,000, with a cash payment of \$139,000 on closing and the \$4,000,000 balance of the purchase price being deferred and payable over a ten year period ending September 30, 2017. Interest accrues at the rate of 6% per annum, payable annually on August 31st of each year.

The security for the Autonomy Loan included a pledge of 8,000,000 Paragon common shares registered in the name of Autonomy (“the Shares”) having a deemed value of \$4,400,001 and warrants to purchase an additional 2,000,000 Paragon common shares (“the Warrants”) at a price of \$1.25 per share.

In exchange, the Company and Autonomy agreed that the cancellation of these securities results in the partial satisfaction of \$4,400,000 of the Autonomy Loan.

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Notes to Consolidated Financial Statements

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(tabular amounts in thousands, except per share amounts)

4. AMALGAMATION WITH 1405257 ALBERTA LTD. (continued)

On August 29, 2008, Autonomy transferred the Shares into 1405257 Alberta Ltd. The Company purchased all of the shares of 1405257 Alberta Ltd. and, as consideration, Autonomy received a non-interest bearing promissory note from the Company in the principal amount of \$4,400,001 (the "Autonomy Note"). The Company and Autonomy entered into a debt set-off agreement, whereby the Autonomy Note was set off against the equivalent amount of the Autonomy Loan and, as a result, the principal amount of the Autonomy Loan after the set off is \$2,738,999, which remain owing by Autonomy to Paragon and remain subject to the Autonomy security. The Company may claim against Autonomy for this amount but at this time the Company does not believe that Autonomy has assets that are available to repay any additional portion of the Autonomy Loan and thus has not recorded this amount as a loan receivable.

Upon amalgamation, the Company cancelled the Shares and the Warrants.

The following table summarizes the results of the amalgamation:

	\$
<u>Consideration:</u>	
Accounts payable	139
Autonomy loan	4,000
Transaction costs	(494)
Autonomy loan, net of financing fees	<u>3,645</u>
<u>Allocation:</u>	
Reduction of share capital from cancellation of 8,000,000 shares with a deemed per share amount of \$0.67545	5,404
Transaction costs	(494)
Contributed surplus	<u>(1,265)</u>
	<u>3,645</u>

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5. ACQUISITIONS

2009

Effective June 29, 2009, the Company increased its interest from 50% to 100% in 1036985 Alberta Ltd. and ACO Super Drug Mart Ltd. by acquiring the remaining 50% of the common shares for cash consideration of two dollars. The acquisition was accounted for by the purchase method. The fair market value of the net assets acquired and consideration given are as follows:

	\$
Current assets	1,337
Capital assets	458
Intangible assets	120
Investment in and advances to private companies	(1,379)
Accounts payable	(491)
Capital lease obligation	(45)
	-
Consideration given:	
Cash consideration	-

Prior to the acquisition of the remaining 50% interest in 1036985 Alberta Ltd., the operating assets of 1036985 Alberta Ltd. were sold to a third party for cash proceeds of \$1.01 million. The Company's share of the loss on disposal of these assets was \$0.08 million and is included in other income (Note 15).

2008

On January 16, 2008, the Company acquired the assets of 4638418 Manitoba Ltd. (operating as Alentex Pharmacy) in Manitoba, an entity that provides pharmacy services to assisted living and long-term care residents, for cash consideration of \$7.8 million.

On December 16, 2007, the Company acquired the assets of Westcoast Central Fill Ltd. ("Westcoast") in British Columbia, an entity that provides pharmacy services to assisted living and long-term care residents. Consideration included cash of \$3.3 million and the cancellation of 2,800,000 shares that the Company held in the parent company of Westcoast.

On November 1, 2007, the Company acquired the shares of Duncan Pharmacy Ltd., an independent retail pharmacy, for cash consideration of \$3.1 million.

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(tabular amounts in thousands, except per share amounts)

5. ACQUISITIONS (continued)

The following table summarizes the consideration paid:

	Westcoast	Alentex	Duncan	Total
	\$	\$	\$	\$
Cash	3,019	7,561	3,016	13,596
Transaction costs	236	240	101	577
Total	3,255	7,801	3,117	14,173

The following table summarizes the estimated fair value of the net assets acquired:

	Westcoast	Alentex	Duncan	Total
	\$	\$	\$	\$
Working capital	660	441	136	1,237
Capital assets	559	493	385	1,437
Prescription files	-	-	800	800
Goodwill	-	-	1,796	1,796
Customer relationships	2,036	6,867	-	8,903
Total	3,255	7,801	3,117	14,173

6. INVESTMENT IN AND ADVANCES TO PRIVATE COMPANIES

Prior to June 29, 2009, the Company had a 50% equity interest in the following companies. The advances were non-interest bearing, unsecured with no fixed terms of repayment.

	2009	2008
	\$	\$
1036985 Alberta Ltd. (Cochrane Super Drug Mart)		
Investment	-	183
Advances to	-	508
	-	691
ACO Super Drug Mart Ltd.		
Advances to	-	263
	-	954

Effective June 29, 2009, the Company acquired the remaining 50% interest in the two private companies (Note 5).

PARAGON PHARMACIES LIMITED

Notes to Consolidated Financial Statements

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(tabular amounts in thousands, except per share amounts)

7. CAPITAL ASSETS

	2009		
	Cost \$	Accumulated Amortization \$	Net Book Value \$
Land	85	-	85
Building	300	15	285
Furniture and fixtures	842	362	480
Automotive	244	144	100
Equipment	2,156	855	1,301
Computer equipment	966	482	484
Computer software	696	253	443
Assets under capital lease	245	164	81
Leasehold improvements	3,818	1,119	2,699
	9,352	3,394	5,958

	2008		
	Cost \$	Accumulated Amortization \$	Net Book Value \$
Land	85	-	85
Building	300	8	292
Furniture and fixtures	758	285	473
Automotive	279	124	155
Equipment	1,983	400	1,583
Computer equipment	900	369	531
Computer software	234	135	99
Assets under capital lease	245	128	117
Leasehold improvements	2,513	817	1,696
	7,297	2,266	5,031

Amortization on capital assets was \$1.308 million for 2009 (2008 - \$0.911 million).

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8. INTANGIBLE ASSETS

	2009		
	Cost	Accumulated Amortization	Net Book Value
	\$	\$	\$
Prescription files	8,607	6,074	2,533
Customer relationships	8,903	2,910	5,993
Pre-operating costs	105	29	76
Operating leases	467	467	-
Rebranding costs	217	49	168
	<u>18,299</u>	<u>9,529</u>	<u>8,770</u>

	2008		
	Cost	Accumulated Amortization	Net Book Value
	\$	\$	\$
Prescription files	8,628	4,976	3,652
Customer relationships	8,903	1,130	7,773
Pre-operating costs	28	11	17
Operating leases	467	289	178
Rebranding costs	98	24	74
	<u>18,124</u>	<u>6,430</u>	<u>11,694</u>

Amortization of intangible assets was \$3.101 million for 2009 (2008 - \$2.779 million).

9. GOODWILL

	2009	2008
	\$	\$
Opening Balance	15,103	13,307
Acquisitions (Note 5)	-	1,796
Closing Balance	<u>15,103</u>	<u>15,103</u>

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10. BANK INDEBTEDNESS

The Company has a \$3.0 million operating line of credit facility, bearing interest at prime plus 1.25% per annum maturing February 6, 2010. The line of credit is secured by a general security agreement representing a first charge on all the assets and undertakings of the Company and its subsidiaries, unlimited guarantees of advances by the Company and its subsidiaries, subordination/priority agreements with a certain supplier and an assignment of fire insurance over assets of the Company and its subsidiaries. The Company is currently renegotiating its term loan facility originally set to expire in December 2009, and now extended to February 6, 2010 (Note 12).

At August 31, 2009, the Company had issued letters of credit aggregating \$0.5 million (August 31, 2008 - \$0.5 million) and had cheques issued in excess of funds on deposit of \$nil (August 31, 2008 - \$0.9 million), leaving \$2.5 million (August 31, 2008 - \$1.6 million) of the \$3 million facility available.

11. CONVERTIBLE DEBENTURE

	2009 \$	2008 \$
Convertible Debenture – debt classification		
Total proceeds of convertible debentures	20,000	20,000
Fair value of convertible debentures - equity component	(6,321)	(6,321)
Financing costs	(1,823)	(1,823)
Value of liability component	11,856	11,856
Accumulated accretion and amortization of financing costs	8,144	5,377
	20,000	17,233
Repayment	(8,450)	-
Conversion	(11,550)	-
Balance, end of year	-	17,233
Convertible Debenture – equity classification		
Fair value of convertible debentures - equity component	6,321	6,321
Conversion	(6,321)	-
Accrued interest to be settled by the issuance of shares	2,159	4,203
Payment of interest with common shares	(2,159)	(3,000)
Balance, end of year	-	7,524

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11. CONVERTIBLE DEBENTURE *(continued)*

In May 2007, the Company issued a \$20.0 million convertible debenture. The proceeds from the issuance of the convertible debenture were restricted for future acquisitions as reviewed and approved by the Board of Directors and were not available for general corporate purposes. Cash from the issuance of the convertible debentures to the extent not invested had been held in escrow and its use restricted. The debenture holder could also demand repayment of the unspent funds and related interest on the first anniversary if less than 50% of the proceeds from the debenture had not been invested at that time.

The convertible debenture provided for a minimum interest rate of 15% and the interest rate could be adjusted (i) should the Company not spend a minimum of 50% of the debenture proceeds within one year or (ii) if the purchase price of the businesses financed with proceeds from the convertible debenture exceeded predetermined criteria. In May 2008, the Company had not invested 50% of the proceeds from the issuance of the debenture. The Company and the debenture holder at that time renegotiated various terms of the convertible debenture resulting in the un-invested funds remaining with the Company at an interest rate of 20% per annum and the \$3,000,000 interest accrued to that time being repaid with the issuance of 6,332,445 shares.

Effective November 14, 2008, the Company and the debenture holder also agreed that the interest adjustment owing under the convertible debenture as a result of purchase cost of investments exceeding predetermined criteria would be \$650,000. This interest expense was recorded in the three months ended November 30, 2008.

On November 14, 2008, the Company and the holder of the \$20.0 million convertible debenture reached agreement to accelerate the conversion of the debenture as follows:

- a) The Company repaid the debenture holder \$8,766,486 including accrued interest of \$316,486 which the debenture holder then reinvested in 33,717,264 common shares of the Company at \$0.26 per common share.
- b) The remaining \$11,550,000 principal owing under the debenture and accrued interest of \$2,159,055 were converted at \$.8028 per common share into 14,387,145 common shares and at \$0.35 per common share into 6,168,729 common shares respectively.
- c) A conversion inducement fee equal to forgone interest for early conversion at the rate otherwise payable to the scheduled maturity of May 2, 2009 including an agreed interest adjustment amount, in the aggregate of \$1,374,170, paid at \$0.35 per share for an aggregate of 3,926,200 common shares.

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11. CONVERTIBLE DEBENTURE *(continued)*

A summary of restricted cash is as follows:

	2009	2008
	\$	\$
Funds received	20,000	20,000
Used in acquisitions	(7,060)	(7,060)
Available for acquisitions	12,940	12,940
Cumulative interest received on escrow funds	890	788
Accrued interest on escrow funds	-	24
Less released from escrow	(13,830)	-
Balance, end of year, including accrued interest receivable	-	13,752

12. LONG-TERM DEBT

	2009	2008
	\$	\$
Toronto Dominion Bank		
Term loan, net of financing costs of \$0.15 million (August 31, 2008 - \$0.54 million), bearing interest at prime plus 1.5% per annum, repayable in monthly installments of \$166,667 plus interest, due February, 2010.	3,537	5,239
Bank loan, net of financing costs of \$0.07 million (August 31, 2008 - \$ nil) bearing at interest prime plus 1.5% per annum repayable in February, 2010.	7,060	7,060
Autonomy Loan (Note 4)		
Loan payable, net of financing costs of \$0.4 million (August 31, 2008 - \$0.5 million), unsecured and repayable over a ten year period ending September 30, 2017. Interest accrues at the rate of 6% per annum, payable annually on August 31 st of each year.	3,485	3,506
Promissory note		
Promissory note of the Company, unsecured, bearing interest at 4.5% per annum and compounded semi-annually, repaid March 2009.	-	300

PARAGON PHARMACIES LIMITED

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12. LONG-TERM DEBT (continued)

Other long-term debt

Various obligations bearing interest between 0% and 5.9%, secured by general security agreements, general assignments of book debts due between September 2009 and September 2013.

	<u>51</u>	<u>170</u>
	14,133	16,275
Less current portion	10,612	2,427
	3,521	13,848

The term and bank loan are secured by a general security agreement representing a first charge on all the assets and undertakings of the Company and its subsidiaries, unlimited guarantees of advances by the Company and its subsidiaries, subordination/priority agreements with a certain supplier and an assignment of fire insurance over assets of the Company and its subsidiaries.

Scheduled principal repayments excluding the Autonomy Loan for 12 months ending August 31 are as follows:

	<u>\$</u>
2010	10,612
2011	25
2012	6
2013	4
2014	1

The Autonomy Loan is repayable in variable amounts annually with total repayment to occur no later than September 30, 2017.

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Notes to Consolidated Financial Statements

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13. SHARE CAPITAL

Authorized

Unlimited number of common voting shares

Unlimited number of first and second preferred shares,
issuable in series, rights to be determined by directors

	Number of Common Shares Issued	Amount \$
Balance, August 31, 2007	41,000	28,993
Issued for cash on exercise of agent options	85	28
Issued on payment of interest on convertible debentures (Note 11)	6,322	3,000
Redeemed on amalgamation with 1405257 Alberta Ltd. (Note 4)	(8,000)	(5,404)
Balance, August 31, 2008	39,407	26,617
Issued for cash under private placement, net of issue costs (Note 11)	33,717	8,568
Issued on conversion of debenture and accrued interest (Note 11)	20,556	20,030
Issued as an inducement to convert the debenture (Note 11)	3,926	1,374
Balance, August 31, 2009	97,606	56,589

Stock-based compensation

Compensation expense for stock options is recognized using the estimated fair value at the time the options are granted and is amortized over the vesting period of the related option. During the year ended August 31, 2009 the Company expensed \$0.068 million (2008 - \$0.121 million).

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Notes to Consolidated Financial Statements

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13. SHARE CAPITAL *(continued)*

The fair value of options granted was estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

	<u>2009</u>	<u>2008</u>
Risk free interest rate	3.5%	3.76%
Expected life of options	5 years	5 years
Expected volatility	60%	67%
Expected dividend rate	0%	0%

Contributed surplus arises from the following:

	<u>2009</u>	<u>2008</u>
	\$	\$
Balance - beginning of year	2,502	1,127
Exercise of agents options	-	(11)
Redemption of shares (Note 4)	-	1,265
Stock-based compensation	68	121
Balance - end of year	2,570	2,502

A summary of stock option transactions is as follows:

	<u>2009</u>		<u>2008</u>	
	Number of Optioned Shares	Weighted average exercise price \$	Number of Optioned Shares	Weighted average exercise price \$
Outstanding - beginning of year	1,201	0.69	1,526	0.92
Issued	350	0.22	617	0.45
Exercised	-	-	(85)	0.20
Expired	(924)	0.59	(857)	0.98
Outstanding - end of year	627	0.60	1,201	0.69
Weighted average fair value per share of options granted during the year	350	0.12	617	0.26

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Notes to Consolidated Financial Statements

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13. SHARE CAPITAL (continued)

The options outstanding at August 31, 2009 are as follows:

Date Issued	Number of Options Outstanding	Number of Options Vested	Exercise Price \$	Expiry Date
December 10, 2004	30	30	1.50	December 10, 2009
June 30, 2005	50	50	1.50	June 30, 2010
March 14, 2007	100	100	0.80	March 14, 2012
May 28, 2008	322	297	0.45	May 28, 2013
October 21, 2008	50	25	0.21	October 21, 2013
November 15, 2008	75	75	0.23	September 21, 2009
	627	577		

The options not vested at August 31, 2009 will vest at various times through June 30, 2010. Under the current shareholder approved stock option plan, a total of 2.3 million options are available for issuance, calculated as 3% of the issued and outstanding common shares of the Company, 2.9 million, less the 0.6 million currently issued and outstanding.

Warrants

During the year ended August 31, 2009, all remaining warrants to acquire shares with the Company expired.

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14. INTEREST AND ACCRETION EXPENSE

Interest and accretion expense includes the following:

	2009	2008
	\$	\$
<u>Convertible debenture</u>		
Interest	1,272	3,223
Amortization of financing costs	1,056	747
Accretion	1,711	3,557
Inducement fee (Note 11)	1,374	-
Total - convertible debenture	5,413	7,527
<u>Other</u>		
Amortization of financing costs	487	58
Bank charges and interest	133	229
Interest on long-term debt	796	790
Interest income	(153)	(668)
	6,676	7,936

15. OTHER ITEMS

	2009	2008
	\$	\$
Share of equity loss/(income) (Note 5):		
1036985 Alberta Ltd.	(137)	90
ACO Super Drug Mart Ltd.	105	187
	(32)	277
Loss (gain) on disposal of capital and intangible assets	61	(506)
	29	(229)

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16. INCOME TAXES

	2009	2008
	\$	\$
Net loss	(7,181)	(10,125)
Computed income tax expense at statutory rate of 30.33% (2008 – 30.72%)	(2,178)	(3,110)
Stock-based compensation	21	37
Accretion on convertible debenture	645	1,031
Other permanent differences	214	390
Impact of future tax rate differences	270	384
Income taxes related to difference between carrying values and tax cost of acquisitions	-	218
Change in valuation allowance	1,028	1,050
	-	-

Subject to confirmation by income tax authorities, the Company has approximately the following tax amounts available for future deduction:

	2009	2008
	\$	\$
Undepreciated capital cost	5,398	5,735
Cumulative eligible capital	17,665	18,944
Share issue costs and financing costs carried forward	3,652	2,781
Non-capital losses carried forward for tax purposes with expiration dates between 2010 and 2029	11,357	7,329
	38,072	34,789

These amounts are deductible from future income at rates prescribed by the Canadian Income Tax Act. The components of the Company's future income tax liability (asset) are a result of the origination and reversal of temporary differences and are comprised of the following:

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Notes to Consolidated Financial Statements

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16. INCOME TAXES (continued)

Nature of temporary differences	2009 \$	2008 \$
Capital assets	94	(424)
Intangible assets	(842)	(259)
Goodwill	562	432
Investment in private companies	-	(20)
Deferred compensation	-	(27)
Rebranding	29	-
Deferred rent inducement	(71)	-
Capital leases	(15)	(21)
Share issue costs and financing costs	(797)	(491)
Non-capital tax losses carry forward	(2,943)	(2,117)
	(3,983)	(2,927)
Valuation allowance	3,983	2,927
Future income tax liability (asset)	-	-

17. PER SHARE AMOUNTS

	2009	2008
Weighted average number of shares		
Basic	85,647	43,070
Fully diluted	85,750	43,070

Diluted earnings per share have been calculated using the treasury stock method and includes the dilutive effect, if any, of options, warrants and the convertible debenture.

18. RELATED PARTY TRANSACTIONS

In addition to the transactions set out in Note 11, for the year ended August 31, 2009, the Company expensed \$0.15 million (2008 - \$0.20 million) for advisory fees due to Canterbury Park Management Inc. Canterbury Park Management Inc. provides management services for a shareholder. Under the current agreement, the Company pays \$0.20 million a year for advisory services and \$0.03 million a month for executive services.

PARAGON PHARMACIES LIMITED

Notes to Consolidated Financial Statements

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18. RELATED PARTY TRANSACTIONS *(continued)*

For the year ended August 31, 2009, the Company expensed \$0.14 million (2008 - \$0.06 million) to one member of the Board of Directors for consulting services. The Company also paid \$0.19 million for the year ended August 31, 2009 (2008 - \$0.30 million) in rent for premises leased under operating leases with parties related by virtue of common management and directors. These transactions are in the normal course of operations and have been recorded at the exchange amount, which is the amount agreed to by the related parties.

19. PENSION PLAN

The Company sponsors a defined contribution pension plan for its employees. The Company matches employees' Registered Retirement Savings Plan ("RRSP") contributions with contributions to a Registered Pension Plan ("RPP"). RPP contributions vest immediately and are fully portable. The contribution of the Company is between 4% and 7% of the employee's gross wages, dependent upon employee class and years of service and limited to the contribution made by the employee to their RRSP. There is no past service liability for this plan. Contributions made by the Company to the plan are expensed as incurred. For the year ended August 31, 2009, the Company expensed \$0.4 million (2008 - \$0.4 million).

20. SUPPLEMENTAL CASH FLOW INFORMATION

	2009	2008
	\$	\$
CHANGE IN NON-CASH WORKING CAPITAL:		
Operating		
Accounts receivable	1,693	(1,846)
Inventory	1,898	612
Prepaid expenses and deposits	257	(313)
Accounts payable and accrued liabilities	(355)	3,791
	<u>3,493</u>	<u>2,244</u>
Financing		
Accounts payable and accrued liabilities	<u>(633)</u>	<u>633</u>
Investing		
Accounts receivable	600	(600)
Accounts payable and accrued liabilities	(148)	148
	<u>452</u>	<u>(452)</u>

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21. COMMITMENTS AND CONTINGENCIES

On April 5, 2007 the Company was named as a defendant in a statement of claim filed by Katz Group Canada Inc., Drug Trading Company Ltd., Pharmx Rexall Drug Stores Ltd. and Katz Group Canada Ltd., as plaintiffs. Management of the Company believes that the allegations raised in the statement of claim are without merit and the Company intends to vigorously defend the action to the full extent permitted under law. Any loss will be recorded in the year the claim is resolved.

Reimbursements of drug costs and dispensing fees by provincial health authorities are subject to post reimbursement review. As at August 31, 2009, there is currently one review in progress. The amount of the reimbursement arising from the review is unknown at this time. The Company, however, has provided a \$200,000 allowance against reimbursements previously claimed. To the extent the results of the review differ from the provision, the variance will be charged against earnings when known.

The Company and its subsidiaries lease premises under operating leases, which expire between 2010 and 2019. Rental payments, excluding operating costs and taxes, over the next five years ending August 31 are as follows:

	\$
2010	2,492
2011	2,330
2012	2,196
2013	1,806
2014	1,612
Thereafter	3,974

Three of the above leases were entered into with entities controlled by related parties, related via common management. These transactions are in the normal course of operations and have been recorded at the exchange amount, which is the amount agreed to by the related parties, and represent rent of \$1.528 million from 2010 through 2014.

22. FINANCIAL INSTRUMENTS

Fair value

The carrying amount reported on the consolidated balance sheet for cash, restricted cash, accounts receivable, due from related parties, accounts payable and accrued liabilities and bank indebtedness approximate their fair value due to the short-term nature of these accounts. The carrying value of capital lease obligations approximate their fair value given that the interest rates inherent in the leases reflect rates currently available for leases with similar terms and maturities. The long-term debt is subject to both fixed and floating interest rates.

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22. FINANCIAL INSTRUMENTS *(continued)*

The floating rate debt appropriately reflects rates currently available for debt with similar terms and maturities. Accordingly, the fair value of the floating rate debt is not materially different from the recorded value except for associated financing costs included therein (see note 12). The fixed rate debt, which has a carrying value of \$4.0 million at August 31, 2009 (August 31, 2008 - \$4.4 million), has a fair value of \$4.0 million (August 31, 2008 - \$4.4 million).

Financial instrument risk management overview

As part of the Company's risk management practices, the financial risks that are significant to the Company are identified, monitored and controlled. The nature of most significant financial risks and how they are managed are described below.

Credit risk

Credit risk arises from cash and other short term investments held with banks along with accounts receivable that arise primarily in respect of prescription sales billed to government and third party drug plans with short periods of credit.

The company monitors the accounts receivable and reduces the carrying value of accounts receivable once amounts are determined to be no longer recoverable.

At August 31, 2009 the details of the aging of the Company's accounts receivable is as follows:

	<u>\$</u>
Due within 60 days	3,305
Due 60-120 days	342
Due 120 days+	<u>198</u>
Total accounts receivable	<u>3,845</u>

Interest rate risk

The Company is exposed to fluctuations in interest rates by virtue of its borrowing under its bank credit facilities and its short term investments. Increases or decreases in interest rates will positively or negatively impact the financial performance of the Company. The Company does not consider its exposure to interest rate fluctuations to be material at this time.

Foreign currency exchange risk

The Company does not consider its exposure to foreign currency exchange risk to be material at this time as its revenues, cost of sales and expenses are substantially conducted in Canadian dollars.

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22. FINANCIAL INSTRUMENTS *(continued)*

Liquidity Risk

Liquidity risk is the risk that the Company will not have cash available to satisfy financial liabilities as they come due. The Company does not consider its exposure to liquidity risk to be material at this time.

23. COMPARATIVE FIGURES

Certain comparative figures have been reclassified to conform to the financial statement presentation adopted in the current year.

24. SUBSEQUENT EVENTS

On October 8, 2009, the Company announced its intention to make a Normal Course Issuer Bid to purchase for cancellation up to a maximum of 4,880,319 shares. The Bid commenced on October 9, 2009 and will terminate on October 8, 2010 or such earlier time as the Bid is completed or terminated at the option of Paragon. As of December 7, 2009, 0.748 million shares have been purchased for cash consideration of \$0.225 million.

On October 28, 2009, the Company acquired the prescription file of Westglen Pharmacy in Calgary, Alberta for cash consideration of \$0.50 million. The acquisition agreement provides for an additional payment in November 2010 dependent on the volume of prescriptions at the Company's Westbrook pharmacy for the year ended October 27, 2010, being the store which was the primary beneficiary of this transaction.