

Interim Consolidated Financial Statements of

PARAGON PHARMACIES LIMITED

*November 30, 2009 and 2008
(Unaudited)*

Notice to Reader

The attached interim consolidated financial statements have been prepared by management of Paragon Pharmacies Limited and have not been reviewed by the independent external auditors of Paragon Pharmacies Limited.

PARAGON PHARMACIES LIMITED

Interim Consolidated Statements of Operations, Comprehensive Loss and Deficit Three Months Ended November 30, 2009 and 2008 (Unaudited)

(Thousands of dollars, except per share amounts)	2009 \$	2008 \$
Revenue	20,926	21,783
Cost of sales	13,318	14,182
Operating expenses	5,596	6,122
	2,012	1,479
Corporate and other costs	951	1,176
Income before undernoted items	1,061	303
Interest and accretion expense (Note 9)	315	5,734
Amortization	1,185	1,081
Stock-based compensation (Note 8)	8	17
Other items	36	29
	1,544	6,861
Loss and comprehensive loss	(483)	(6,558)
Deficit, beginning of period	(25,511)	(18,330)
Impact of change in accounting policy (Note 3)	(76)	-
Deficit, end of period	(26,070)	(24,888)
Loss per share (Note 11)		
Basic and diluted	(0.00)	(0.13)

PARAGON PHARMACIES LIMITED

Interim Consolidated Balance Sheets

November 30, 2009 and August 31, 2009

(Thousands of dollars)

	November 30, 2009 \$	August 31, 2009 \$
	(Unaudited)	
ASSETS		
CURRENT		
Cash and cash equivalents	13,335	14,980
Accounts receivable	4,336	3,845
Inventory	8,850	8,114
Prepaid expenses and deposits	441	434
	26,962	27,373
Capital assets	5,655	5,515
Intangible assets	8,842	9,137
Goodwill	15,103	15,103
	56,562	57,128
LIABILITIES		
CURRENT		
Accounts payable and accrued liabilities	9,762	9,093
Current portion of deferred rent inducements	35	30
Current portion of long-term debt (Note 7)	10,224	10,612
Current portion of capital leases	26	28
	20,047	19,763
Long-term debt (Note 7)	3,359	3,521
Long-term deferred rent inducements	268	243
Capital leases	16	29
	23,690	23,556
SHAREHOLDERS' EQUITY		
Share capital (Note 8)	56,311	56,589
Contributed surplus (Note 8)	2,631	2,570
Deficit	(26,070)	(25,587)
	32,872	33,572
	56,562	57,128
Subsequent event (Note 8)		
Commitments and contingencies (Note 13)		

PARAGON PHARMACIES LIMITED

Interim Consolidated Statement of Cash Flows Three Months Ended November 30, 2009 and 2008 (Unaudited)

(Thousands of dollars)	2009 \$	2008 \$
CASH FLOWS RELATED TO THE FOLLOWING ACTIVITIES:		
OPERATING		
Loss for the period	(483)	(6,558)
Adjustments for:		
Interest and accretion expense (Note 9)	131	5,193
Amortization	1,185	1,081
Loss on disposal of capital assets	36	6
Stock-based compensation (Note 8)	8	17
Loss on equity investments	-	23
	<u>877</u>	<u>(238)</u>
Net change in non-cash working capital	(565)	166
	<u>312</u>	<u>(72)</u>
FINANCING		
Reduction in advances to related parties	-	(268)
Issuance of share capital, net of issuance costs	-	8,568
Financing costs	-	(118)
Repayment of long term debt	(681)	(583)
Additions to deferred rent inducement	30	-
Repayment of convertible debenture (Note 6)	-	(8,450)
Decrease in bank indebtedness	-	(921)
Repayment of capital leases	(15)	(6)
Shares repurchased (Note 8)	(225)	-
Net change in non-cash working capital	-	(128)
	<u>(891)</u>	<u>(1,906)</u>
INVESTING		
Restricted cash	-	13,830
Interest paid into restricted cash	-	(102)
Addition to intangible assets	(577)	-
Proceeds on disposal of capital assets	22	-
Purchase of capital assets	(511)	(601)
Net change in non-cash working capital	-	606
	<u>(1,066)</u>	<u>13,733</u>
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(1,645)	11,755
CASH AND CASH EQUIVALENTS BEGINNING OF PERIOD	14,980	541
CASH AND CASH EQUIVALENTS END OF PERIOD	13,335	12,296
Supplemental cash flow disclosure:		
Interest paid	191	308
Income taxes paid	-	-

PARAGON PHARMACIES LIMITED

Notes to Interim Consolidated Financial Statements

Three Months Ended November 30, 2009 and 2008

(tabular amounts in thousands, except per share amounts)

(Unaudited)

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. 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

The interim consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles (“GAAP”) and follow the same accounting policies and methods of application with those used in preparation of the audited annual consolidated financial statements for the year ended August 31, 2009, except as described in Note 3 under Changes in Accounting Policies. Certain information and disclosures included in the year end consolidated financial statements have been condensed or omitted. These financial statements should be read in conjunction with the consolidated financial statements and notes for the year ended August 31, 2009.

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

Goodwill and intangible assets, financial statement concepts

Effective September 1, 2009, the Company adopted a new accounting standard Handbook Section 3064 “Goodwill and Intangible Assets”. This section replaces the existing guidance on goodwill and other intangible assets and research and development costs, and 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.

Following the adoption of Section 3064, the Company reclassified the net carrying value of computer software that met the definition of intangible assets from capital assets to intangible assets on the consolidated balance sheet. The Company also wrote-off pre-operating costs through opening deficit. The prior year’s loss for the three-month period November 30, 2008 was restated to recognize pre-operating costs relating to new store openings as operating expenses and to eliminate the amortization of pre-operating costs in the interim consolidated statement of operations.

Cumulative adjustments, following the adoption of Section 3064, to the consolidated balance sheet as at August 31, 2009 and to the interim consolidated statements of earnings and cash flows for the three months ended November 30, 2008, are summarized as follows:

	<u>August 31, 2009</u> \$
Balance Sheet	
	increase/ (decrease)
Capital assets	(442)
Intangible assets	<u>366</u>
	<u>(76)</u>
Deficit	<u>(76)</u>

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(Unaudited)

3. CHANGE IN ACCOUNTING POLICIES – (continued)

	<u>November 30, 2008</u> \$
Statement of operations, comprehensive loss and deficit	<u>increase/ (decrease)</u>
Operating expenses	173
Amortization	(7)
Loss for the period	<u>(166)</u>
Loss per share	
Basic and diluted	<u>(0.00)</u>
	<u>November 30, 2008</u> \$
Statement of cash flows	<u>increase/ (decrease)</u>
Operating activities	
Loss for the period	(166)
Amortization	(7)
	<u>(173)</u>
Investing activities	
Reduction in intangibles	(173)
Net change in cash and cash equivalents	<u>-</u>

Future Accounting Standards

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 2012 fiscal year. The Company expects to assess the impact of the new standard as part of its overall review of its convergence to IFRS.

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3. CHANGE IN ACCOUNTING POLICIES – *(continued)*

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. ACQUISITIONS

On October 28, 2009, the Company acquired the prescription file of a pharmacy in Calgary, Alberta for \$0.50 million cash consideration. The total cash cost of the acquisition was allocated to intangible assets prescription files on the basis of the fair value acquired. The acquisition agreement provides for an additional payment in November 2010 dependent on the volume of prescriptions at the store which was the primary beneficiary of this transaction for the year ended October 27, 2010.

5. 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 credit facility originally set to expire in December 2009, and now extended to April 6, 2010 (Note 7).

At November 30, 2009, the Company had issued letters of credit aggregating \$0.5 million (August 31, 2009 - \$0.5 million) leaving \$2.5 million (August 31, 2009 - \$2.5 million) of the \$3 million facility available.

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6. CONVERTIBLE DEBENTURE

The Company originally issued a \$20.0 million convertible debenture in 2007. In November 2008, the Company and the holder of the \$20.0 million convertible debenture reached agreement to an interest adjustment of \$0.600 million and to accelerate the conversion of this 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.

Complete details of the original transaction, subsequent amendments and accelerated conversion are disclosed in the audited annual August 31, 2009 financial statements.

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7. LONG-TERM DEBT

	November 30, 2009 \$ (Unaudited)	August 31 2009 \$
Toronto Dominion Bank		
Term loan, net of financing costs of \$0.12 million (August 31, 2009 - \$0.54 million), bearing interest at prime plus 1.5% per annum, repayable in monthly installments of \$0.167 million plus interest, due April, 2010.	3,156	3,537
Bank loan, net of financing cost of \$0.04 million (August 31, 2009 - \$0.07) bearing interest at prime plus 1.5% per annum repayable in April, 2010.	7,060	7,060
Autonomy Loan		
Loan payable, net of financing costs of \$0.4 million (August 31, 2009 - \$0.4 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.	3,326	3,485
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 December 2009 and September 2013.	41	51
	13,583	14,133
Less current portion	10,224	10,612
	3,359	3,521

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.

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7. LONG-TERM DEBT – (continued)

Scheduled principal repayments excluding the Autonomy Loan for the year ending August 31, are as follows:

	\$
2010	10,224
2011	24
2012	5
2013	4
2014	-

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

8. 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, 2008	39,407	26,617
Issued for cash under private placement, net of issue costs	33,717	8,568
Issued on conversion of debenture and accrued interest	20,556	20,030
Issued as an inducement to convert the debenture	3,926	1,374
Balance, August 31, 2009	97,606	56,589
Purchased through market and subsequently cancelled, net of \$0.014 million purchase costs	(717)	(278)
Balance, November 30, 2009	96,889	56,311

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8. SHARE CAPITAL – (continued)

Contributed surplus arises from the following:

	November 30, 2009 \$ (Unaudited)	August 31, 2009 \$
Balance - beginning of period	2,570	2,502
Cancellation of purchased shares	53	-
Stock-based compensation	8	68
Balance - end of period	<u>2,631</u>	<u>2,570</u>

Normal course issuer bid

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 November 30, 2009, 0.717 million shares have been purchased for cash consideration of \$0.225 million.

To date, the Company purchased 1.799 million shares for cash consideration of \$0.572 million.

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 three months ended November 30, 2009 the Company expensed \$0.008 million (2008 - \$0.017 million).

The options not vested at November 30, 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.

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9. INTEREST AND ACCRETION EXPENSE

Interest and accretion expense includes the following:

	November 30, 2009	November 30, 2008
	\$	\$
<u>Convertible debenture</u>		
Interest	-	1,272
Amortization of financing costs	-	1,056
Accretion	-	1,711
Inducement fee (Note 6)	-	1,374
Total - convertible debenture	-	5,413
<u>Other</u>		
Amortization of financing costs	131	96
Bank charges and interest	31	52
Interest on long-term debt	160	256
Interest income	(7)	(83)
	315	5,734

10. INCOME TAXES

	November 30, 2009	November 30, 2008
	\$	\$
Loss for the period	(483)	(6,558)
Computed income tax expense at statutory rate of 30.44% (2009 – 30.33%)	(147)	(1,928)
Stock-based compensation	2	5
Accretion on convertible debenture	-	642
Other permanent differences	75	305
Impact of future tax rate differences	10	161
Change in valuation allowance	60	815
	-	-

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(Unaudited)

10. INCOME TAXES - (continued)

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

	November 30, 2009 \$ (Unaudited)	August 31, 2009 \$
Undepreciated capital cost	5,292	5,398
Cumulative eligible capital	17,725	17,665
Share issue costs and financing costs carried forward	3,420	3,652
Non-capital losses carried forward for tax purposes with expiration dates between 2010 and 2029	11,434	11,357
	<u>37,871</u>	<u>38,072</u>

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:

Nature of temporary differences	November 30, 2009 \$ (Unaudited)	August 31, 2009 \$
Capital assets	76	94
Intangible assets	(906)	(842)
Goodwill	556	562
Rebranding	29	29
Deferred rent inducements	(79)	(71)
Capital leases	(11)	(15)
Share issue costs and financing costs	(739)	(797)
Non-capital tax losses carry forward	(2,970)	(2,943)
	<u>(4,043)</u>	<u>(3,983)</u>
Valuation allowance	4,043	3,983
Future income tax liability (asset)	<u>-</u>	<u>-</u>

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(Unaudited)

11. PER SHARE AMOUNTS

	November 30, 2009	November 30, 2008
Weighted average number of shares		
Basic	97,545	50,279
Diluted	97,595	50,355

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.

12. RELATED PARTY TRANSACTIONS

In addition to the transactions set out in Note 6, for the period ended November 30, 2009, the Company expensed \$0.13 million (2008 - \$0.03 million) for advisory and executive services fees to Canterbury Park Management Inc. Canterbury Park Management Inc. provides management services as 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.

For the period ended November 30, 2009, the Company expensed \$Nil million (2008 - \$0.135 million) to one member of the Board of Directors for consulting services. The Company also paid \$0.050 million for the period ended November 30, 2009 (2008 - \$0.050 million) in rent for premises leased under operating leases with parties related to a director. 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.

13. 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 November 30, 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 \$0.200 million 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.

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14. 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 period.

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. Currently, the Company has available cash resources to make necessary capital investments and to fund a limited number of 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 (earnings before interest and accretion expense, interest income, depreciation and amortization, stock based compensation, other items including loss from equity investments, and income taxes) ratio as defined in its lending agreement. At November 30, 2009 the Company's cash on deposit exceeded senior debt and the Company was in compliance with its bank covenants.

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14. CAPITAL MANAGEMENT – (continued)

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 periods indicated.

	November 30, 2009 \$ (Unaudited)	August 31, 2009 \$
Cash	(13,335)	(14,980)
Current portion of long-term debt and capital leases	10,250	10,640
Long-term debt and capital leases	3,375	3,550
Net debt	290	(790)
Shareholders' equity	32,872	33,572
Total capitalization	33,162	32,782
Net debt: Shareholders' equity	0.01	(0.02)
Net debt: Total capitalization	0.01	(0.02)
EBITDA: Cash interest expense ⁽¹⁾⁽²⁾	5.77	5.16

(1) For purposes of calculating the ratios, EBITDA is for each of the periods 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 the periods then ended and also excludes the amortization of deferred financing costs and accretion expense net of interest income.

15. COMPARATIVE FIGURES

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