

Consolidated Financial Statements of

PARAGON PHARMACIES LIMITED

August 31, 2007 and 2006

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Auditors' Report

To the Shareholders of
Paragon Pharmacies Limited:

We have audited the consolidated balance sheets of **Paragon Pharmacies Limited** as at August 31, 2007 and 2006 and the consolidated statements of loss and deficit and cash flows for each of the years 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 audits.

We conducted our audits 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 from 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, 2007 and 2006 and the results of its operations and its cash flows for each of the years then ended in accordance with Canadian generally accepted accounting principles.

(Signed) "*Deloitte & Touche LLP*"

Chartered Accountants

Calgary, Alberta

November 9, 2007 (except for Note 28 which is dated December 11, 2007)

PARAGON PHARMACIES LIMITED

Consolidated Statements of Loss and Deficit Years Ended August 31, 2007 and 2006

	2007	2006 (Note 1)
	\$	\$
Revenue	66,145,816	37,777,010
Cost of sales	44,405,384	26,183,479
Operating expenses	16,953,845	9,663,478
Operating income	4,786,587	1,930,053
Corporate and other costs	2,893,173	1,254,125
Income before undernoted items	1,893,414	675,928
Amortization	2,158,938	1,409,420
Interest expense (Note 4)	2,856,312	625,398
Other items (Note 18)	374,861	98,339
	5,390,111	2,133,157
Net loss from continuing operations	(3,496,697)	(1,457,229)
Loss from discontinued operations (Note 9)	(78,232)	(165,250)
Net loss	(3,574,929)	(1,622,479)
Deficit, beginning of year	(4,900,249)	(3,651,356)
Disposition of Paragon Central Fill Ltd.	-	373,586
Deficit, end of year	(8,475,178)	(4,900,249)
Loss per share – continuing operations		
Basic	(\$0.10)	(\$0.10)
Diluted	(\$0.10)	(\$0.10)
Loss per share – discontinued operations		
Basic and diluted	-	(\$0.01)
Loss per share (note 21)		
Basic	(\$0.10)	(\$0.10)
Diluted	(\$0.10)	(\$0.10)

PARAGON PHARMACIES LIMITED

Consolidated Balance Sheets

	August 31, 2007	August 31, 2006 (Note 1)
	\$	\$
ASSETS		
CURRENT		
Cash and cash equivalents	2,833,569	86,331
Cash held in trust (Note 5)	-	1,500,000
Accounts receivable	2,300,214	2,828,929
Inventory	9,796,129	8,826,745
Prepaid expenses and deposits	356,639	165,449
Due from related parties (Note 14)	419,231	597,684
	<u>15,705,782</u>	<u>14,005,138</u>
Restricted cash (Note 22)	20,110,574	-
Deferred transaction costs (Note 12)	1,798,605	367,533
Capital assets (Note 10)	1,664,468	1,368,903
Intangible assets (Note 11)	4,763,813	5,457,545
Investment in private companies (Note 19)	436,554	435,445
Goodwill (Note 13)	13,307,474	12,420,709
	<u>57,787,270</u>	<u>34,055,273</u>
LIABILITIES		
CURRENT		
Accounts payable and accrued liabilities	5,439,784	4,004,263
Current portion of compensation obligation (Note 15)	100,000	-
Current portion of long-term debt (Note 15)	2,671,326	3,037,853
Current portion of capital leases (Note 16)	52,221	61,061
	<u>8,263,331</u>	<u>7,103,177</u>
Compensation obligation (Note 15)	100,000	-
Long-term debt (Note 15)	5,679,665	7,891,608
Convertible debenture (Note 22)	14,732,500	-
Capital leases (Note 16)	66,159	86,138
	<u>28,841,655</u>	<u>15,080,923</u>
COMMITMENTS & CONTINGENCIES (Note 26)		
SUBSEQUENT EVENTS (Note 28)		
SHAREHOLDERS' EQUITY		
Share capital (Note 17)	28,992,958	22,939,536
Contributed surplus (Note 17)	1,126,835	935,063
Convertible debenture (Note 22)	7,301,000	-
Deficit	(8,475,178)	(4,900,249)
	<u>28,945,615</u>	<u>18,974,350</u>
	<u>57,787,270</u>	<u>34,055,273</u>

APPROVED BY THE BOARD

(signed) "Craig Cameron", Director

(signed) "Denis Taillieu", Director

PARAGON PHARMACIES LIMITED

Consolidated Statements of Cash Flows Years Ended August 31, 2007 and 2006

	2007	2006
	\$	(Note 1) \$
CASH FLOWS RELATED TO THE FOLLOWING ACTIVITIES:		
OPERATING		
Net loss from continuing operations	(3,496,697)	(1,457,229)
Adjustments for:		
Financing costs on convertible debenture (Note 4)	2,341,647	-
Amortization	2,158,938	1,409,420
Stock-based compensation (Note 17)	200,228	698,114
Loss on equity investment (Note 19)	183,893	96,771
	<u>1,388,009</u>	<u>747,076</u>
Changes in non-cash working capital:		
Accounts receivable	562,298	(1,535,749)
Inventory	(1,066,811)	852,186
Prepaid expenses and deposits	(96,802)	(745)
Accounts payable and accrued liabilities	1,490,936	1,367,627
Income taxes receivable	-	30,970
Cash flow from operations from continuing operations	<u>2,277,630</u>	<u>1,461,365</u>
Cash flow from operations from discontinued operations (Note 9)	(54,293)	(57,474)
	<u>2,223,337</u>	<u>1,403,891</u>
FINANCING		
Advances to related parties	178,453	(648,822)
Cash from Rinoa (Note 3)	585,982	-
Issuance of convertible debenture, net of issuance costs (Note 22)	18,246,142	-
Issuance of share capital, net of share issuance costs (Note 17)	5,658,984	10,617,282
Advances (repayments) of long-term debt, net	(3,178,470)	8,743,566
Repayment of capital leases, net	(28,819)	(246,154)
	<u>21,462,272</u>	<u>18,465,872</u>
INVESTING		
Restricted cash (Note 23)	(20,110,574)	-
Cash held in trust	1,500,000	(1,500,000)
Proceeds on disposition of Paragon Central Fill Ltd.	-	250,000
Proceeds on disposition of pharmacy (Note 8)	465,211	-
Investment in private companies (Note 19)	(185,000)	-
Deferred acquisition costs	-	(156,774)
Purchase of intangible assets	-	(97,823)
Proceeds on disposal of capital assets	-	285,540
Purchase of capital assets	(792,917)	(299,374)
Cash paid on purchase of pharmacy (Note 7)	(1,815,091)	-
Cash paid on purchase of Super Drug Mart assets (Note 7)	-	(18,682,277)
	<u>(20,938,371)</u>	<u>(20,200,708)</u>
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	2,747,238	(330,945)
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	86,331	417,276
CASH AND CASH EQUIVALENTS, END OF YEAR	2,833,569	86,331

PARAGON PHARMACIES LIMITED

Notes to the Consolidated Financial Statements

Years Ended August 31, 2007 and 2006

1. NATURE OF OPERATIONS

Paragon Pharmacies Ltd. (the “Company” or “Paragon”) was incorporated on August 1, 2002 in the province of Alberta under the Alberta Business Corporations Act and commenced active operations in March 2003. The Company is comprised of one single operating segment which is drug store operations which focuses on the customer and the communities in which they are located. In addition, the pharmacies offer supplemental services such as Canada Post outlets, lottery tickets and transit sales.

On October 13, 2006 the respective shareholders of Paragon and Rinoa Enterprises Ltd. (“Rinoa”) approved the amalgamation of both companies. On October 31, 2006, the amalgamation was completed. The terms of the amalgamation involved the reverse take over of Rinoa by Paragon to create a new company under the name Paragon Pharmacies Limited (Note 3).

These consolidated financial statements reflect the amalgamation of Rinoa and Paragon on October 31, 2006 to create Paragon Pharmacies Limited.

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”).

Comparative Information

Comparative information has been reclassified to conform to current year’s presentation.

Consolidation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries which include Mironuck Pharmacy Ltd. (Note 8), Paragon Glenpark Pharmacy Ltd., Paragon Medical Supplies Ltd., Paragon Payless Pharmacy Ltd., Paragon Crestview Pharmacy Ltd., Paragon South Calgary Ltd. (Note 9), Paragon Black Mountain Pharmacy Ltd., Paragon Lake Country Pharmacy Ltd., Paragon Central Fill Ltd. (until October 31, 2005), Paragon Mission Pharmacy (B.C.) Ltd., Paragon Nordic Pharmacy Ltd. (Note 7) and Paragon Columbia Pharmacy Ltd.

All intercompany balances and transactions are eliminated on consolidation.

PARAGON PHARMACIES LIMITED

Notes to the Consolidated Financial Statements

Years Ended August 31, 2007 and 2006

2. SIGNIFICANT ACCOUNTING POLICIES (Continued)

Accounting for long-term investments

The Company's equity investments in, Catalyst Healthcare Ltd., ACO Super Drug Mart Ltd. and 1036985 Alberta Ltd. (Cochrane Super Drug Mart) have been recorded using the equity method.

Use of estimates

The preparation of the consolidated financial statements in conformity with Canadian generally accepted accounting principles 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 testing goodwill and long-lived assets for impairment. Changes in those estimates could materially affect the consolidated financial statements

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 22).

Inventory

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

PARAGON PHARMACIES LIMITED

Notes to the Consolidated Financial Statements

Years Ended August 31, 2007 and 2006

2. SIGNIFICANT ACCOUNTING POLICIES (Continued)

Capital assets

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

Furniture and fixtures	20%
Automotive	30%
Pharmacy equipment	30%
Computer equipment	30%
Computer software	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 useful life or a straight-line basis over the non-cancellable term of the lease.

Intangible assets

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

Prescription files	5 years
Pre-operating costs	5 years
Rebranding costs	2 years
Non-competition agreements	2 years

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

Deferred transaction costs

Deferred transaction costs include expenses incurred in the acquisition of new stores, including legal fees and other direct costs associated with ongoing acquisitions. These costs are deferred until the acquisition is made and are then included in the purchase price allocation for the acquisition. Costs associated with acquisitions that are not completed are written off when management makes a determination that the acquisition will not occur.

Also, included in deferred transaction costs are loan financing fees and deferred financing costs including commissions, legal fees and other direct costs of financing. These costs are amortized over the term of the related debt and/or advance.

PARAGON PHARMACIES LIMITED

Notes to the Consolidated Financial Statements

Years Ended August 31, 2007 and 2006

2. SIGNIFICANT ACCOUNTING POLICIES (Continued)

Goodwill

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

Goodwill is not amortized but is tested for impairment on an annual basis. In the event of impairment, the excess of the carrying amount over the fair value of these assets would be charged to earnings.

Long-lived assets

The carrying value of the Company's long-lived assets, including intangible assets and goodwill, is tested for recoverability when events or circumstances indicate that the carrying value exceeds the sum of the 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 fair value. The Company reviews long-lived assets for impairment annually.

Future income taxes

Income taxes are accounted for by the liability method of income tax allocation. 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.

Stock-based compensation

The Company issues stock options and warrants to certain directors, executives, employees and consultants (note 17). The Company accounts for grants under its plan in accordance with the fair value based method of accounting for stock-based compensation. The compensation expense is recognized over the period in which the option vests, with a corresponding increase to contributed surplus in shareholders' equity.

Per share amounts

Earnings per share is 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.

PARAGON PHARMACIES LIMITED

Notes to the Consolidated Financial Statements

Years Ended August 31, 2007 and 2006

3. AMALGAMATION WITH RINO A ENTERPRISES LTD.

Pursuant to the amalgamation (Note 1), all outstanding securities of both Paragon and Rinoa were exchanged for the Company's securities on a one for one basis. On November 2, 2006, the TSX Venture Exchange ("the Exchange") approved the amalgamation as Rinoa's Qualifying Transaction.

As a result, on November 3, 2006, Rinoa ceased to be a Capital Pool Company and its common shares were delisted from trading on the Exchange. Also on November 3, 2006, in accordance with Exchange Policy 2.5, the common shares of Paragon Pharmacies Limited commenced trading on the Exchange.

As Paragon was deemed to be the acquirer for accounting purposes, the Company's assets and liabilities are included in the consolidated financial statements at their carrying value.

As the shareholders of Paragon obtained control of Rinoa, reverse takeover accounting was applied. The amalgamation transaction costs of \$190,968 in excess of cash received have been charged to the consolidated statement of loss (Note 18).

The consolidated financial statements of the combined entities are considered a continuation of the financial statements of Paragon Pharmacies Limited.

The accounting for the reverse take-over reflects the fair value of Rinoa's assets acquired, after reflecting the business combination with Paragon as follows:

	\$
Current assets	3,896
Current liabilities	(79,815)
	(75,919)
Cash acquired	585,982
	510,063

As part of this transaction, 145,115 stock options ("Rinoa options") were assumed by the Company, with an exercise price of \$0.20. These options expire November 3, 2007 (note 17).

PARAGON PHARMACIES LIMITED

Notes to the Consolidated Financial Statements Years Ended August 31, 2007 and 2006

4. INTEREST EXPENSE

Interest expense includes the following:

	2007	2006
	\$	\$
Bank charges and interest	136,593	279,695
Interest on long term debt	658,896	385,133
Financing costs on convertible debenture (Note 12 and 23)	2,341,647	-
Interest income	(280,824)	(39,430)
Interest expense	<u>2,856,312</u>	<u>625,398</u>

5. CASH HELD IN TRUST

In 2006, the Company had funds held in trust related to acquisitions that were in progress.

6. BANK INDEBTEDNESS

The Company has a demand operating line of credit available to a maximum of \$2,500,000. This line bears interest at prime plus 1%. As at August 31, 2007, \$Nil (2006, \$Nil) has been drawn on this line of credit.

Included in the facility above, the Company has available a maximum of \$500,000 for the issuance of letters of credit in favor of Canada Post Corporation. These issued letters are renewed annually on August 1, as required. As at August 31, 2006 and 2007, letters aggregating \$480,000 have been issued.

These facilities 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.

PARAGON PHARMACIES LIMITED

Notes to the Consolidated Financial Statements

Years Ended August 31, 2007 and 2006

7. ACQUISITIONS

On March 1, 2007, the Company acquired all of the business assets of an independent pharmacy, for cash consideration of \$1,815,091, including acquisition costs, and an unsecured promissory note of the Company. This note bears interest at 4.5% per annum, is compounded semi-annually, unsecured and payable in two equal instalments, due March 2009.

The following table summarizes the consideration paid:

	<u>\$</u>
Cash consideration	1,727,518
Transaction costs	87,573
Promissory note (Note 15)	<u>600,000</u>
Total consideration paid	<u>2,415,091</u>

The following table summarizes the assets acquired:

	<u>\$</u>
Working capital	307,519
Capital assets	40,000
Intangible assets	1,109,999
Goodwill	<u>957,573</u>
Net assets acquired	<u>2,415,091</u>

b) Super Drug Mart

During fiscal, 2006, the Company purchased the business assets, inventory, contracts, agreements and intellectual property utilized by nine Super Drug Mart (“SDM”) retail pharmacy operations located in Western Canada as well as a 50% interest in the shares of 1036985 Alberta Ltd. (Cochrane Super Drug Mart) and a 50% interest in the shares of ACO Super Drug Mart Ltd. for aggregate consideration of \$22,724,468.

PARAGON PHARMACIES LIMITED

Notes to the Consolidated Financial Statements Years Ended August 31, 2007 and 2006

7. ACQUISITIONS (Continued)

The following table summarizes the assets acquired:

	<u>\$</u>
Working capital	7,153,984
Capital Assets	325,206
Intangible assets	3,533,712
Leases	466,551
Investments	362,350
Goodwill	10,882,665
Net assets acquired	<u>22,724,468</u>

8. DISPOSITION OF BUSINESS ASSETS

On May 9, 2007, the Company disposed of all of the business assets of a pharmacy for cash consideration of \$534,700. The purchaser assumed lease obligations of \$11,364. \$60,000 of the net proceeds are included in accounts receivable.

The following table summarizes the consideration received:

	<u>\$</u>
Cash received	474,700
Accounts receivable	60,000
Lease obligation assumed	11,364
Transaction costs	<u>(9,489)</u>
Net proceeds on disposition	536,575
Book value of assets disposed of	<u>(466,999)</u>
Gain on disposition of assets	<u>69,576</u>

The following table summarizes the assets disposed of:

	<u>\$</u>
Working capital	200,386
Capital assets	58,558
Intangible assets	137,247
Goodwill	70,808
Net assets disposed of	<u>466,999</u>

PARAGON PHARMACIES LIMITED

Notes to the Consolidated Financial Statements

Years Ended August 31, 2007 and 2006

9. DISCONTINUED OPERATIONS

The following table sets forth the results of discontinued operations relating to the disposition of pharmacies.

	2007	2006
	\$	\$
Revenue	975,071	1,954,771
Cost of sales	674,420	1,474,725
Gross profit	300,651	480,046
Expenses	448,459	610,508
Loss before other items	(147,808)	(130,462)
Loss on sales of capital assets	-	(16,360)
Write down of inventory due to discontinued operations	-	(18,428)
Gain on disposition	69,576	-
Loss from discontinued operations	(78,232)	(165,250)

	2007	2006
	\$	\$
Loss from discontinued operations	(147,808)	(165,250)
Non-cash items	12,343	30,664
Current assets	227,098	369,482
Current liabilities	(145,926)	(292,370)
Operating cash flow from discontinued operations	(54,293)	(57,474)

PARAGON PHARMACIES LIMITED

Notes to the Consolidated Financial Statements Years Ended August 31, 2007 and 2006

10. CAPITAL ASSETS

	2007		
	Cost	Accumulated	Net Book
	\$	Amortization	Value
	\$	\$	\$
Furniture and fixtures	893,020	316,380	576,640
Automotive	180,427	84,347	96,080
Equipment	54,173	19,959	34,214
Computer equipment	595,105	292,064	303,041
Computer software	117,075	101,439	15,636
Equipment under capital lease	214,724	77,144	137,580
Leasehold improvements	1,090,108	588,831	501,277
	3,144,632	1,480,164	1,664,468
	2006		
	Cost	Accumulated	Net Book
	\$	Amortization	Value
	\$	\$	\$
Furniture and fixtures	645,611	346,354	299,257
Automotive	131,689	52,884	78,805
Equipment	19,366	8,769	10,597
Computer equipment	545,083	325,402	219,681
Computer software	129,407	68,380	61,027
Equipment under capital lease	185,807	37,268	148,539
Leasehold improvements	1,089,279	538,282	550,997
	2,746,242	1,377,339	1,368,903

PARAGON PHARMACIES LIMITED

Notes to the Consolidated Financial Statements Years Ended August 31, 2007 and 2006

11. INTANGIBLE ASSETS

	2007		
	Cost	Accumulated	Net Book
	\$	Amortization	Value
	\$	\$	\$
Prescription files	7,945,816	3,529,322	4,416,494
Pre-operating costs	27,823	6,495	21,328
Operating leases	466,551	225,705	240,846
Rebranding costs	90,039	4,894	85,145
Non-competition agreements	10,000	10,000	-
	8,540,229	3,776,416	4,763,813

	2006		
	Cost	Accumulated	Net Book
	\$	Amortization	Value
	\$	\$	\$
Prescription files	7,245,105	2,270,100	4,975,005
Pre-operating costs	27,826	1,728	26,098
Operating leases	466,551	75,442	391,109
Deferred financing costs	70,000	4,667	65,333
Non-competition agreements	10,000	10,000	-
	7,819,482	2,361,937	5,457,545

PARAGON PHARMACIES LIMITED

Notes to the Consolidated Financial Statements Years Ended August 31, 2007 and 2006

12. DEFERRED TRANSACTION COSTS

	2007		
	Cost	Accumulated	Net Book
	\$	Amortization	Value
		\$	\$
Financing costs ⁽¹⁾	1,823,858	308,147	1,515,711
Acquisition costs	282,894	-	282,894
	2,106,752	308,147	1,798,605

⁽¹⁾ Of this amount, \$1,753,858 relates to the convertible debenture (note 22)

	2006		
	Cost	Accumulated	Net Book
	\$	Amortization	Value
		\$	\$
Acquisition costs	367,533	-	367,533
	367,533	-	367,533

The Company amortized \$308,147 (2006 - \$Nil) of deferred financing costs into interest expense.

13. GOODWILL

	2007	2006
	\$	\$
Opening Balance	12,420,709	1,538,044
Acquisitions (Note 7)	957,573	10,882,665
Dispositions (Note 8)	(70,808)	-
Closing Balance	13,307,474	12,420,709

PARAGON PHARMACIES LIMITED

Notes to the Consolidated Financial Statements Years Ended August 31, 2007 and 2006

14. DUE FROM (TO) RELATED PARTIES

	2007	2006
	\$	\$
ACO Super Drug Mart Ltd.	(132,433)	(67,392)
Catalyst Healthcare Ltd.	-	96,904
1036985 Alberta Ltd. (Cochrane Super Drug Mart)	551,664	184,058
Super Drug Mart Partnership	-	384,114
	419,231	597,684

The amounts due from (to) related parties are non-interest bearing, unsecured with no fixed terms of repayment. The parties are related as they have common shareholders.

15. LONG-TERM DEBT

	2007	2006
	\$	\$
Toronto Dominion Bank		
Loan payable bearing interest at tiered rates from prime plus 0.50% to prime plus 1.50% per annum, repayable in monthly instalments of \$166,667 plus interest, due April 2011.	7,333,333	9,333,333
Third Party Loan Agreement		
Non-interest bearing loan, unsecured, repayable in monthly instalments of \$83,333, due February 2008.	339,939	1,500,000
Promissory note (Note 7)		
Promissory note of the Company, unsecured, bearing interest at 4.5% per annum and compounded semi-annually payable in two equal instalments, due March 2009.	600,000	-
Other long-term debt		
Various loans bearing interest between 0% and prime plus 4.9%, secured by general security agreements, general assignments of book debts and personal guarantees, due between September 2007 and January 2012.	77,719	96,128
	8,350,991	10,929,461
Less current portion	2,671,326	3,037,853
	5,679,665	7,891,608

PARAGON PHARMACIES LIMITED

Notes to the Consolidated Financial Statements Years Ended August 31, 2007 and 2006

15. LONG-TERM DEBT (Continued)

Principal payments required in each of the next five twelve month periods ended August 31 are as follows:

	<u>\$</u>
2008	2,671,326
2009	2,320,652
2010	2,017,051
2011	1,340,033
2012	1,929

As part of the agreed upon terms of the purchase of the assets of Super Drug Mart Partnership Group the Company incurred a compensation obligation with respect to two employees. The obligation requires an annual payment of \$100,000 on each of April 28, 2008 and 2009.

16. CAPITAL LEASES

	<u>\$</u>
Repayments	
Period ending August 31, 2008	52,221
2009	25,580
2010	16,744
2011	14,871
2012	8,964
Balance of obligation	118,380
Less current portion	52,221
Long term capital leases expiring between 2009 and 2012	66,159

PARAGON PHARMACIES LIMITED

Notes to the Consolidated Financial Statements Years Ended August 31, 2007 and 2006

17. SHARE CAPITAL

	Number of Common Shares Issued	Amount \$
Authorized		
Unlimited number of common voting shares		
Unlimited number of first and second preferred shares, issuable in series, rights to be determined by directors		
Issued, common shares		
Balance, August 31, 2005, net of share issuance costs	9,453,099	8,322,254
Issuance of common shares for cash	7,500,000	7,500,000
Issuance of common shares for cash	4,931,500	3,945,200
Issuance of common shares on acquisition of SDM (note 7 (b))	5,000,000	4,000,000
Share issuance costs	-	(827,918)
Balance, August 31, 2006	26,884,599	22,939,536
Shares issued to the shareholders of Rinoa on the acquisition of Rinoa by Paragon, (Note 3)	5,299,825	510,063
Issued for cash on exercise of agent options	65,045	21,465
Issued for cash on private placement	5,000,000	4,000,000
Issued for cash on private placement (Note 17)	3,750,000	3,000,000
Share issuance costs ⁽¹⁾	-	(1,478,106)
Balance, August 31, 2007	40,999,469	28,992,958

⁽¹⁾ Share issuance costs include non-cash costs of \$115,625

PARAGON PHARMACIES LIMITED

Notes to the Consolidated Financial Statements

Years Ended August 31, 2007 and 2006

17. SHARE CAPITAL (continued)

Granting of options

The aggregate number of Common Shares that can be granted under the option plan to directors, officers, employees and consultants cannot exceed 10% of the Common Shares outstanding and no one optionee is permitted to hold options entitling such optionee to purchase more than 5% of the issued and outstanding Common Shares. The Options will vest as determined by the Board of Directors.

A summary of the stock option transactions is as follows:

	Number of Optioned Shares	Weighted average exercise price \$
Outstanding at August 31, 2005	585,500	1.31
Granted	-	-
Exercised	-	-
Expired/cancelled	-	-
Outstanding at August 31, 2006	585,500	1.31
Granted	1,055,000	0.80
Rinoa options assumed (note 3)	145,115	0.20
Exercised	(59,985)	0.20
Expired/cancelled	(199,998)	1.11
Outstanding at August 31, 2007	1,525,632	0.92

The options outstanding at August 31, 2007 were as follows:

Date Issued	Number of Options Outstanding	Exercise Price \$	Expiry Date
February 27, 2004	152,000	1.00	February 27, 2009
December 10, 2004	98,500	1.50	December 10, 2009
June 30, 2005	200,000	1.50	June 30, 2010
November 3, 2005	85,130	0.20	November 3, 2007
March 14, 2007	990,002	0.80	March 14, 2012
	<u>1,525,632</u>	0.92	

PARAGON PHARMACIES LIMITED

Notes to the Consolidated Financial Statements Years Ended August 31, 2007 and 2006

17. SHARE CAPITAL (Continued)

The options outstanding at August 31, 2006 were as follows:

Date Issued	Number of Options Outstanding	Exercise Price \$	Expiry Date
February 27, 2004	217,000	1.00	February 27, 2009
December 10, 2004	118,500	1.50	December 10, 2009
June 30, 2005	250,000	1.50	June 30, 2010
	<u>585,500</u>	1.31	

Warrants

A summary of the warrants transactions is as follows:

	Number of Warrant	Weighted average exercise price \$
Outstanding at August 31, 2005	312,905	1.32
Granted	5,635,000	0.96
Expired/cancelled	(255,918)	1.28
Outstanding at August 31, 2006	5,691,987	0.97
Granted	4,725,000	0.99
Expired/cancelled	(56,987)	1.28
Outstanding at August 31, 2007	10,360,000	0.97

The warrants outstanding at August 31, 2007 were as follows:

Date Issued	Number of Warrants	Number of Warrants Exercised	Number of Warrant s Expired	Total Warrants Outstanding	Exercise Price \$	Expiry Date
September 15, 2004	15,787	-	15,787	-	1.50	September 15, 2006
December 1, 2004	9,200	-	9,200	-	1.50	December 1, 2006
December 15, 2004	32,000	-	32,000	-	1.50	December 15, 2006
February 28, 2006	2,000,000	-	-	2,000,000	1.25	August 25, 2008
April 28, 2006	3,635,000	-	-	3,635,000	0.80	April 28, 2008
February 16, 2007	2,500,000	-	-	2,500,000	1.00	February 16, 2009
February 16, 2007	350,000	-	-	350,000	0.80	February 16, 2009
May 4, 2007	1,875,000	-	-	1,875,000	1.00	May 4, 2009
	<u>10,416,987</u>	-	<u>56,987</u>	<u>10,360,000</u>		

PARAGON PHARMACIES LIMITED

Notes to the Consolidated Financial Statements Years Ended August 31, 2007 and 2006

17. SHARE CAPITAL (Continued)

The warrants outstanding at August 31, 2006 were as follows:

Date Issued	Number of Warrants	Number of Warrants Exercised	Number of Warrants Expired	Total Warrants Outstanding	Exercise Price \$	Expiry Date
December 11, 2003	113,600	-	113,600	-	1.00	December 11, 2005
March 23, 2004	10,536	-	10,536	-	1.00	March 23, 2006
April 16, 2004	52,792	-	52,792	-	1.50	April 16, 2006
May 31, 2004	60,270	-	60,270	-	1.50	May 31, 2006
August 6, 2004	18,720	-	18,720	-	1.50	August 6, 2006
September 15, 2004	15,787	-	-	15,787	1.50	September 15, 2006
December 1, 2004	9,200	-	-	9,200	1.50	December 1, 2006
December 15, 2004	32,000	-	-	32,000	1.50	December 15, 2006
February 28, 2006	2,000,000	-	-	2,000,000	1.25	August 25, 2008
April 28, 2006	3,635,000	-	-	3,635,000	0.80	April 28, 2008
	<u>5,947,905</u>	<u>-</u>	<u>255,918</u>	<u>5,691,987</u>		

In conjunction with the \$3,000,000 private placement completed in 2007, 3.750 million units were issued (Note 22) whereby the Company issued 3.750 million common shares. In addition, attached to these units was a total of 1.875 million common share purchase warrants, exercisable at \$1.00 with an expiry term of two years.

The Company determined the fair value of the 1.875 million common share purchase warrants to be \$232,688, or \$0.19 each relating to this Convertible Debenture using the Black-Scholes option pricing model using the following assumptions: Nil dividend yields, expected volatility of 37%, risk-free interest rate of 4.25% and a term of two years.

In conjunction with the Company's private placement in February 2007 of 5 million units, a total of 2.5 million warrants were issued with the units and 350,000 warrants were issued to the agent, each exercisable into a common share at \$1.00 and \$0.80 per common share, respectively.

The Company determined the fair value of the 2.5 million common share purchase warrants to be \$306,776, or \$0.12, using the Black-Scholes option pricing model using the following assumptions: Nil dividend yields, expected volatility of 37%, risk-free interest rate of 4.00% and a term of two years.

The Company determined the fair value of the 350,000 common share purchase warrants to be \$66,965, or \$0.19, using the Black-Scholes option pricing model using the following assumptions: Nil dividend yields, expected volatility of 37%, risk-free interest rate of 4.00% and a term of two years.

PARAGON PHARMACIES LIMITED

Notes to the Consolidated Financial Statements Years Ended August 31, 2007 and 2006

17. SHARE CAPITAL (Continued)

Stock-based compensation

The Company recorded compensation expense totalling \$200,228 for the year ended August 31, 2007 (2006 - \$698,114). The company determined the fair value of the 1,055,000 options to be \$308,059, or \$0.31 each relating to this Convertible Debenture using the Black-Scholes option pricing model using the following assumptions: Nil dividend yields (2006 – Nil), expected volatility of 37% (2006 – 17 to 21%), risk-free interest rate of 3.92% (2006 – 3.13 to 3.47%) and a term of five years (2006 - five years).

Contributed surplus results from the recording of stock-based compensation as follows:

	2007	2006
	\$	\$
Contributed surplus, opening	935,063	236,949
Exercise of agents options	(8,456)	-
Stock-based compensation	200,228	698,114
Contributed surplus, ending	<u>1,126,835</u>	<u>935,063</u>

18. OTHER ITEMS

	2007	2006
	\$	\$
Amalgamation costs in excess of cash received (Note 3)	190,968	-
Income Tax Recovery	-	1,568
Loss (income) on equity investments:		
1036985 Alberta Ltd. (Cochrane Super Drug Mart)	143,183	(12,775)
ACO Super Drug Mart Ltd.	(31,935)	12,335
Catalyst Healthcare Ltd.	72,645	97,211
	<u>374,861</u>	<u>98,339</u>

PARAGON PHARMACIES LIMITED

Notes to the Consolidated Financial Statements

Years Ended August 31, 2007 and 2006

19. INVESTMENT IN PRIVATE COMPANIES AND LOSS ON EQUITY INVESTMENTS

The investment in private companies includes the following:

	<u>2007</u>	<u>2006</u>
	\$	\$
1036985 Alberta Ltd. (Cochrane Super Drug Mart)	272,839	362,800
ACO Super Drug Mart Ltd.	163,715	-
Catalyst Healthcare Ltd.	-	72,645
	<u>436,554</u>	<u>435,445</u>

a) 1036985 Alberta Ltd. (operating as Cochrane Super Drug Mart)

On April 28, 2006, the Company purchased 50% beneficial interest in the outstanding shares in 1036985 Alberta Ltd. (“Cochrane Super Drug Mart”) for \$350,025, an equity investment. In the year ended August 31, 2007 an additional investment of \$53,221 was made. The Company has recognized its portion of loss of \$143,183 for the year ended August 31, 2007 and income of \$12,775 for the year ended August 31, 2006, in the consolidated statements of operations and in its investment on the consolidated balance sheet at August 31, 2007 and August 31, 2006, respectively.

b) ACO Super Drug Mart Ltd.

On April 28, 2006, the Company purchased a 50% beneficial interest in the outstanding shares of ACO Super Drug Mart Ltd. (“ACO”) for \$12,325, an equity investment. In 2007, an additional investment of \$131,779 was made. The Company has recognized its portion of income of \$31,935 and loss of \$12,335 in the consolidated statements of operations and in its investment on the consolidated balance sheet at August 31, 2007 and August 31, 2006, respectively.

c) Catalyst Healthcare Ltd.

The Company has recognized its cumulative portion of loss in the investment of Catalyst Healthcare Ltd. of \$72,645 and \$97,211 in the consolidated statements of operations and in its investment on the consolidated balance sheet at August 31, 2007 and August 31, 2006, respectively. Since the Company’s portion of the cumulative loss exceeded its total investment, the investment was written down to \$Nil at November 30, 2006.

PARAGON PHARMACIES LIMITED

Notes to the Consolidated Financial Statements Years Ended August 31, 2007 and 2006

20. SUPPLEMENTAL CASH FLOW INFORMATION

	2007 \$	2006 \$
Cash and Cash equivalents represented by:		
Cash	719,769	86,331
Term deposits	2,113,800	-
Cash and cash equivalents	<u>2,833,569</u>	<u>86,331</u>
Interest paid	<u>658,896</u>	<u>385,388</u>

21. EARNINGS PER SHARE

	2007 \$	2006 \$
Weighted average shares used in:		
Basic	35,259,781	16,654,372
Diluted	36,590,146	16,654,372

Outstanding stock options, warrants and the accrued interest on the convertible debenture are the only instruments that are currently dilutive to earnings per share. In computing diluted per share amounts for the year ended August 31, 2007, 1,330,455 shares (2006 – Nil) were added to the basic weighted average shares outstanding for the dilutive effect of stock options, warrants and the accrued interest on the convertible debenture. At August 31, 2007, 1,440,502 options (2006 – 585,500) and 10,360,000 warrants (2006 – 5,691,987) to purchase common shares were not included in the computation because they were out of the money. No adjustments were required to the reported earnings in computing diluted per share amounts.

PARAGON PHARMACIES LIMITED

Notes to the Consolidated Financial Statements

Years Ended August 31, 2007 and 2006

22. CONVERTIBLE DEBENTURE

In May 2007, the Company issued a \$20,000,000 convertible debenture (“Convertible Debenture”). The Convertible Debenture has a term of two years and bears interest at 15% per annum, compounded and payable annually and matures in May 2009. The interest rate on the Convertible Debenture is subject to adjustment in certain circumstances and will convert into common shares under certain circumstances, or at the option of the lender. The Company has also agreed to indemnify the debenture holder for their share of the loss, if any, resulting from the claim described in Note 26. The debenture holder has the option to convert the principal amount of the debenture into equity at \$ 0.8028 per share at any time in the two year term of the debenture. As such, 24,912,085 shares have been reserved by the Company. Interest on the debenture, assuming no adjustment to the interest rate, over the two year term will total \$6,450,000 if the debenture is held to maturity or if the debenture is converted under the mandatory conversion provisions in the debenture agreement. In the event that the conversion is triggered due to the mandatory conversion provision, there is an interest pre-payment clause that will require the Company to compensate the debenture holder in an amount equal to the interest that would have been paid to maturity date, less interest accrued and paid to date of conversion. Subject to regulatory approval, the accrued interest will be paid in shares based on current share trading prices. The Company has reserved an additional 8,034,380 shares to facilitate future accrued interest settlements.

The liability component and the equity component of convertible instrument were segregated on initial recognition. The value of the equity component of this debenture was determined using the Black Scholes option pricing model using the following assumptions: Nil dividend yield, expected volatility of 37%, risk-free interest rate of 4.25% and a term of two years. The difference between the proceeds of the debentures issued and the fair value of the equity is assigned to debt.

	<u>\$</u>
Convertible Debenture – debt classification	
Total proceeds of convertible debentures	20,000,000
Fair value of convertible debentures, equity component	<u>(6,321,000)</u>
Value of liability component	13,679,000
Accretion to date	<u>1,053,500</u>
Balance, August 31, 2007	<u>14,732,500</u>
	<u>\$</u>
Convertible Debenture – equity classification	
Fair value of convertible debentures, equity component	6,321,000
Accrued interest to be settled by the issuance of shares	<u>980,000</u>
Balance, August 31, 2007	<u>7,301,000</u>

PARAGON PHARMACIES LIMITED

Notes to the Consolidated Financial Statements

Years Ended August 31, 2007 and 2006

22. CONVERTIBLE DEBENTURE (Continued)

In conjunction with the placement of the Convertible Debenture, the Company completed a private placement of 3,750,000 units for cash consideration of \$3,000,000 (Note 17). These units are comprised of 1 common share and ½ common share purchase warrant. The share purchase warrants have an exercise price of \$1.00 per share and have a term of two years.

The Company incurred \$1,753,858 million of direct financing costs for legal fees and other expenses as deferred charges, which are being amortized over the term of Convertible Debenture (Note 12).

Funds of \$20,000,000 from the Convertible Debenture financing are restricted for future acquisitions as reviewed and approved by the Board of Directors, and are not available for general use and are included in restricted cash on the Balance Sheet as at August 31, 2007. Interest of \$110,574 has been earned on these funds and is included in Restricted cash. These funds are held in Guaranteed Investment Certificates earning interest between 3.6% and 4.43%

23. RELATED PARTY TRANSACTIONS

During the year ended August 31, 2007, the Company completed a \$3,000,000 private placement (Note 17) and issued a \$20,000,000 Convertible Debenture (Note 22). The convertible debenture is held by Canterbury Park Capital L.P. and Canterbury Park Capital (U.S.) L.P. (collectively the "Partnerships"). Canterbury Park Management Inc. (Canterbury) is, the manager of The Partnerships. The Company has an Advisory agreement, for \$400,000 to be paid over a two year term commencing May 2007, with Canterbury, for ongoing consulting and advisory services. For the year ended August 31, 2007, the Company has paid \$82,258 to the Canterbury related to this Advisory agreement.

During 2007 the Company paid \$281,683 (2006 – \$95,168) in rent for premises leased under operating leases with related parties. 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.

During 2007 the Company paid a former director \$33,637 (2006 – \$14,907) for consulting services provided. 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.

PARAGON PHARMACIES LIMITED

Notes to the Consolidated Financial Statements

Years Ended August 31, 2007 and 2006

24. PENSION PLAN

Effective March 1, 2007, the Company established a defined contribution pension plan for its staff. 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 transportable. The contribution of the Company is between 4% and 7% of the employee’s gross wages, dependant upon employee class and years of service and limited by 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, 2007, the Company had contributed \$225,207 (2006 – Nil).

25. INCOME TAXES

	2007	2006
	\$	\$
Computed income tax expense at statutory rate of 33.50%, (2006 – 33.86%)	(1,197,601)	(534,058)
Stock-based compensation	67,076	234,566
Accretion costs on convertible debenture	352,923	-
Other permanent differences and rate changes	(190,341)	64,097
Change in valuation allowance	967,943	235,395
	-	-

At the end of the year, subject to confirmation by income tax authorities, the Company has approximately the following undeducted tax pools:

	2007	2006
	\$	\$
Undepreciated capital cost	2,208,825	1,672,180
Cumulative eligible capital	11,617,965	10,945,340
Non-capital losses carried forward for tax purposes with expiration dates between 2010 and 2027	3,918,976	2,080,625
Undeducted share issue costs carried forward	2,134,318	1,269,110
	19,880,084	15,967,255

PARAGON PHARMACIES LIMITED

Notes to the Consolidated Financial Statements

Years Ended August 31, 2007 and 2006

25. INCOME TAXES (Continued)

These pools 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	2007	2006
	\$	\$
Capital assets	(182,360)	(106,150)
Intangible assets	(579,484)	(1,939,970)
Goodwill	1,047,087	2,381,448
Investment in private companies	(47,011)	-
Deferred compensation	(67,000)	-
Capital leases	(39,657)	(51,520)
Share issue costs	(696,028)	(452,057)
Unused tax losses carry forward	(1,312,857)	(741,118)
	(1,877,310)	(909,367)
Valuation allowance	1,877,310	909,367
Future income tax liability (asset)	-	-

26. COMMITMENTS AND CONTINGENCIES

On April 5, 2007 the Corporation 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 Corporation believes that the allegations raised in the statement of claim are without merit and the Corporation intends to vigorously defend the action to the full extent permitted under law.

The Company is committed to a pre-payment clause on the Convertible Debenture (Note 22) that may require the Company, under certain condition, to pay an amount equal to the remaining interest due on the Convertible Debenture to the scheduled maturity date if mandatory conversion of the Convertible Debenture is triggered before the scheduled maturity date. The likelihood of the Company incurring an expense under the pre payment clause is currently not determinable and as such no accrual for this amount has been provided in the Company's financial statements.

PARAGON PHARMACIES LIMITED

Notes to the Consolidated Financial Statements

Years Ended August 31, 2007 and 2006

26. COMMITMENTS AND CONTINGENCIES (Continued)

The Company and its subsidiaries leased premises under operating leases, which expire between December 2007 and August 2014. Rental payments, excluding operating costs and taxes, over the next five periods ended August 31 are as follows:

	\$
2008	1,968,163
2009	2,075,397
2010	1,776,261
2011	1,628,905
2012	1,646,194

Three of the above leases were entered into 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 annual rent of \$282,350 in 2008, \$283,998 in 2009, \$212,539 in 2010, \$199,437 in 2011 and \$199,437 in 2012.

The Company also had access to a \$2,500,000 operating line with a Canadian chartered bank as at August 31, 2007. The Company utilized \$480,000 of the operating line for letter of credits (Note 6).

27. FINANCIAL INSTRUMENTS

Fair value

The carrying amount reported on the consolidated balance sheet for cash and cash equivalents, accounts receivable, due from (to) related parties and accounts payable and accrued liabilities approximated their fair value due to the short-term nature of these accounts. The carrying value of capital lease obligations approximated 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. The floating rate debt appropriately reflects rates currently available for debt with similar terms and maturities. Accordingly, the fair value of the debt is not materially different from the recorded value. The fixed rate debt, which has a carrying value of \$1,069,660 (2006 - \$1,579,241) at August 31, 2007, has a fair value of \$1,007,572 (2006 - \$1,493,030).

PARAGON PHARMACIES LIMITED

Notes to the Consolidated Financial Statements Years Ended August 31, 2007 and 2006

27. FINANCIAL INSTRUMENTS (Continued)

Interest rate risk

A portion of long-term debt is at a floating interest rate and as a result, the Company is exposed to changes in interest rates. Increases or decreases in these rates could affect the Company's earnings. A 1% change in the prime interest rate would reduce annual earnings by approximately \$63,000 (2006 - \$93,000).

Credit risk

The Company has credit risk associated with accounts receivable. The risk of collection is mitigated since these balances have been billed primarily to governments and third-party drug plans. There is no concentration of balances with debtors in the remaining accounts receivable.

28. SUBSEQUENT EVENTS

Subsequent to year end, the Company closed the acquisition of all the outstanding shares and business assets of a pharmacy for aggregate cash consideration of \$3,400,000 (subject to certain post-closing adjustments).

Subsequent to year end, the Company announced that it has entered into a purchase and sale agreement (the "Agreement") to acquire all of the assets of Westcoast Central Fill Ltd. ("Westcoast") from Westcoast and its parent, Catalyst Healthcare Ltd. ("Catalyst"). The total purchase price for the Westcoast assets is \$5,750,000, subject to adjustments.

Paragon currently owns 2,800,000 shares (26.4%) of Catalyst. Pursuant to the Agreement, payment of the purchase price will consist of \$2,950,000 in cash and the cancellation of the 2,800,000 shares that Paragon holds in the capital of Catalyst at a price of \$1.00 per share. Closing of this transaction is subject to receipt of all necessary third party consents and regulatory approvals.

The above acquisitions were funded 50% from the restricted cash (Note 22) and 50% from the debt facility below.

Subsequent to year end, the Company entered into a new debt facility. This facility includes an increase in the committed operating loan from \$2,500,000 to \$3,000,000, the existing reducing term loan of \$6,833,333, and an added revolving acquisition loan of \$7,500,000. All of these facilities have a two year term.