*Interim Consolidated Financial Statements of*

# PARAGON PHARMACIES LIMITED

*February 28, 2009 and February 29, 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 and Six Month Periods Ended February 28, 2009 and February 29, 2008**
**(Unaudited) (Thousands of dollars)**

| | **February 28, 2009 (3 months) $** | February 29, 2008 (3 months) $ | **February 28, 2009 (6 months) $** | February 29, 2008 (6 months) $ |
|---|---|---|---|---|
| **Revenue** | **22,204** | 21,589 | **43,987** | 39,267 |
| Cost of sales | **14,358** | 14,126 | **28,497** | 25,980 |
| Operating expenses | **5,699** | 5,536 | **11,571** | 10,100 |
| | **2,147** | 1,927 | **3,919** | 3,187 |
| Corporate and other costs | **1,037** | 809 | **2,333** | 1,719 |
| **Income before undernoted items** | **1,110** | 1,118 | **1,586** | 1,468 |
| Interest and accretion expense (Note 14) | **307** | 1,965 | **6,041** | 3,552 |
| Amortization | **1,065** | 838 | **2,153** | 1,401 |
| Stock-based compensation (Note 13) | **29** | 13 | **46** | 47 |
| Other items (Note 15) | **120** | 99 | **149** | 158 |
| | **1,521** | 2,915 | **8,389** | 5,158 |
| **Net loss and comprehensive loss** | **(411)** | (1,797) | **(6,803)** | (3,690) |
| **Deficit, beginning of period** | **(24,722)** | (10,098) | **(18,330)** | (8,475) |
| **Impact of adoption of financial instruments (Note 2)** | **-** | - | **-** | 270 |
| **Deficit, end of period** | **(25,133)** | (11,895) | **(25,133)** | (11,895) |
| **Loss per share (Note 17)** | | | | |
| Basic and diluted | **(0.01)** | (0.04) | **(0.07)** | (0.03) |

# PARAGON PHARMACIES LIMITED

## Interim Consolidated Balance Sheets
**February 28, 2009 and August 31, 2008**
**(Unaudited) (Thousands of dollars)**

| | **February 28, 2009** | August 31, 2008 |
|---|---|---|
| | **$** | $ |
| | (Unaudited) | |
| **ASSETS** | | |
| CURRENT | | |
| Cash and cash equivalents | **11,446** | 541 |
| Restricted cash (Note 11) | **-** | 13,728 |
| Accounts receivable | **4,211** | 5,042 |
| Inventory | **8,818** | 10,012 |
| Prepaid expenses and deposits | **451** | 691 |
| | **24,926** | 30,014 |
| Deferred transaction costs | **41** | 41 |
| Investment in and advances to private companies (Note 6) | **1,094** | 954 |
| Capital assets (Note 7) | **5,080** | 5,031 |
| Intangible assets (Note 8) | **10,351** | 11,694 |
| Goodwill (Note 9) | **15,103** | 15,103 |
| | **56,595** | 62,837 |
| **LIABILITIES** | | |
| CURRENT | | |
| Bank indebtedness (Note 10) | **-** | 921 |
| Accounts payable and accrued liabilities | **7,396** | 10,012 |
| Current portion of long-term debt (Note 12) | **9,182** | 2,427 |
| Current portion of capital leases | **9** | 32 |
| | **16,587** | 13,392 |
| Convertible debenture (Note 11) | **-** | 17,233 |
| Long-term debt (Note 12) | **5,997** | 13,848 |
| Capital leases | **7** | 51 |
| | **22,591** | 44,524 |
| **SHAREHOLDERS' EQUITY** | | |
| Share capital (Note 13) | **56,589** | 26,617 |
| Contributed surplus (Note 13) | **2,548** | 2,502 |
| Convertible debenture (Note 11) | **-** | 7,524 |
| Deficit | **(25,133)** | (18,330) |
| | **34,004** | 18,313 |
| | **56,595** | 62,837 |

Commitments and contingencies (Note 21)

# PARAGON PHARMACIES LIMITED

## Interim Consolidated Statement of Cash Flows

### Three Month and Six Month Periods Ended February 28, 2009 and February 29, 2008
### (Unaudited) (Thousands of dollars)

| | **February 28, 2009 (3 months) $** | February 29, 2008 (3 months) $ | **February 28, 2009 (6 months) $** | February 29, 2008 (6 months) $ |
|---|---|---|---|---|
| **CASH FLOWS RELATED TO THE FOLLOWING ACTIVITIES:** | | | | |
| **OPERATING** | | | | |
| Net loss and comprehensive loss | **(411)** | (1,797) | **(6,803)** | (3,690) |
| Adjustments for: | | | | |
| Interest and accretion expense (Note 14) | **128** | 1,894 | **5,321** | 3,516 |
| Amortization | **1,065** | 838 | **2,153** | 1,401 |
| Loss on disposal of capital assets | **-** | - | **6** | - |
| Stock-based compensation | **29** | 13 | **46** | 47 |
| Loss on equity investments | **120** | 99 | **143** | 158 |
| | **931** | 1,047 | **866** | 1,433 |
| Net change in non-cash working capital (Note 20) | **(141)** | (998) | **25** | (1,290) |
| Cash flow from continuing operations | **790** | 49 | **891** | 144 |
| **FINANCING** | | | | |
| Advances from (to) related parties | **22** | (228) | **(246)** | (148) |
| Issuance of share capital, net of share issuance costs | **-** | - | **8,568** | 17 |
| Financing costs | **(18)** | - | **(136)** | - |
| Proceeds on issuance (repayments)of long-term debt | **(791)** | 6,886 | **(1,374)** | 6,037 |
| (Repayment) of convertible debt | **-** | - | **(8,450)** | - |
| Decrease in bank indebtedness | **-** | - | **(921)** | - |
| Repayment of capital leases, net | **(61)** | (13) | **(67)** | (25) |
| Net change in non-cash working capital (Note 20) | **(680)** | - | **(808)** | - |
| | **(1,528)** | 6,645 | **(3,434)** | 5,881 |
| **INVESTING** | | | | |
| Restricted cash | **-** | 5,324 | **13,830** | 7,030 |
| Interest earned on restricted cash | **-** | (129) | **(102)** | (395) |
| Purchase of intangible assets | **-** | (5) | **(172)** | (6) |
| Purchase of capital assets | **(84)** | (561) | **(686)** | (1,135) |
| Deferred acquisition costs | **-** | (274) | **-** | (459) |
| Acquisitions (Note 5) | **-** | (10,710) | **-** | (14,103) |
| Net change in non-cash working capital (Note 20) | **(28)** | **-** | **578** | **-** |
| | **(112)** | **(6,355)** | **13,448** | **(9,068)** |
| **NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS** | **(850)** | 339 | **10,905** | (3,043) |
| **CASH AND CASH EQUIVALENTS (BANK INDEBTEDNESS) BEGINNING OF PERIOD** | **12,296** | (548) | **541** | 2,834 |
| **CASH AND CASH EQUIVALENTS (BANK INDEBTEDNESS) END OF PERIOD** | **11,446** | (209) | **11,446** | (209) |
| **Supplemental cash flow disclosure:** | | | | |
| Interest paid | **223** | 233 | **531** | 425 |
| Taxes paid | **-** | - | **-** | - |

### 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 these amalgamations, 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 the preparation of the audited annual consolidated financial statements for the year ended August 31, 2008, 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, 2008.

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

### Adoption of New Accounting Standards

***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. 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 ensures 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 February 28, 2009 the ratio as calculated by the Company was 0.516 compared to a maximum ratio of 2.5x provided in the lending agreement.

(tabular amounts in thousands, except per share amounts)

**3. CHANGE IN ACCOUNTING POLICIES *(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.

| | **February 28, 2009 $** (Unaudited) | August 31, 2008 $ |
|---|---|---|
| Cash and cash in escrow | **(11,446)** | (14,269) |
| Bank indebtedness | **-** | 921 |
| Current portion of long-term debt and capital leases | **9,191** | 2,459 |
| Convertible debenture | **-** | 17,233 |
| Long-term debt and capital leases | **6,004** | 13,899 |
| Net debt | **3,749** | 20,243 |
| Shareholders' equity | **34,004** | 18,313 |
| Total capitalization | **37,753** | 38,556 |
| Net debt: Shareholders' equity | **0.11** | 1.11 |
| Net debt: Total capitalization | **0.10** | 0.52 |
| EBITDA: Cash interest expense (1)(2) | **3.93** | 3.97 |

(1) For purposes of calculating the ratios, EBITDA is comprised of EBITDA 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 each of the periods 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

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

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 below and in Management's Discussion and Analysis.

**Future Accounting Standards**

***Goodwill and intangible assets***

In February 2008, the CICA issued a new accounting standard concerning Goodwill and Intangible Assets ("Section 3064"), which is based on the IASB's International Accounting Standard 38, 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. The standard is effective for interim and annual financial statements for fiscal years beginning on or after October 1, 2008. The Company currently anticipates applying the new accounting standards at the beginning of its 2010 fiscal year. The Company is currently assessing the impact of the new standard on the Company's results of operations, financial position and disclosures.

***Financial statement concepts***

In February 2008, the CICA issued amendments to Section 1000, "Financial Statement Concepts" to clarify the criteria for recognition of an asset and the timing of expense recognition. The new requirements are effective for fiscal years beginning on or after October 1, 2008. The Company currently anticipates applying the amendments to Section 1000 at the beginning of its 2010 fiscal year. The implementation of the amendments to Section 1000 are not expected to have an impact on the Company's results of operations, financial position and disclosures as the amendments are clarifications on the application of Section 1000.

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 are expected to converge with International Financial Reporting Standards ("IFRS") by the end of 2011. The Company is assessing the impact of convergence of Canadian GAAP and IFRS.

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

***Business combinations***

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 the convergence of Canadian GAAP with 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 Pharmacies Limited 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 Pharmacies Limited 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.

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 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

(tabular amounts in thousands, except per share amounts)

**4. AMALGAMATION WITH 1405257 ALBERTA LTD.** ***(continued)***

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. Subsequent to August 31, 2008, the Company paid the major third party pharmaceutical supplier the cash portion of the purchase price of $139,000 pursuant to the Debt Purchase Agreement.

The following table summarizes the results of the amalgamation:

| | $ |
|---|---|
| **Consideration:** | |
| Accounts payable | 139 |
| Autonomy loan | 4,000 |
| Transaction costs | (494) |
| Autonomy loan, net of financing fees | 3,645 |
| | |
| **Allocation:** | |
| 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 | (1,265) |
| | 3,645 |

## 5. ACQUISITIONS

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

(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

The Company has a 50% equity interest in the following companies. The advances due to private companies are non-interest bearing, unsecured with no fixed terms of repayment.

| | **February 28, 2009** **$** (Unaudited) | August 31, 2008 $ |
|---|---|---|
| 1036985 Alberta Ltd. (Cochrane Super Drug Mart) | | |
| Investment | **40** | 183 |
| Advances to | **753** | 508 |
| | **793** | 691 |
| ACO Super Drug Mart Ltd. | | |
| Advances to | **301** | 263 |
| | **1,094** | 954 |

(tabular amounts in thousands, except per share amounts)

## 7. CAPITAL ASSETS

| | February 28, 2009 (Unaudited) | | |
|---|---|---|---|
| | Cost $ | Accumulated Amortization $ | Net Book Value $ |
| Land | 85 | - | **85** |
| Building | 300 | 11 | **289** |
| Furniture and fixtures | 781 | 331 | **450** |
| Automotive | 280 | 145 | **135** |
| Equipment | 2,139 | 611 | **1,528** |
| Computer equipment | 956 | 447 | **509** |
| Computer software | 253 | 162 | **91** |
| Assets under capital lease | 153 | 93 | **60** |
| Leasehold improvements | 2,943 | 1,010 | **1,933** |
| | 7,890 | 2,810 | **5,080** |

| | August 31, 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** |

(tabular amounts in thousands, except per share amounts)

## 8. INTANGIBLE ASSETS

| | **February 28, 2009** (Unaudited) | | |
|---|---|---|---|
| | Cost $ | Accumulated Amortization $ | Net Book Value $ |
| Prescription files | 8,628 | 5,550 | **3,078** |
| Customer relationships | 8,903 | 2,020 | **6,883** |
| Pre-operating costs | 200 | 28 | **172** |
| Operating leases | 467 | 314 | **153** |
| Rebranding costs | 98 | 33 | **65** |
| | 18,296 | 7,945 | **10,351** |

| | **August 31, 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** |
| | 18,124 | 6,430 | **11,694** |

## 9. GOODWILL

| | **February 28, 2009 $** (Unaudited) | August 31, 2008 $ |
|---|---|---|
| Opening Balance | **15,103** | 13,307 |
| Acquisitions (Note 5) | **-** | 1,796 |
| Closing Balance | **15,103** | 15,103 |

(tabular amounts in thousands, except per share amounts)

## 10. BANK INDEBTEDNESS

The Company has a $3.0 million operating line of credit facility, bearing interest at prime plus 1.25% per annum. 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.

At February 28, 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 million (August 31, 2008 - $0.9 million), leaving $2.5 million (August 31, 2008 - $1.6 million) of the $3 million facility available. At February 28, 2009, the Company was in compliance with bank covenants.

## 11. CONVERTIBLE DEBENTURE

| **Convertible Debenture – debt classification** | **February 28, 2009 $ (Unaudited)** | August 31, 2008 $ |
|---|---|---|
| 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 period | - | 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 period | **-** | **7,524** |

**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 14,487,145 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, convertible at $0.35 per share for an aggregate of 3,926,200 common shares.

(tabular amounts in thousands, except per share amounts)

## 11. CONVERTIBLE DEBENTURE *(continued)*

A summary of restricted cash is as follows:

| | **February 28, 2009 $ (Unaudited)** | August 31, 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 period, including accrued interest receivable | **-** | 13,752 |

## 12. LONG-TERM DEBT

| | **February 28, 2009 $ (Unaudited)** | August 31, 2008 $ |
|---|---|---|
| Toronto Dominion Bank | | |
| Term loan, net of financing costs of $0.56 million (August 31, 2008 - $0.54 million), bearing interest at prime plus 1.75% per annum, repayable in monthly installments of $166,667 plus interest, due April, 2011. | **4,419** | 5,239 |
| Bank loan, net of financing costs of $0.11 million (August 31, 2008 - $ nil million) bearing interest prime plus 1.75% per annum repayable on December 9, 2009. | **6,940** | 7,060 |
| Autonomy Loan (note 4) | | |
| Loan payable, net of financing costs of $0.5 million (August 31, 2008 - $0.5 million), repayable 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. | **3,460** | 3,506 |
| Promissory note | | |
| Promissory note of the Company, unsecured, bearing interest at 4.5% per annum and compounded semi-annually, repayable March 2009. | **-** | 300 |

(tabular amounts in thousands, except per share amounts)

### 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 April 2009 and September 2013. | **360** | 170 |
| | **15,179** | 16,275 |
| Less current portion | **9,182** | 2,427 |
| | **5,997** | 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 February 28 are as follows:

| | $ |
|---|---|
| 2009 | **9,182** |
| 2010 | **2,032** |
| 2011 | **308** |
| 2012 | **4** |
| 2013 | **193** |

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

(tabular amounts in thousands, except per share amounts)

## 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 5) | (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, February 28, 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 three and six months ended February 28, 2009 the Company expensed $29,281 and $46,330 compared to $12,645 and $47,265 for the same periods in 2008.

(tabular amounts in thousands, except per share amounts)

## 13. SHARE CAPITAL (continued)

The fair value of options granted in the six months ended February 28, 2009, $78,000, was estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

| | |
|---|---|
| Risk free interest rate | 3.5% |
| Expected life of options | 5 years |
| Expected volatility | 60% |
| Expected dividend rate | 0% |

Contributed surplus arises from the following:

| | **February 28, 2009 $** (Unaudited) | August 31, 2008 $ |
|---|---|---|
| Balance - beginning of period | **2,502** | 1,127 |
| Exercise of agents options | **-** | (11) |
| Redemption of shares (Note 4) | **-** | 1,265 |
| Stock-based compensation | **46** | 121 |
| Balance - end of period | **2,548** | 2,502 |

A summary of stock option transactions is as follows:

| | **February 28, 2009** | | August 31, 2008 | |
|---|---|---|---|---|
| | **Number of Optioned Shares** | **Weighted average exercise price $** | Number of Optioned Shares | Weighted average exercise price $ |
| Outstanding - beginning of period | **1,201** | **0.69** | 1,526 | 0.92 |
| Issued | **350** | **0.22** | 617 | 0.45 |
| Exercised | **-** | **-** | (85) | 0.20 |
| Expired | **(547)** | **0.72** | (857) | 0.98 |
| Outstanding - end of period | **1,004** | **0.52** | 1,201 | 0.69 |

(tabular amounts in thousands, except per share amounts)

## 13. SHARE CAPITAL (continued)

The options outstanding at February 28, 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 | 200 | 200 | 0.80 | March 14, 2012 |
| May 28, 2008 | 374 | 339 | 0.45 | May 28, 2013 |
| October 21, 2008 | 50 | 17 | 0.21 | October 21, 2013 |
| November 15, 2008 | 300 | 50 | 0.23 | November 15, 2013 |
| | **1,004** | 686 | | |

The options not vested at February 28, 2009 will vest at various times through September 15, 2010. Under the current shareholder approved stock option plan, a total of 8.8 million options are available for issuance, calculated as 10% of the issued and outstanding common shares of the Company, 9.8 million, less the 1.0 million currently issued and outstanding.

*Warrants*

At February 28, 2009 the Company has 1,875,000 issued and outstanding fully vested warrants. The warrants have an exercise price of $1.00 and expire on May 4, 2009.

(tabular amounts in thousands, except per share amounts)

## 14. INTEREST AND ACCRETION EXPENSE

Interest and accretion expense includes the following:

| | **February 28, 2009 (3 months) $** | February 29, 2008 (3 months) $ | **February 28, 2009 (6 months) $** | February 29, 2008 (6 months) $ |
|---|---|---|---|---|
| **Convertible debenture** | | | | |
| Interest | - | 750 | **1,272** | 1,500 |
| Amortization of financing costs | - | 220 | **1,056** | 302 |
| Accretion | - | 922 | **1,711** | 1,712 |
| Inducement fee (note 11) | - | - | **1,374** | - |
| Total - convertible debenture | - | 1,892 | **5,413** | 3,514 |
| **Other** | | | | |
| Amortization of financing costs | **128** | 2 | **224** | 3 |
| Bank charges and interest | **14** | 38 | **66** | 77 |
| Interest on long-term debt | **209** | 195 | **465** | 348 |
| Interest income | **(44)** | (162) | **(127)** | (390) |
| | **307** | 1,965 | **6,041** | 3,552 |

* Note interest includes cash interest paid of $0.316 million Note 11(a)

## 15. OTHER ITEMS

| | **February 28, 2009 (3 months) $** | February 29, 2008 (3 months) $ | **February 28, 2009 (6 months) $** | February 29, 2008 (6 months) $ |
|---|---|---|---|---|
| Equity Loss: | | | | |
| 1036985 Alberta Ltd. (Cochrane Super Drug Mart) | **120** | 24 | **143** | 68 |
| ACO Super Drug Mart Ltd. | - | 75 | - | 90 |
| | **120** | 99 | **143** | 158 |
| Loss on disposal of capital assets | - | - | **6** | - |
| | **120** | **99** | **149** | 158 |

(tabular amounts in thousands, except per share amounts)

## 16. INCOME TAXES

| | **February 28, 2009 $** | February 29, 2008 $ |
|---|---|---|
| Net loss | **(6,803)** | (3,690) |
| Computed income tax expense at statutory rate of 30.17% (2008 – 29.29%) | **(2,052)** | (1,081) |
| Stock-based compensation | **14** | 14 |
| Accretion on convertible debenture | **642** | 461 |
| Other permanent differences | **331** | 355 |
| Effect of statutory rate change | **151** | 235 |
| Income taxes related to difference between carrying values and tax cost of acquisitions | **-** | (457) |
| Change in valuation allowance | **914** | 473 |
| | **-** | - |

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

| | **February 28, 2009 $** (Unaudited) | August 31, 2008 $ |
|---|---|---|
| Undepreciated capital cost | **5,161** | **5,735** |
| Cumulative eligible capital | **18,335** | **18,944** |
| Share issue costs and financing costs carried forward | **4,399** | **2,781** |
| Non-capital losses carried forward for tax purposes with expiration dates between 2010 and 2028 | **10,423** | **7,329** |
| | **38,318** | **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:

(tabular amounts in thousands, except per share amounts)

## 16. INCOME TAXES (continued)

| Nature of temporary differences | **February 28, 2009 $ (Unaudited)** | August 31, 2008 $ |
|---|---|---|
| Capital assets | **(67)** | (424) |
| Intangible assets | **(450)** | (259) |
| Goodwill | **499** | 432 |
| Investment in private companies | **(68)** | (20) |
| Deferred compensation | **(13)** | (27) |
| Preoperating costs | **25** | - |
| Deferred lease inducement | **(52)** | - |
| Capital leases | **(5)** | (21) |
| Share issue costs and financing costs | **(933)** | (491) |
| Non-capital tax losses carry forward | **(2,777)** | (2,117) |
| | **(3,841)** | (2,927) |
| Valuation allowance | **3,841** | 2,927 |
| **Future income tax liability (asset)** | **-** | - |

## 17. PER SHARE AMOUNTS

| | **February 28, 2009 (3 months)** | February 29, 2008 (3 months) | **February 28, 2009 (6 months)** | February 29, 2008 (6 months) |
|---|---|---|---|---|
| Basic and diluted weighted average number of shares | **97,606** | 41,085 | **73,491** | 41,055 |

As the Company has a loss, no adjustments were required in computing diluted per share amounts as all options and warrants to purchase common shares as well as the convertible debenture are anti-dilutive.

## 18. RELATED PARTY TRANSACTIONS

In addition to the transactions set out in Note 11, for the three and six months ended February 28, 2009, the Company expensed $25,000 and $50,000 respectively (three and six months ended February 29, 2008 $50,000 and $100,000 respectively) for advisory fees due to Canterbury Park Management Inc. Canterbury Park Management Inc. provides management services for a shareholder.

## 18. RELATED PARTY TRANSACTIONS (continued)

For the three and six months ended February 28, 2009, the Company expensed $nil and $135,000 respectively (2008-$ nil for both periods) to one member of the Board of Directors for consulting services. The Company also paid $66,000 for the three months ended, and $116,000 for the six months ended February 28, 2009 (three and six months ended February 29, 2008 $87,371 and $176,890 respectively) 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 three and six months ended February 28, 2009, the Company expensed $98,012 and $197,165 respectively (three and six months ended February 29, 2008 $87,371 and $176,890 respectively).

(tabular amounts in thousands, except per share amounts)

## 20. SUPPLEMENTAL CASH FLOW INFORMATION

| | **February 28, 2009 $ (3 months)** | February 29, 2008 $ (3 months) | **February 28, 2009 $ (6 months)** | February 29, 2008 $ (6 months) |
|---|---|---|---|---|
| **CHANGE IN NON-CASH WORKING CAPITAL** | | | | |
| **Operating** | | | | |
| Accounts receivable | 34 | (871) | 454 | (1,433) |
| Inventory | 1,635 | 139 | 1,194 | 164 |
| Prepaid expenses and deposits | (10) | (10) | 240 | (236) |
| Accounts payable and accrued liabilities | (1,800) | (256) | (1,863) | 216 |
| | (141) | (998) | 25 | (1,289) |
| **Financing** | | | | |
| Accounts receivable | (57) | - | (267) | - |
| Accounts payable and accrued liabilities | (623) | - | (541) | - |
| | (680) | - | (808) | - |
| **Investing** | | | | |
| Accounts receivable | - | - | 600 | - |
| Accounts payable and accrued liabilities | (28) | - | (22) | - |
| | (28) | - | 578 | - |

## 21. 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 and its subsidiaries lease premises under operating leases, which expire between 2009 and 2018. Rental payments, excluding operating costs and taxes, over the next five years ending February 28 are as follows:

| | **$** |
|---|---|
| 2009 | **2,265** |
| 2010 | **2,216** |
| 2011 | **2,220** |
| 2012 | **2,143** |
| 2013 | **1,886** |
| Thereafter | **3,076** |

## 21. COMMITMENTS AND CONTINGENCIES (continued)

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 $1.240 million from 2009 through 2013.

## 22. FINANCIAL INSTRUMENTS

*Fair value*
The carrying amount reported on the consolidated balance sheet for cash, restricted cash, accounts receivable, due from related parties and 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. 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 except for associated financing costs included therein (see note 12). The fixed rate debt, which has a carrying value of $0.56 million at February 28, 2009 (August 31, 2008 - $0.4 million), has a fair value of $0.56 million (August 31, 2008 - $0.4 million).

At August 31, 2008, the book value of the convertible debenture was $24.8 million, including the equity component thereof and associated financing costs. On November 14, 2008 the full amount of the debenture was converted and or repaid (see note 11).

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 February 28, 2009 the details of the aging of the Company's accounts receivable is as follows:

## 22. FINANCIAL INSTRUMENTS (continued)

| | |
|---|---|
| Due within 60 days | $3,899 |
| Due 60-120 days | 122 |
| Due 120 days+ | 190 |
| Total accounts receivable | $4,211 |

*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.

*Liquidity Risk*
Liquidity risk is the risk that the Company will not have cash available to satisfy financial liabilities as they come due.

In the prior quarter, the Company eliminated its convertible debenture and renegotiated certain terms of its debt agreements with its principal bank. As a result, restrictions requiring cash to be held in escrow were removed and the Company's capital structure improved significantly as more fully described in note 3.