

**PARAGON PHARMACIES LIMITED**

**MANAGEMENT'S DISCUSSION & ANALYSIS  
FOR THE THREE MONTH PERIOD ENDED NOVEMBER 30, 2010**

**As at January 27, 2011**

The following is a discussion of the consolidated financial condition and results of operations of Paragon Pharmacies Limited (the "Company") for the three month period ended November 30, 2010. This discussion and analysis should be read in conjunction with the Company's interim unaudited consolidated financial statements and accompanying notes for the three month period ended November 30, 2010. The interim unaudited consolidated financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles ("GAAP"). All references to dollars are in Canadian funds unless otherwise indicated. Additional information relating to the Company is available at [www.helloparagon.com](http://www.helloparagon.com) or [www.sedar.com](http://www.sedar.com).

**FORWARD LOOKING STATEMENTS**

This discussion of the consolidated financial condition and results of operations of the Company contains forward-looking statements regarding, among other things, the Company's beliefs, plans, objectives, strategies, estimates, intentions and expectations, including as they relate to its operating and financial results, capital expenditures and the ability to execute on its operating, investing and financing strategies. Consequently, actual results and events may differ materially from those included in, contemplated or implied by such forward looking statements for a variety of reasons. Forward-looking statements are subject to inherent risks and uncertainties including, but not limited to, market and general economic conditions, certain property and casualty risks, the ability to attract and retain pharmacists, the availability and terms of financing, changes in the Company's relationship with its key suppliers, competitive factors, changes in regulatory environments affecting the Company's business, and the accuracy in management's assumptions (see "RISKS AND RISK MANAGEMENT"). This list is not exhaustive of the factors that may affect any of the Company's forward-looking statements. Investors and others should carefully consider these and other factors and not place undue reliance on these forward-looking statements. In addition, these forward-looking statements relate to the date on which they were made and the Company disclaims and has no intention or obligation to update or revise any forward-looking statement, whether as a result of new information, future events or otherwise.

**NON-GAAP FINANCIAL MEASURES**

The Company reports its financial results in accordance with Canadian GAAP. However, the MD&A contains references to non-GAAP financial measures, such as operating income, gross margin, comparable store revenue, EBITDA (earnings before interest expense, interest income, depreciation and amortization, stock based compensation, other items, and income taxes), EBITDA per common share; cash interest expense, net debt and total capitalization. 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.

## Management's Discussion and Analysis *(continued)*

These non-GAAP financial measures have been included in this Management's Discussion and Analysis as they are measures which management uses to assist in evaluating the Company's operating performance against its expectations and against other companies in the retail pharmacy industry. Management believes that non-GAAP financial measures assist in identifying underlying operating trends.

These non-GAAP financial measures, particularly EBITDA, are also common measures used by investors, financial analysts and rating agencies. These groups may use EBITDA and other non-GAAP financial measures to value the Company and assess the Company's ability to service its debt.

### OVERVIEW

Paragon is headquartered in Kelowna, British Columbia and currently employs over 400 full and part time staff. The Company owns and operates 19 retail pharmacies and three central fill pharmacies in British Columbia, Alberta and Manitoba.

### STRATEGIES AND OUTLOOK

The pharmacy industry is facing significant regulatory change that is impacting prices of generic drugs and pharmacy allowances. These changes together with the general competitive environment pose significant challenges to the pharmacy industry's current economic model. This challenging regulatory and competitive environment also provides opportunity for companies with capital and the ability to adapt.

Paragon's success in achieving its objectives is dependent on its ability to adapt to these regulatory changes, and effectively utilize its capital position. The Company continues to focus on business strategies designed to provide success in the current environment that support revenue growth, build customer loyalty, develop the Paragon management team, improve profitability, and expand brand awareness.

The Company will continue to search for new acquisitions that support its long term growth strategies. The Company's capital position enables it to continue to search for new business development opportunities through acquisitions of pharmacies, prescriptions, and new store developments in Western Canada.

The Company is focused on developing further growth in its long term care operations through improved service and innovative technology and processes. Specifically the Company has begun to automate certain processes in its pharmacies to increase service, enhance quality control and improve efficiencies.

The hard work and dedication to customer service by the Company's pharmacy, front store and post office employees are primary contributors to the Company establishing itself as a community pharmacy of choice and are a key factor in building customer loyalty. The Company will continue strengthening training and development programs and focusing on improved customer service and brand awareness. Recent changes to pharmacy regulations will allow the Company to expand its professional service offerings to its customers in support of their health and wellness goals and the Company is active in moving forward on these opportunities.

## Management's Discussion and Analysis *(continued)*

The Company is improving its management team through careful recruitment and the development of appropriate employee policies to retain key people. The Company is specifically focused on strengthening its senior executive team with individuals who have a combination of solid training with national retailers, in addition to experience in smaller more dynamic organizations.

To improve profitability the Company has put significant effort into improving its supply chain process and relationships in order to maximize gross margin rates. Over the past quarter the Company has negotiated, and it continues to negotiate new supply agreements for both front store and pharmacy products. In addition, the wholesale and distribution process has been updated to provide the Company with direct control over purchasing programs, and closer ties to its key vendors. If future negotiations are successful, the Company believes it will see a continued steady increase in gross margins and profitability over the next four quarters.

### SUMMARY

#### ***Key Operating, Investing and Financial Metrics***

The following provides a summary of the Company's performance for the three month period ended November 30, 2010 compared to the three month period ended November 30, 2009.

- Revenue of \$19.668 million (2009: \$20.926 million), a decrease of 6.0%. (Refer to page 6 for further explanation)
- Comparable store revenue reduction of (5.3%) (Refer to page 6 for further explanation)
  - Comparable store pharmacy revenue reduction of (5.8%)
  - Comparable front store revenue<sup>1</sup> reduction of (6.7%).
- Gross margin<sup>2</sup> as a percentage of revenue of 38.8% (2009: 36.4%), an increase of 6.6%. (Refer to page 6 for further explanation)
- Operating income<sup>3</sup> of \$2.163 million (2009: \$2.012 million), an increase of 7.5%. (Refer to page 7 for further explanation)
- EBITDA of \$0.802 million (2009: \$1.061 million), a decrease of 24.4%. (Refer to page 7 for further explanation)

<sup>1</sup> Front store revenue includes all non-pharmacy revenue.

<sup>2</sup> Gross margin is defined as revenue minus cost of sales

<sup>3</sup> Operating income defined as revenue less cost of sales and operating expenses but excluding corporate and other costs, interest expense, amortization, stock based compensation and other items

### **First Quarter**

- The Company continued with its Information Technology improvement plan. An interactive voice response system was installed in most of its pharmacy locations. This system will reduce prescription fill times and improve customer service by allowing greater convenience and increased options for filling their prescriptions. With this system now in place it will further position the Company to take advantage of future technology advancements. The Company also began project work on an in-house payroll and time and attendance system that will be launched in early 2011. Once in place, this system will give management more effective tools to manage customer service level requirements as well as lower payroll processing fees.
- During the quarter, the Company continued strengthening its management team by recruiting two Vice Presidents.

Mr. Edward Li has joined the Company as Vice President, Operations. Mr. Li brings 35 years of extensive retail experience, during which he has a proven record of performance in guiding retail, grocery and consumer-goods companies through strategic growth and expansion. His past roles include positions as Vice President of Retail and Chairman of the Merchandising Committee at Overwaitea Food Group, and Senior Vice President, Loeb Products at Loeb, Inc. Mr. Li has balanced this strong corporate background with successful start-up and general management roles.

Mr. Michael Thomas has joined the Company as Vice President, Merchandising. Mr. Thomas brings 25 years of extensive retail experience in the marketing of groceries and dry goods in both retail and wholesale environments including private label marketing. Previously as the Vice President Grocery Merchandising at Westfair Foods, Mr. Thomas managed a \$3.5 billion per year merchandising group. He combines this strong corporate background with experience working with both smaller private companies and start-up enterprises.

- During the quarter, the Company appointed Ms. Kristal Kaye, Director of Finance and Administration, to the position of Chief Financial Officer. Ms. Kaye joined the Company in July 2008. In her new position, Ms. Kaye will continue to provide leadership across all functions of the Company, and will directly oversee Paragon's financial management and information technology.
- The Company completed renovations on one of its Calgary stores in preparation for this location to offer medical consultations and clinics to its patients, further positioning the location as the community pharmacy of choice in the area.
- In October 2010, the British Columbia Ministry of Health Services implemented the first of three scheduled pricing adjustments for generic molecules in the province. This adjustment maximized existing generics to 50% of brand equivalent, new generics (launched post November 2008) to 42% of brand equivalent, and increased the maximum dispensing fee reimbursed by PharmaCare to \$9.60 from the previous fee of \$9.10.

**RESULTS OF OPERATIONS**

The following table presents a summary of certain selected operating data and consolidated financial information for the Company:

(Thousands of dollars except per share amounts)	3 Months Ended		\$ Change	% Change
	Nov 30, 2010 \$	Nov 30, 2009 \$		
Revenue	19,668	20,926	(1,258)	(6.0%)
Gross Margin	7,635	7,608	27	0.4%
Operating Expenses <sup>1</sup>	5,472	5,596	(124)	(2.2%)
Operating Income	2,163	2,012	151	7.5%
Corporate and other costs	1,361	951	410	43.1%
EBITDA <sup>2</sup>	802	1,061	(259)	(24.4%)
Stock-based compensation	-	8	(8)	(100.0%)
Amortization	1,324	1,185	139	11.7%
Interest and accretion expense <sup>3</sup>	226	315	(89)	(28.3%)
Other Items <sup>4</sup>	17	36	(19)	(52.8%)
Net loss	(765)	(483)	(282)	(58.4%)
EBITDA per common share				
- Basic	\$0.01	\$0.01	-	-
- Diluted	\$0.01	\$0.01	-	-
Loss per common share				
- Basic	(\$0.01)	(\$0.00)	(\$0.01)	100.0%
- Diluted	(\$0.01)	(\$0.00)	(\$0.01)	100.0%

<sup>1</sup> Operating expenses include store level selling, general and administration expenses (excludes corporate expenses, amortization, interest expense and stock-based compensation)

<sup>2</sup> EBITDA defined as earnings before interest expense, income taxes, amortization, stock-based compensation and other items as defined.

<sup>3</sup> Interest expense includes bank charges and interest 2010: \$0.031 million (2009: \$0.031 million); interest on long term debt 2010: \$0.165 million, (2009: \$0.160 million); and interest income of 2010: \$0.003 million (2009: \$0.007 million). <sup>4</sup> Other items include loss on disposal of capital and intangible assets of 2010: \$0.017 million loss (2009: \$0.036 million loss).

The following table provides a quantitative reconciliation of net loss to EBITDA:

(Thousands of dollars)	3 Month Ended	
	November 30, 2010 \$	November 30, 2009 \$
Net loss	(765)	(483)
Add the following:		
Interest expense	226	315
Amortization	1,324	1,185
Stock-based compensation	-	8
Other items	17	36
EBITDA	802	1,061

### **Revenue**

Revenue is comprised of sales to customers of the Company's retail pharmacies and central fill pharmacies. Revenue was \$19.668 million in the first quarter compared to \$20.926 million in the same period last year, a decrease of \$1.258 million or 6.0%. Decreases were a result of a decline in comparable front store and pharmacy revenue.

Pharmacy revenue was impacted by reductions to generic pricing that came into effect in October 2010 offset by increases in dispensing fees that came into effect in British Columbia in July and October 2010 and Alberta in April 2010. Pharmacy revenues have also declined due to the continuing shift to lower priced generic drugs from brand products and a decline in script volumes in some regions.

Front store revenue has trended down due to the need for more effective category management, more consistent pricing strategies, and stronger in-store execution. To accelerate these needed changes Paragon has hired a Vice President of Merchandising and Vice President of Operations who each have significant experience in all phases of retail execution.

The Company continues to work on several initiatives to improve store competitiveness, including: working to improve its merchandising and promotions; working to elevate the competency of its store personnel; improving the Company's physical store infrastructure both in design and routine maintenance; improving asset protection to reduce shrinkage and increase margin; and continuing its focus on customer service.

### **Gross Margin**

Gross margin is calculated as revenue less cost of sales. Cost of sales is comprised of the cost of goods sold through the Company's retail pharmacies and central fill pharmacies. Gross margin was \$7.635 million in the first quarter compared to \$7.608 million in the same period last year, an increase of \$0.027 million or 0.4%. This is due to improved pharmacy margins of 2.9% over prior year resulting from the increased availability of generic products and an increase in front store margin of 3.4%.

This is the result of a shift to direct buying of high volume special merchandise, as well as management's continued focus on improved front store product offering, inventory management and in-store sales and promotions.

Gross margin as a percentage of revenue increased to 38.8% from 36.4% in the same period last year partially due to the pharmacy revenue changing to a greater percentage of sales coming from higher margin pharmacy revenues.

### **Operating Expenses**

Operating expenses include all store level selling, general and administration expenses (which include wages and benefits), store occupancy costs, and administration/other costs and excludes all corporate costs, interest expense, amortization, stock based compensation and other items as defined.

Operating expenses were \$5.472 million in the first quarter compared to \$5.596 million in the same period last year, a decrease of \$0.124 million or 2.2%. This was primarily a result of decreased occupancy costs offset by increased operating wages over the same period last year. Operating expenses as a percentage of revenue were 27.8% compared to 26.7% for the same period last year.

### **Operating Income**

Operating income is income generated from store level operations before corporate costs, amortization, interest expense, stock-based compensation and other items as defined.

Operating income was \$2.163 million in the first quarter compared to \$2.012 million in the same period last year, an increase of \$0.151 million or 7.5%. This increase is a result of improved gross margin and cost containment initiatives.

### **Corporate and Other Costs**

Corporate and other costs include all costs related to the corporate and administration offices including wages, benefits, occupancy, administration, and public company costs but excluding stock based compensation. Corporate and other costs were \$1.361 million in the first quarter compared to \$0.951 million in the same period last year, an increase of \$0.410 million or 43.1%. This increase is due to increased personnel and information technology spending, offset by decreased management fees and marketing expenses.

### **EBITDA**

EBITDA was \$0.802 million in the first quarter compared to \$1.061 million in the same period last year, a decrease of \$0.259 million or 24.4%. The decrease in EBITDA was primarily a result of decreased revenue and increased corporate costs offset by a stronger gross margin over the same period last year.

### **Interest expense**

Interest expense includes financing costs, bank charges and interest, interest on long-term debt and capital leases and is reported net of interest income.

Interest expense was \$0.226 million in the first quarter compared to \$0.315 million in the same period last year, a decrease of \$0.089 million. Bank charges and interest were \$0.031 million (2009 - \$0.031 million); interest and amortization of related financing costs on long-term debt was \$0.198 million (2009 - \$0.291 million); and interest income was \$0.003 million (2008 - \$0.007 million). Interest income declined due to lower levels of cash and cash equivalents.

### **Amortization**

Amortization of capital and intangible assets was \$1.324 million in the first quarter compared to \$1.185 million in the same period last year, an increase of \$0.139 million or 11.7%. This increase is due to amortization on capital and intangible asset additions.

### **Stock based compensation**

Stock based compensation was \$nil million in the first quarter compared to \$0.008 million in the same period last year, a decrease of \$0.008 million or 100.0%.

### **Net loss**

The net loss was \$0.765 million in the first quarter compared to a net loss of \$0.483 million in the same period last year, an increase in the loss of \$0.282 million or 58.4%. This change is primarily due to the reasons described above in EBITDA along with an increase in amortization.

## FINANCIAL POSITION

The following table provides a summary of certain information with respect to the Company's financial position at the end of the periods indicated.

Thousands of dollars	November 30, 2010 \$	August 31, 2010 \$
Cash and cash equivalents	(3,413)	(4,285)
Current portion of long-term debt and capital leases	951	952
Long-term debt and capital leases	6,694	7,008
Net debt <sup>1</sup>	4,232	3,675
Shareholders' equity	28,390	29,523
Total capitalization	32,622	33,198
Net debt: Shareholders' equity	0.15:1	0.12:1
Net debt: Total capitalization	0.13:1	0.11:1
EBITDA: Cash interest expense <sup>2</sup>	4.16:1	5.30:1

<sup>1</sup> Net debt is defined as total bank indebtedness, long term debt (including current portion), capital leases (including current portion), and is net of cash and cash equivalents.

<sup>2</sup> Cash interest expense excludes amortization of financing costs and is net of interest income.

## OUTSTANDING SHARE DATA

As of November 30, 2010 the Company had 92.5 million issued common shares outstanding. This reduction in common shares is the result of cancellation of 0.8 million shares through a normal course issuer bid initiated in October 2009 and renewed in October 2010. Further details are available in Note 7 of the unaudited consolidated financial statements as at November 30, 2010.

## LIQUIDITY AND CAPITAL RESOURCES

The Company has a three year credit facility which includes a \$5.0 million operating line which bears interest at prime plus 1% to prime plus 2% which is adjusted each quarter dependent on Company specific covenants outlined in the agreement. The operating line 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 November 30, 2010, the Company had issued letters of credit aggregating \$0.5 million (August 31, 2010 - \$0.5 million) leaving \$4.5 million (August 31, 2010 - \$4.5 million) of the \$5.0 million (August 31, 2010 - \$5.0 million) facility available. The Company was in compliance with its financial covenants as at November 30, 2010 and for the period then ended.

## Management's Discussion and Analysis *(continued)*

The Company's principal capital requirements are to fund working capital needs and renovate existing stores. These capital requirements have generally been satisfied by a combination of cash flow from operations and borrowings under its term and operating line of credit facility and the issuance of common shares. Capital required to fund acquisitions of pharmacies has been obtained through a combination of cash, debt financing and the issuance of common shares.

At November 30, 2010 the Company had, in addition to its bank facilities, on deposit \$3.4 million available to fund capital projects relating to existing stores as well as for working capital and acquisitions.

### **Operating Activities**

Cash flow from operating activities in the first quarter increased to \$0.392 million from \$0.342 million in the same period last year.

### **Financing Activities**

Net cash expenditures used in financing activities was (\$0.717) million in the first quarter compared to (\$0.921) million in the same period last year. The Company repaid \$0.384 million of long term debt obligations during the first quarter compared to \$0.681 million during the same period last year. The Company repurchased shares for \$0.368 million in the quarter under the Normal Course Issuer Bid that commenced October 9, 2009 and was extended October 12, 2010, compared to \$0.225 for the same period last year.

### **Investing Activities**

Net investment from investing activities was (\$0.547) million in the first quarter compared to a (\$1.066) million in the same period last year. The current year investing activities relates to the purchase of capital assets of (\$0.488) million including computer equipment and leasehold improvements and the purchase of intangible assets (\$0.072) million which is comprised mainly of computer software acquisitions. The prior year investing activities relate primarily to the acquisition of the prescription file of a pharmacy in Calgary, AB, for \$0.500 million and other capital and intangible asset expenditures of \$0.588 million. The pharmacy acquisition is discussed further under Note 5 of the unaudited consolidated financial statements as at November 30, 2010.

### **Future Liquidity**

The Company estimates that sufficient means exist to satisfy the Company's working capital needs, a limited number of acquisitions or greenfield developments and debt-service requirements for the coming fiscal year. Further acquisitions or greenfield developments may require additional debt and equity financing to ensure compliance with credit facility covenants. The Company remains subject to future impact of pharmacy reform and how it impacts the Company's ability to raise new debt or equity financing, or refinance existing debt.

## Management's Discussion and Analysis *(continued)*

The Company has secured a three year credit facility with a \$5.0 million operating line, \$5.0 million term loan and \$15.0 million acquisition facility effective April 6, 2010 with interest rates of prime plus 1% to prime plus 2% which is adjusted every quarter dependent on Company specific covenants outlined in the agreement. The term loan is payable in quarterly principal instalments amortized over five years from advance date. Advances under the acquisition facility are payable in quarterly principal installments amortized over five years from each advance date. The facility 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.

### TRANSACTIONS WITH RELATED PARTIES

For the quarter ended November 30, 2010, the Company expensed \$0.05 million (2009 - \$0.13 million) for advisory and executive services fees due to Canterbury Park Management Inc. Canterbury Park Management Inc. provides management services as a shareholder.

For the quarter ended November 30, 2010, the Company also paid \$0.05 million (2009 - \$0.05 million) in rent for premises leased under operating leases to one director.

These transactions are in the normal course of operations and have been recorded at the exchange amount, which is the amount agreed to by the related parties.

### QUARTERLY INFORMATION

#### Summary of Quarterly Information

The fiscal year-end of the Company is August 31 with quarter end falling on the following dates: November 30 (Quarter 1); February 28 (Quarter 2); May 31 (Quarter 3); August 31 (Quarter 4). The following table provides a summary of certain selected consolidated financial information for the Company for each of the eight most recently completed fiscal quarters. The consolidated financial statements have been prepared by management in accordance GAAP.

Thousands (except per share amounts)	First Quarter		Fourth Quarter		Third Quarter		Second Quarter	
	2011	2010	2010	2009	2010	2009	2010	2009
Revenue	19,668	20,926	20,260	20,532	20,947	21,615	20,785	22,204
EBITDA	802	1,061	632	965	890	1,529	976	1,110
- EBITDA per share - Basic	\$0.01	\$0.01	\$0.01	\$0.01	\$0.01	\$0.02	\$0.01	\$0.03
- EBITDA per share - Diluted	\$0.01	\$0.01	\$0.01	\$0.01	\$0.01	\$0.02	\$0.01	\$0.03
Net (loss) income	(765)	(483)	(1,063)	(469)	(584)	171	(464)	(401)
- Net loss per share - Basic	(\$0.01)	(\$0.00)	(\$0.01)	(\$0.01)	(\$0.01)	\$0.00	(\$0.01)	(\$0.01)
- Net loss per share - Diluted	(\$0.01)	(\$0.00)	(\$0.01)	(\$0.01)	(\$0.01)	\$0.00	(\$0.01)	(\$0.01)

### **RISKS AND RISK MANAGEMENT**

The Company is exposed to a number of operating and financial risks. A summary of these are as follows:

#### **Competition**

Pharmacy operations are very competitive, particularly in the front store merchandise and non-prescription drug categories. Many of the Company's current competitors are of a size and scale of operations that greatly exceeds those of the Company. Thus they may have access to more favorable procurement terms and other operating benefits not available to the Company that permits them to have certain cost advantages. Additionally, as the Company's competitors in the retail pharmacy business include independent operators, banner groups, retail chains, mass merchandisers and larger supermarket chains with combination food/drug retail operations, the Company may need to reduce prices in front store merchandise or reduce dispensing fees to maintain or increase market share, which could have an adverse impact on the Company's earnings.

#### **General economic conditions**

The Company currently operates in Western Canada and, like all businesses globally, it has been subject to the impact of the global credit and financial crisis on consumers in its areas of operations and the discretionary spending available to them. General economic conditions have resulted in reduced consumer spending and have impacted the Company's profitability. Should these conditions continue to prevail, there will be further pressure on the Company's profitability.

#### **Key Personnel**

The successful operation of the Company's business depends upon the abilities, expertise, judgment, discretion, integrity and good faith of its executive officers, management, employees and consultants. In addition, the ability of the Company to expand its services will depend upon the ability to attract qualified personnel as needed. The demand for skilled employees is high and the supply is limited. The unexpected loss of the Company's key personnel or the inability to retain or recruit skilled personnel could have a material adverse effect on the Company's business, financial condition, results of operations and cash flows. In particular, the Company is dependent upon its ability to attract, motivate and retain pharmacists for its stores. Increased competition in the retail pharmacy business has led to a shortage of pharmacists in Western Canada. The inability to attract and retain pharmacists could adversely affect the Company's business and earnings.

#### **Reliance on Information Systems and Technology**

The Company's business relies upon information technology systems to support its distribution, merchandise and pharmacy dispensing systems and to service customers at the point of sale. Its information technology systems may be vulnerable to unauthorized access, computer viruses, system failures, other malicious acts or acts of nature. Were a significant disruption to its information technology to occur, the Company's earnings could be adversely affected through loss of revenue and costs to rectify the disruption.

### **Industry and Regulatory**

The Company is reliant on prescription drug sales for a significant and growing portion of its sales and profits. Prescription drugs and their sales are subject to numerous federal, provincial, territorial and local laws and regulations. Changes to these laws and regulations, or non-compliance with these laws and regulations, could have a material adverse impact on the Company's business, sales and profitability. See also "REGULATORY CHANGES THAT IMPACT THE COMPANY'S INDUSTRY".

The Company is subject to periodic post reimbursement review of drug costs and dispensing fees by provincial health and third party authorities.

### **Internal Control Deficiencies**

The Company's inability to successfully address potential material weaknesses in internal controls or other control deficiencies may affect its ability to report its financial results on a timely and accurate basis and to comply with disclosure and other requirements.

### **Financial covenants in lending agreements**

The Company is dependent upon continued access to capital on terms acceptable to the Company, including bank indebtedness and lending facilities. There is no assurance that the Company will be able to comply with any or all financial covenants in the future. Should it not be able to meet covenants or arrange for amendments in the future, the Company would be exposed to the bank realizing on its security, thus hindering the ability of the Company to operate effectively.

### **Third-party Service Providers**

The Company is reliant upon third-party service providers in respect of certain of its operations, including a limited number of major suppliers of prescription drugs and specialized pharmacy equipment and software. Any negative events affecting these third-party service providers could, in turn, potentially impact the Company. The Company has entered into contractual arrangements to formalize these relationships and, to minimize operating risks the Company actively manages its relationships with its third-party service providers.

### **Real Estate**

The Company's success is dependent, among other things, on acquiring and maintaining locations suitable for its pharmacy and retail operations. The Company's business may be impacted if it is unable to secure or maintain suitable locations on lease terms that are commercially reasonable.

### **Seasonality**

The Company's core prescription drug operations are not typically subject to seasonal fluctuations. Its front store operations may see quarterly variation resulting from holiday periods such as Christmas or Easter.

### **Financial Instruments**

The Company is exposed to a number of risks associated with financial instruments that have the potential to affect its operating and financial performance. The Company's primary financial instrument risk exposure is to interest rate risk. The Company's exposure to foreign currency risk, credit risk and other price risk is not considered to be material. The Company may use derivative financial instruments to manage certain of these risks. The Company does not use derivative financial instruments for trading or speculative purposes.

### **Exposure to Interest Rate Fluctuations**

The Company is exposed to fluctuations in interest rates by virtue of its borrowings under its bank credit facilities. 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 rate risk to be material at this time as its revenues, costs of sales and expenses are substantially conducted in Canadian \$.

### **Credit Risk**

The Company does not consider its exposure to credit risk to be material as accounts receivable arise primarily in respect of prescription sales billed to governments and third-party drug plans.

## **REGULATORY CHANGES THAT IMPACT THE COMPANY'S INDUSTRY**

The Provincial jurisdictions in which the Company operates have undergone regulatory reform over the past several months.

In British Columbia, on July 9, 2010, the Ministry of Health Services announced a new long term agreement relating to the pricing of generic drugs and a fee schedule for services provided by pharmacists. The British Columbia strategy aims to reduce generic drug prices and make improvements to the drug system to benefit all residents of the province. The agreement limits the price of generic drugs previously set at up to 70% of the brand name equivalent, to 35% in step down phases over the next two year period. To help preserve the future viability of the community pharmacy, an increase in dispensing fee reimbursements by PharmaCare to pharmacies is also included in the agreement. Dispensing fees will increase from current rate of \$9.60 per prescription to \$10.50 gradually through April 2, 2012. Expansion of clinical pharmacy services is also expected and will be defined over the course of the agreement.

Further reductions to generic drug pricing were announced in Alberta. Effective April 1, 2010, the prices of existing generic drugs have been limited to 56% of the brand name product. Alberta has provided certain transitional and regional relief which will mitigate the effect of the changes announced from April 2010 to March 2013. Paragon, other pharmacy service providers and pharmacy focused organizations continue to discuss opportunities to better utilize pharmacists' education and expertise to deliver quality healthcare as well as to outline the potential harm to their financial viability resulting from efforts to reduce generic drug prices. As in British Columbia, community pharmacy stakeholders in Alberta are working to raise compensation rates for dispensing services.

The Company is also monitoring possible Manitoba regulatory change in reaction to the latest announcements in Alberta and British Columbia; however, no change has been announced at this time.

## Management's Discussion and Analysis *(continued)*

The previously announced changes in British Columbia and Alberta have been assessed to determine their impact on both Paragon's profitability and future strategy. The Company is working with its supply chain partners to develop more effective supply chain strategies that may help ensure that there is only moderate impact from these regulatory changes.

While regulatory changes do pose risks to Paragon's economic model, they also provide for new and alternative revenue stream opportunities. The Company is currently working to expand its scope of pharmacy practice to take advantage of these additional funding programs that are being simultaneously introduced. Companies such as Paragon with capital to implement changes to take advantage of these opportunities are positioned to succeed.

### **ESTIMATES**

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

### **OFF-BALANCE SHEET ARRANGEMENTS/VARIABLE INTEREST ENTITIES**

The Company has no off-balance sheet arrangements or variable interest entities.

### **CHANGES IN ACCOUNTING POLICIES**

In January 2009, the Canadian Institute of Chartered Accountants ("CICA") issued new accounting standards concerning Business Combinations and Consolidated Financial Statements which is based on IFRS 3 and International Accounting Standards "IAS" 27. The new sections replace 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 adopted these standards on September 1, 2010 and has concluded there is no material impact on its consolidated financial statements.

### **FUTURE ACCOUNTING PRONOUNCEMENTS**

International Financial Reporting Standards will replace Canadian GAAP for Canadian publically accountable enterprises effective for fiscal years beginning on or after January 1, 2011. The Company will implement these standards on September 1, 2011.

In accordance with IFRS, the Company will be required to report its results commencing with its fiscal year ending August 31, 2012, with the quarter ending November 30, 2011 being the first set of consolidated financial statements prepared under IFRS. Comparative figures for the quarter ending November 30, 2010 and year ended August 31, 2011 also need to be restated and presented, including an opening balance sheet as at September 1, 2010 reconciled from current Canadian GAAP to IFRS. For the year ended August 31, 2011 and comparative year ended August 31, 2010, the Company will continue to report its results in accordance with Canadian GAAP.

## Management's Discussion and Analysis *(continued)*

The Company commenced its process to transition to IFRS and developed an implementation plan of five phases, which in certain cases will be in process concurrently. The five phases are: (1) preliminary diagnostic and scoping; (2) detailed evaluation and design; (3) solution development; (4) integration; and (5) post-implementation review. To date, the Company is progressing according to its implementation plan, has completed the first phase and is beginning to work through the detailed evaluation and design. Below is a summary of the key deliverables for each phase, along with the project status.

1. Preliminary diagnostic and scoping phase. The Company completed this phase in the fourth quarter of fiscal 2010. During this phase, the Company: (1) developed its project structure; (2) established an estimated timeline for the plan completion; (3) created a project team to plan for and achieve a smooth transition to IFRS; (4) engaged a public accounting firm to assist with the high-level assessment of the significant differences between Canadian GAAP and IFRS specific to the Company; and (5) prioritized potentially affected areas based on their financial reporting impact, business impact and overall complexity to the Company.
2. Detailed evaluation and design phase. The Company commenced this phase in the first quarter of fiscal 2011 and plans to: (1) evaluate the IFRS standards, including the transitional provisions of IFRS 1, First-time Adoption of International Financial Reporting Standards; (2) assess policy alternatives allowed under the standards and any resulting impact to the Company; (3) select accounting policies when alternatives are available; and (4) develop draft IFRS consolidated financial statements and note disclosures. Any potential choice of policies and optional exemptions recommended during this phase will be reviewed by the Company's Audit Committee.
3. Solution development phase. The Company will commence this phase concurrent with many of the phase 2 activities in fiscal 2011 and plans to: consider the impact of the IFRS conversion on the Company's business processes, including information technology and data systems, internal control over financial reporting, disclosure control and procedures, financial reporting expertise, and other business activities; (2) develop and document solutions to each business process; and (3) quantify the impact of accounting policies chosen under IFRS at the date of transition and thereafter. Any significant impacts identified during this stage will be reviewed by the Company's Audit Committee.
4. Integration phase. The Company will commence this phase after the completion of the second and third phases. This phase of the work plan will include: (1) the approval, testing, and execution of solutions to each business process identified in the third phase; and (2) the collection of financial information necessary to compile IFRS compliant financial statements, including any information required to reconcile Canadian GAAP to IFRS at transition. The Company's Audit Committee will review and approve the IFRS compliant financial statements.
5. Post-implementation review phase. The Company will commence this stage after the changeover to IFRS and completion of the fourth phase. This phase involves assessing and evaluating the overall project performance.

## Management's Discussion and Analysis *(continued)*

The Company is completing its technical review of identified Canadian GAAP and IFRS differences and is focusing its efforts on the following standards:

### *IAS 36, Impairment of Assets*

The objective of IAS 36, "Impairment of Assets" (IAS 36") is to ensure that assets are carried at no more than their recoverable amount, through use or sale. An asset carried at more than its recoverable amount is considered impaired and an impairment loss must be recognized in income. A previously recognized impairment loss on an asset may be reversed if the factors have changed that were used to determine the asset's recoverable amount. An impairment loss for goodwill may not be reversed.

The requirements in IAS 36 are similar to those that exist in Canadian GAAP however there are differences in identification of cash-generating units, reversals in previously recognized impairment losses and the methodology for calculating the recoverable amount, including the use of discounting. The Company is currently reviewing the implications of IAS 36.

### *IFRS 3, Business Combinations*

The primary effects of adopting IFRS 3, "Business Combinations" ("IFRS 3"), compared to the current Canadian GAAP requirements are: the inability to capitalize acquisition costs which are currently considered part of the purchase price; subsequent acquisition purchase price adjustments (within 12 months) will require retroactive application and a restatement of prior periods; greater limitations exist for establishing restructuring provisions, thereby reducing the number or amount of provisions recognized on acquisition; and intangible assets (liabilities) arising from favourable (unfavourable) operating leases are recognized as a component of the leased asset where they are currently recognized as separate intangible assets or liabilities.

IFRS 1, "First-time adoption of International Financial Reporting Standards" ("IFRS 1"), states that first-time adopters may elect not to apply IFRS 3 retrospectively to business combinations that occurred before the date of transition to IFRS. The Company's current intention is to make election under IFRS 1 and only apply IFRS 3 to business combinations prospectively, or after September 1, 2010.

### *Other Standards*

In addition to the above standards, the Company is also focusing on IAS 12 "Income taxes" and the further options of IFRS 1 beyond those mentioned above. This list should not be regarded as a complete list of the IFRS standards that may have an impact on the Company's results of operations, financial position and disclosures. The list is intended to highlight areas the Company has identified may be significant. Final conclusions could change as the Company progresses through its implementation plan.

The IASB has ongoing projects, which management is monitoring, that could affect the ultimate differences between Canadian GAAP and IFRS and the impact those differences have on the Company's results of operations, financial position and disclosures.

**DISCLOSURE CONTROLS AND PROCEDURES AND INTERNAL CONTROLS OVER FINANCIAL REPORTING**

Multilateral Instrument 52-109 Certification of Disclosure in Issuers' Annual and Interim Filings requires the Chief Executive Officer ("CEO") and the Chief Financial Officer ("CFO") of the Company to file annual and quarterly certificates certifying that they are responsible for establishing and maintaining controls and procedures for the Company, and that they have designed such disclosure controls and procedures, or have caused them to be designed under their supervision, to provide reasonable assurance that material information relating to the Company is made known to them by others within the Company during the period in which the interim filings are being prepared.

Based on that evaluation and in light of the control weaknesses discussed below, the CEO and the CFO concluded that the disclosure controls and procedures as at the end of the period covered by the interim filings are effective in providing reasonable assurance that material information relating to the Company and its consolidated subsidiaries, that is required to be disclosed in reports filed or submitted under applicable securities law, is made known to them by others within these entities.

Internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation. Also, projections of any evaluation of effectiveness to future periods are subject to the risks that controls become inadequate because of changes in conditions or personnel, or that the degree of compliance with the policies or procedures may deteriorate.

In compliance with Multilateral Instrument 52-109, management must disclose in its MD&A any material weakness found to exist within its system of internal control over financial reporting. As reported last year, management had identified a material weakness in lack of segregation of duties. The management group of the Company is small and full segregation of all duties has not been possible. Management believes this is a typical issue for smaller companies.

Notwithstanding the above control weaknesses, the CEO and CFO have satisfied themselves that the control environment and reporting practices are such that reasonable assurance exists that material information related to the corporation and its subsidiaries has been made known to them.

The Board of Directors together with the Audit Committee have direct oversight responsibilities for the review and approval of the quarterly and annual financial disclosures.