

*Interim Consolidated Financial Statements of*

**PARAGON PHARMACIES LIMITED**

*For the nine month period ended May 31, 2010 and 2009  
(Unaudited)*

#### Notice to Reader

The attached interim consolidated financial statements of Paragon Pharmacies Limited for the three and nine month periods ended May 31, 2010 and 2009 have been prepared by management and have not been reviewed by the Company's independent external auditors.

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**PARAGON PHARMACIES LIMITED****Interim Consolidated Statements of Operations, Comprehensive (Loss) Income and Deficit  
Three Month and Nine Month Periods Ended May 31, 2010 and 2009  
(Unaudited)**

(Thousands of dollars, except per share amounts)

	<b>2010</b>	2009	<b>2010</b>	2009
	<b>(3 months)</b>	(3 months)	<b>(9 months)</b>	(9 months)
	<b>\$</b>	\$	<b>\$</b>	\$
<b>Revenue</b>	<b>20,947</b>	21,615	<b>62,658</b>	65,602
Cost of sales	<b>12,975</b>	13,383	<b>39,469</b>	41,971
Operating expenses (Note 3)	<b>5,821</b>	5,547	<b>16,846</b>	17,383
	<b>2,151</b>	2,685	<b>6,343</b>	6,248
Corporate and other costs	<b>1,261</b>	1,156	<b>3,416</b>	3,306
<b>Income before taxes and undernoted items</b>	<b>890</b>	1,529	<b>2,927</b>	2,942
Interest and accretion expense (Note 9)	<b>198</b>	316	<b>714</b>	6,357
Amortization (Note 3)	<b>1,298</b>	950	<b>3,737</b>	3,087
Stock-based compensation (Note 8)	<b>1</b>	14	<b>2</b>	60
Other items	<b>(23)</b>	78	<b>5</b>	226
	<b>1,474</b>	1,358	<b>4,458</b>	9,730
<b>(Loss) income and comprehensive (loss) income</b>	<b>(584)</b>	171	<b>(1,531)</b>	(6,788)
<b>Deficit, beginning of period</b>	<b>(26,534)</b>	(25,289)	<b>(25,511)</b>	(18,330)
Impact of change in accounting policy (Note 3)	-	-	<b>(76)</b>	-
<b>Deficit, end of period</b>	<b>(27,118)</b>	(25,118)	<b>(27,118)</b>	(25,118)
<b>(Loss) income per share (Note 11)</b>				
Basic and diluted	<b>(0.01)</b>	0.00	<b>(0.02)</b>	(0.08)

# PARAGON PHARMACIES LIMITED

## Interim Consolidated Balance Sheets

May 31, 2010 and August 31, 2009

(Thousands of dollars)

	May 31, 2010 \$ <b>(Unaudited)</b>	August 31, 2009 \$
<b>ASSETS</b>		
<b>CURRENT</b>		
Cash and cash equivalents	<b>6,945</b>	14,980
Accounts receivable	<b>4,291</b>	3,845
Inventory	<b>9,144</b>	8,114
Prepaid expenses and deposits	<b>772</b>	434
	<b>21,152</b>	27,373
Capital assets (Note 3)	<b>5,724</b>	5,515
Intangible assets (Note 3)	<b>7,058</b>	9,137
Goodwill	<b>15,103</b>	15,103
	<b>49,037</b>	57,128
<b>LIABILITIES</b>		
<b>CURRENT</b>		
Accounts payable and accrued liabilities	<b>9,159</b>	9,093
Current portion of deferred rent inducements	<b>91</b>	30
Current portion of long-term debt (Note 7)	<b>949</b>	10,612
Current portion of capital leases	<b>22</b>	28
	<b>10,221</b>	19,763
Long-term debt (Note 7)	<b>7,260</b>	3,521
Long-term deferred rent inducements	<b>645</b>	243
Capital leases	<b>-</b>	29
	<b>18,126</b>	23,556
<b>SHAREHOLDERS' EQUITY</b>		
Share capital (Note 8)	<b>54,687</b>	56,589
Contributed surplus (Note 8)	<b>3,342</b>	2,570
Deficit	<b>(27,118)</b>	(25,587)
	<b>30,911</b>	33,572
	<b>49,037</b>	57,128
Contingency (Note 13)		
Subsequent event (Note 16)		

# PARAGON PHARMACIES LIMITED

## Interim Consolidated Statement of Cash Flows

Three Month and Nine Month Periods Ended May 31, 2010 and 2009

(Unaudited)

(Thousands of dollars)

	2010 (3 months) \$	2009 (3 months) \$	2010 (9 months) \$	2009 (9 months) \$
<b>CASH FLOWS RELATED TO THE FOLLOWING ACTIVITIES:</b>				
<b>OPERATING</b>				
(Loss) income for the period	(584)	171	(1,531)	(6,788)
Adjustments for:				
Interest and accretion expense (Note 9)	26	132	180	5,453
Amortization	1,298	950	3,737	3,087
Write off deferred transaction costs	-	41	-	41
Loss on disposal of capital assets	-	1	28	6
Stock-based compensation (Note 8)	1	14	2	60
Loss on equity investments	-	77	-	220
	<b>741</b>	1,386	<b>2,416</b>	2,079
Net change in non-cash working capital	<b>552</b>	3,012	<b>(1,282)</b>	2,952
	<b>1,293</b>	4,398	<b>1,134</b>	5,031
<b>FINANCING</b>				
Reduction in advances to related parties	-	(28)	-	(311)
Issuance of share capital, net of issuance costs	-	-	-	8,568
Financing costs	(178)	-	(182)	(136)
Repayment of long term debt	(9,729)	(622)	(10,918)	(1,966)
Repayment of convertible debenture (Note 6)	-	-	-	(8,450)
Issuance of long term debt	5,000	-	5,000	-
Decrease in bank indebtedness	-	-	-	(921)
Repayment of capital leases	(6)	(2)	(41)	(69)
Shares repurchased (Note 8)	(498)	-	(1,132)	-
Net change in non-cash working capital	-	(18)	-	(826)
	<b>(5,411)</b>	(670)	<b>(7,273)</b>	(4,111)
<b>INVESTING</b>				
Restricted cash	-	-	-	13,830
Interest paid into restricted cash	-	-	-	(102)
Reduction (Addition) of intangible assets	28	-	(633)	-
Proceeds on disposal of capital assets	-	-	22	-
Purchase of capital assets	(220)	(515)	(1,285)	(1,108)
Net change in non-cash working capital	-	-	-	578
	<b>(192)</b>	(515)	<b>(1,896)</b>	13,198
<b>NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS</b>	<b>(4,310)</b>	3,213	<b>(8,035)</b>	14,118
<b>CASH AND CASH EQUIVALENTS BEGINNING OF PERIOD</b>	<b>11,255</b>	11,446	<b>14,980</b>	541
<b>CASH AND CASH EQUIVALENTS END OF PERIOD</b>	<b>6,945</b>	14,659	<b>6,945</b>	14,659
<b>Supplemental cash flow disclosure:</b>				
Interest paid	176	203	556	734
Income taxes paid	-	-	-	-

# **PARAGON PHARMACIES LIMITED**

## **Notes to Interim Consolidated Financial Statements**

**Nine Months Ended May 31, 2010 and 2009**

(tabular amounts in thousands, except per share amounts)

(Unaudited)

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### **1. NATURE OF OPERATIONS**

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

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

### **2. SIGNIFICANT ACCOUNTING POLICIES**

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

# PARAGON PHARMACIES LIMITED

## Notes to Interim Consolidated Financial Statements

Nine Months Ended May 31, 2010 and 2009

(tabular amounts in thousands, except per share amounts)

(Unaudited)

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

#### *Goodwill and intangible assets, financial statement concepts*

Effective September 1, 2009, the Company adopted a new accounting standard Handbook Section 3064 “Goodwill and Intangible Assets”. This section replaces the existing guidance on goodwill and other intangible assets and research and development costs, and provides additional guidance on measuring the cost of goodwill and intangible assets. Section 1000, “Financial Statement Concepts”, was also amended to provide consistency with this new standard to clarify the criteria for recognition of an asset and the timing of expense recognition.

Following the adoption of Section 3064, the Company reclassified the net carrying value of computer software that met the definition of intangible assets from capital assets to intangible assets on the consolidated balance sheet. The Company also wrote-off pre-operating costs through opening deficit. The prior year’s losses for the three and nine month periods ended May 31, 2009 were restated to recognize pre-operating costs relating to new store openings as operating expenses and to eliminate the amortization of pre-operating costs in the interim consolidated statement of operations.

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

	<u>August 31, 2009</u> \$
<b>Balance Sheet</b>	
	increase/ (decrease)
Capital assets	(443)
Intangible assets	<u>367</u>
	<u>( 76)</u>
Deficit	<u>( 76)</u>

# PARAGON PHARMACIES LIMITED

## Notes to Interim Consolidated Financial Statements

Nine Months Ended May 31, 2010 and 2009

(tabular amounts in thousands, except per share amounts)

(Unaudited)

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

	May 31, 2009 \$ (3 months)	May 31, 2009 \$ (9 months)
<b>Statement of operations, comprehensive (loss) income and deficit</b>	increase/ (decrease)	increase/ (decrease)
Operating expenses	(104)	69
Amortization	4	(13)
(Loss) income for the period	(100)	56
(Loss) income per share Basic and diluted	(0.00)	(0.00)
<b>Statement of cash flows</b>	May 31, 2009 \$ (3 months)	May 31, 2009 \$ (9 months)
Operating activities	increase/ (decrease)	increase/ (decrease)
(Loss) income for the period	(100)	56
Amortization	4	(13)
Investing activities	104	(69)
Reduction in intangibles	104	(69)
Net change in cash and cash equivalents	-	-

### Future Accounting Standards

#### *Business combinations and consolidated financial statements*

In January 2009, the CICA issued Handbook Section 1582, "Business Combinations", which replaces the existing standard. This section establishes the standards for the accounting of business combinations, and states that all assets and liabilities of an acquired business will be recorded at fair value. Obligations for contingent considerations and contingencies will also be recorded at fair value at the acquisition date. The standard also states that acquisition-related costs will be expensed as incurred and that restructuring charges will be expensed in the periods after the acquisition date and that non-controlling interests would be measured at fair value at the date of acquisition. This standard is applied prospectively to business

# PARAGON PHARMACIES LIMITED

## Notes to Interim Consolidated Financial Statements

Nine Months Ended May 31, 2010 and 2009

(tabular amounts in thousands, except per share amounts)

(Unaudited)

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

combinations with acquisition dates on or after January 1, 2011 and earlier adoption is permitted. The Company currently anticipates applying the new accounting standards at the beginning of its 2012 fiscal year. The Company expects to assess the impact of the new standard as part of its overall review of its convergence to IFRS.

#### *Multiple Deliverable Revenue Arrangements*

In December 2009, the Emerging Issues Committee (“EIC”) of the CICA issued EIC 175 “Multiple Deliverable Revenue Arrangements,” which replaces EIC 142 “Revenue Arrangements with Multiple Deliverables.” This new EIC addresses some aspects of the accounting by a vendor for arrangements under which it will perform multiple revenue generating activities and is effective for the first annual fiscal period beginning on or after January 1, 2011. The Company is currently evaluating the impact of the new EIC.

#### *International Financial Reporting Standards (IFRS)*

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

### 4. ACQUISITIONS

On October 28, 2009, the Company acquired the prescription file of a pharmacy in Calgary, Alberta for \$0.50 million cash consideration. The total cash cost of the acquisition was allocated to intangible assets prescription files on the basis of the fair value acquired. The acquisition agreement provides for an additional payment in November 2010 dependent on the volume of prescriptions at the store which was the primary beneficiary of this transaction for the year ended October 27, 2010. Based on current prescription volumes the Company estimates a further payment in the range of \$0.25 and \$0.40 million will be made to the seller.

# PARAGON PHARMACIES LIMITED

## Notes to Interim Consolidated Financial Statements

Nine Months Ended May 31, 2010 and 2009

(tabular amounts in thousands, except per share amounts)

(Unaudited)

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### 5. BANK INDEBTEDNESS

On April 6, 2010, the Company secured a new three year credit facility which includes a \$5.0 million operating line which bears interest at prime plus 1% to prime plus 2% dependent on Company specific covenants outlined in the agreement and revalued every quarter. The Company's previous credit facility, which matured April 6, 2010, contained a \$3.0 million operating line, bearing interest at prime plus 1.25% per annum.

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 (Note 7).

At May 31, 2010, the Company had issued letters of credit aggregating \$0.5 million (May 31, 2009 - \$0.5 million) leaving \$4.5 million (May 31, 2009 - \$2.5 million) of the \$5 million (May 31, 2009 - \$3.0 million) facility available.

### 6. CONVERTIBLE DEBENTURE

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

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

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

# PARAGON PHARMACIES LIMITED

## Notes to Interim Consolidated Financial Statements

### Nine Months Ended May 31, 2010 and 2009

(tabular amounts in thousands, except per share amounts)

(Unaudited)

#### 7. LONG-TERM DEBT

	May 31, 2010 \$ (Unaudited)	August 31 2009 \$
Canadian Imperial Bank of Commerce		
Term loan, net of \$0.18 million financing costs (August 31, 2009 - \$nil), bearing interest at prime plus 1.00% to prime plus 2.00% per annum depending on Company specific covenants, repayable in quarterly installments of \$0.25 million plus interest, due April 8, 2013.	4,832	-
Toronto Dominion Bank		
Term loan, net of \$nil financing costs (August 31, 2009 - \$0.54 million), bearing interest at prime plus 1.50% per annum, repayable in monthly installments of \$0.17 million plus interest, due April 6, 2010.	-	3,537
Bank loan, net of \$nil financing costs (August 31, 2009 - \$0.07) bearing interest at prime plus 1.50% per annum repayable April 6, 2010.	-	7,060
Autonomy Loan		
Loan payable, net of financing costs of \$0.4 million (August 31, 2009 - \$0.4 million), unsecured and repayable over a ten year period ending September 30, 2017. Interest accrues at the rate of 6.00% per annum.	3,350	3,485
Other long-term debt		
Various obligations bearing interest between 0% and 5.9%, secured by general security agreements, general assignments of book debts due between March 2010 and September 2013.	27	51
	<b>8,209</b>	14,133
Less current portion	<b>949</b>	10,612
	<b>7,260</b>	3,521

On April 6, 2010, the Company secured a new three year credit facility with a \$5.0 million operating line (Note 5), \$5.0 million term loan and \$15.0 million acquisition facility. Interest rates on the new credit facility are set at prime plus 1% to prime plus 2% dependent on Company specific covenants outlined in the agreement and revalued every quarter. The term loan is payable in quarterly principal installments amortized over 5 years from advance date. Advances under the acquisition facility are payable in quarterly principal installments amortized over 5 years from each advance date. The new facility is due to be repaid April 8, 2013.

# PARAGON PHARMACIES LIMITED

## Notes to Interim Consolidated Financial Statements

Nine Months Ended May 31, 2010 and 2009

(tabular amounts in thousands, except per share amounts)

(Unaudited)

### 7. LONG-TERM DEBT – (continued)

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.

This new facility replaces the existing \$3.0 million operating line and the bank term loan of approximately \$9.6 million which were repaid on closing the new facility.

Scheduled principal repayments excluding the Autonomy Loan for the period ending May 31, 2010 are as follows:

	\$
2011	949
2012	953
2013	2,955
2014	2

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

### 8. SHARE CAPITAL

Authorized

Unlimited number of common voting shares

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

	Number of Common Shares Issued	Amount \$
Balance, August 31, 2008	39,407	26,617
Issued for cash under private placement, net of issue costs	33,717	8,568
Issued on conversion of debenture and accrued interest	20,556	20,030
Issued as an inducement to convert the debenture	3,926	1,374
Balance, August 31, 2009	97,606	56,589
Purchased through market and subsequently cancelled	(3,141)	(1,902)
Balance, May 31, 2010	94,465	54,687

# PARAGON PHARMACIES LIMITED

## Notes to Interim Consolidated Financial Statements

Nine Months Ended May 31, 2010 and 2009

(tabular amounts in thousands, except per share amounts)

(Unaudited)

### 8. SHARE CAPITAL – (continued)

#### *Normal course issuer bid*

On October 8, 2009, the Company announced its intention to make a Normal Course Issuer Bid to purchase for cancellation up to a maximum of 4,880,319 shares. The Bid commenced on October 9, 2009 and will terminate on October 8, 2010 or such earlier time as the Bid is completed or terminated at the option of Paragon. As of May 31, 2010, 3.389 million shares have been purchased for cash consideration of \$1.132 million, of which 3.141 million were cancelled as of that date.

As of July 21, 2010, the Company has purchased 4.217 million shares for cash consideration of \$1.365 million, of which 3.975 million have been cancelled.

#### *Share unit plan*

In the third quarter of fiscal 2010, the Company has adopted a Share Unit Plan where up to 2.0 million common shares may be issued as Unit Awards and designated as restricted or performance awards. Each common share fair market value will be calculated using the weighted average of the common shares traded on the TSXV for ninety calendar days immediately preceding such date. Each Unit Award granted shall be subject to the terms and conditions of the Plan, and be subject to the requirements of the TSXV. As at May 31, 2010, no unit awards have been granted under the plan.

Contributed surplus arises from the following:

	<b>May 31, 2010</b>	August 31, 2009
	\$	\$
	<b>(Unaudited)</b>	
Balance - beginning of period	<b>2,570</b>	2,502
Cancellation of purchased shares	<b>770</b>	-
Stock-based compensation	<b>2</b>	68
Balance - end of period	<b>3,342</b>	2,570

# PARAGON PHARMACIES LIMITED

## Notes to Interim Consolidated Financial Statements

### Nine Months Ended May 31, 2010 and 2009

(tabular amounts in thousands, except per share amounts)

(Unaudited)

#### 8. SHARE CAPITAL – (continued)

##### *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 nine months ended May 31, 2010 the Company recorded a stock-based compensation expense of \$0.001 and \$0.002 million compared to \$0.014 million and \$0.060 million for the same periods in 2009.

Under the current shareholder approved stock option plan, a total of 2.4 million options are available for issuance, calculated as 3% of the issued and outstanding common shares of the Company, 2.8 million, less the 0.4 million currently issued and outstanding. At May 31, 2010, 0.01 million options have not vested but are scheduled to vest on June 30, 2010.

#### 9. INTEREST AND ACCRETION EXPENSE

Interest and accretion expense includes the following:

	May 31, 2010 (3 months) \$	May 31, 2009 (3 months) \$	May 31, 2010 (9 months) \$	May 31, 2009 (9 months) \$
<b><u>Convertible debenture</u></b>				
Interest	-	-	-	1,272
Amortization of financing costs	-	-	-	1,056
Accretion	-	-	-	1,711
Inducement fee (Note 6)	-	-	-	1,374
Total - convertible debenture	-	-	-	5,413
<b><u>Other</u></b>				
Amortization of financing costs	26	132	180	356
Bank charges and interest	49	30	114	96
Interest on long-term debt	127	173	442	638
Interest income	(4)	(19)	(22)	(146)
	<b>198</b>	<b>316</b>	<b>714</b>	<b>6,357</b>

# PARAGON PHARMACIES LIMITED

## Notes to Interim Consolidated Financial Statements

### Nine Months Ended May 31, 2010 and 2009

(tabular amounts in thousands, except per share amounts)

(Unaudited)

#### 10. INCOME TAXES

	May 31, 2010 \$	May 31, 2009 \$
Loss for the period	(1,531)	(6,788)
Computed income tax expense at statutory rate of 30.44% (2009 – 30.33%)	(466)	(2,058)
Stock-based compensation	1	18
Accretion on convertible debenture	-	642
Other permanent differences	227	351
Impact of future tax rate differences	(9)	141
Change in valuation allowance	247	906
	-	-

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

	May 31, 2010 \$ (Unaudited)	August 31, 2009 \$
Undepreciated capital cost	5,658	5,398
Cumulative eligible capital	17,346	17,665
Share issue costs and financing costs carried forward	2,528	3,652
Non-capital losses carried forward for tax purposes with expiration dates between 2010 and 2029	11,053	11,357
	36,585	38,072

# PARAGON PHARMACIES LIMITED

## Notes to Interim Consolidated Financial Statements

Nine Months Ended May 31, 2010 and 2009

(tabular amounts in thousands, except per share amounts)

(Unaudited)

### 10. INCOME TAXES - (continued)

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

Nature of temporary differences	May 31,	August 31,
	2010	2009
	\$	\$
	(Unaudited)	
Capital assets	(1)	94
Intangible assets	(1,240)	(813)
Goodwill	613	562
Deferred rent inducements	(191)	(71)
Capital leases	(6)	(15)
Share issue costs and financing costs	(507)	(797)
Non-capital tax losses carry forward	(2,898)	(2,943)
	(4,230)	(3,983)
Valuation allowance	4,230	3,983
<b>Future income tax liability (asset)</b>	<b>-</b>	<b>-</b>

### 11. PER SHARE AMOUNTS

	May 31,	May 31,	May 31,	May 31,
	2010	2009	2010	2009
	(3 months)	(3 months)	(9 months)	(9 months)
Weighted average number of shares				
Basic	95,549	97,606	96,669	81,618
Diluted	95,549	97,754	96,669	81,618

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

### 12. RELATED PARTY TRANSACTIONS

In addition to the transactions set out in Note 6, for the three and nine months ended May 31, 2010, the Company expensed \$0.10 million and \$0.33 million respectively (three and nine months ended May 31, 2009 - \$0.03 million and \$0.08 million respectively) for advisory and executive services fees to Canterbury Park Management Inc. Canterbury Park Management Inc. provides management services as a shareholder. Under the current agreement, the

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## Notes to Interim Consolidated Financial Statements

### Nine Months Ended May 31, 2010 and 2009

(tabular amounts in thousands, except per share amounts)

(Unaudited)

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#### 12. RELATED PARTY TRANSACTIONS - *(continued)*

Company pays \$0.20 million a year for advisory services and paid \$0.03 million a month up to April 30, 2010 for executive services.

For the three and nine months ended May 31, 2010, the Company expensed \$nil million and \$nil million respectively (three and nine months ended May 31, 2009 - \$Nil and \$0.135 million respectively) to one member of the Board of Directors for consulting services. The Company also paid \$0.050 million for the three months ended, and \$0.145 million for the nine months ended May 31, 2010 (three and nine months ended May 31, 2009 - \$0.066 million and \$0.116 million respectively) in rent for premises leased under operating leases with parties related to a director. These transactions are in the normal course of operations and have been recorded at the exchange amount, which is the amount agreed to by the related parties.

#### 13. CONTINGENCY

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

#### 14. CAPITAL MANAGEMENT

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

# PARAGON PHARMACIES LIMITED

## Notes to Interim Consolidated Financial Statements

Nine Months Ended May 31, 2010 and 2009

(tabular amounts in thousands, except per share amounts)

(Unaudited)

### 14. CAPITAL MANAGEMENT – (continued)

The Company considers its total capitalization to be long-term debt (including the current portion thereof) and shareholders' equity, net of cash. The Company also gives consideration to its obligations under operating leases when assessing its total capitalization. Currently, the Company has available cash resources to make necessary capital investments and to fund a limited number of acquisitions. The Company will require additional debt and/or equity capital to fund any significant opportunities.

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

As part of its existing lending agreement, the Company monitors its net senior debt to EBITDA (earnings before interest and accretion expense, interest income, depreciation and amortization, stock based compensation, other items including loss from equity investments, and income taxes) ratio as defined in its lending agreement. At May 31, the Company was in compliance with its bank covenants.

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

	May 31, 2010 \$ (Unaudited)	August 31, 2009 \$
Cash and cash equivalents	(6,945)	(14,980)
Current portion of long-term debt and capital leases	971	10,640
Long-term debt and capital leases	7,260	3,550
Net debt	1,286	(790)
Shareholders' equity	30,911	33,572
Total capitalization	32,197	32,782
Net debt: Shareholders' equity	0.04	(0.02)
Net debt: Total capitalization	0.04	(0.02)
EBITDA: Cash interest expense <sup>(1)(2)</sup>	5.26	5.16

# PARAGON PHARMACIES LIMITED

## Notes to Interim Consolidated Financial Statements

Nine Months Ended May 31, 2010 and 2009

(tabular amounts in thousands, except per share amounts)

(Unaudited)

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### 14. CAPITAL MANAGEMENT – *(continued)*

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

### 15. COMPARATIVE FIGURES

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

### 16. SUBSEQUENT EVENT

On July 9, 2010, the British Columbia 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 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. The agreement also allows for an increase in dispensing fee reimbursements by PharmaCare to pharmacies. These dispensing fees will increase from the current rate of \$8.60 per prescription to \$10.50 gradually through April 2, 2012. Expansion of clinical pharmacy services are also expected and will be defined over the course of the agreement. The outcome of these changes is not determinable at this time.