

Consolidated Financial Statements of

PARAGON PHARMACIES LIMITED

August 31, 2011 and 2010



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INDEPENDENT AUDITORS' REPORT

To the Shareholders of Paragon Pharmacies Limited

We have audited the accompanying consolidated financial statements of Paragon Pharmacies Limited, which comprise the consolidated balance sheets as at August 31, 2011 and August 31, 2010, the consolidated statements of operations, comprehensive loss and deficit, and cash flows for the years then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with Canadian generally accepted accounting principles, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.



Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the consolidated financial position of Paragon Pharmacies Limited as at August 31, 2011 and August 31, 2010, and its consolidated results of operations and its consolidated cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Signed "**KPMG LLP**"

Chartered Accountants

November 17, 2011

Winnipeg, Canada

PARAGON PHARMACIES LIMITED

Consolidated Statements of Operations, Comprehensive Loss and Deficit

(in thousands of Canadian dollars except per share amounts)

Years ended August 31	2011	2010
Revenue	\$ 76,688	\$ 82,217
Cost of sales	46,108	50,965
Operating expenses	22,244	22,974
	8,336	8,278
Corporate and other costs	5,475	4,719
Income before undernoted items	2,861	3,559
Amortization (Notes 6 and 7)	5,359	5,061
Interest expense (Note 11)	805	885
Stock-based compensation (Note 10)	36	2
Other (income) expense	(101)	205
	6,099	6,153
Loss and comprehensive loss for the year	(3,238)	(2,594)
Deficit, beginning of year	(28,181)	(25,587)
Deficit, end of year	\$ (31,419)	\$ (28,181)
Loss per share (Note 13)		
Basic and diluted	\$ (0.04)	\$ (0.03)

See accompanying notes to the consolidated financial statements

PARAGON PHARMACIES LIMITED

Consolidated Balance Sheets

(in thousands of Canadian dollars)

As at August 31	2011	2010
Assets		
Current		
Cash and cash equivalents	\$ 3,429	\$ 4,285
Accounts receivable	4,672	4,889
Inventory	8,388	8,921
Prepaid expenses and deposits	563	643
	17,052	18,738
Capital assets (Note 6)	6,843	6,386
Intangible assets (Note 7)	3,532	6,922
Goodwill	15,103	15,103
	\$ 42,530	\$ 47,149
Liabilities		
Current		
Accounts payable and accrued liabilities	\$ 8,036	\$ 8,953
Current portion of long-term debt (Note 9)	1,144	936
Current portion of deferred rent inducements	106	91
Current portion of capital leases	-	16
	9,286	9,996
Long-term debt (Note 9)	6,692	7,008
Other long-term liabilities (Note 8)	927	-
Deferred rent inducements	588	622
	17,493	17,626
Shareholders' Equity		
Share capital (Note 10)	51,572	54,010
Contributed surplus (Note 10)	4,884	3,694
Deficit	(31,419)	(28,181)
	25,037	29,523
	\$ 42,530	\$ 47,149

Commitments and contingencies (Note 18)

See accompanying notes to the consolidated financial statements

On behalf of the Board of Directors:

(signed) *"Martin Weinberg", Director*

(signed) *"Gerry Martin", Director*

PARAGON PHARMACIES LIMITED

Consolidated Statements of Cash Flows

(in thousands of Canadian dollars)

Years ended August 31	2011	2010
Operating activities		
Loss and comprehensive loss for the year	\$ (3,238)	\$ (2,594)
Items not affecting cash:		
Amortization	5,359	5,061
Amortization of financing costs (Note 11)	134	214
(Gain) loss on disposal of capital assets	(101)	205
Stock-based compensation	36	2
	2,190	2,888
Net change in non-cash working capital (Note 17)	(31)	(2,080)
	2,159	808
Financing activities		
Repayment of long-term debt	(1,304)	(11,184)
Proceeds on issuance of long-term debt	1,078	5,000
Share purchase under normal course issuer bid (Note 10)	(1,281)	(1,457)
Advances from suppliers (Note 8)	1,034	-
Financing costs	(16)	(219)
Repayment of capital leases, net	(16)	(41)
	(505)	(7,901)
Investing activities		
Purchase of capital assets	(2,131)	(2,515)
Additions to intangible assets	(224)	(1,428)
Proceeds on disposal of capital assets	30	21
Net change in non-cash working capital (Note 17)	(185)	320
	(2,510)	(3,602)
Decrease in cash and cash equivalents	(856)	(10,695)
Cash and cash equivalents, beginning of year	4,285	14,980
Cash and cash equivalents, end of year	\$ 3,429	\$ 4,285
Supplemental cash flow disclosure:		
Interest paid	\$ 470	\$ 457
Income taxes paid	-	-

See accompanying notes to the consolidated financial statements

PARAGON PHARMACIES LIMITED

Notes to Consolidated Financial Statements Years Ended August 31, 2011 and 2010

(All amounts in thousands of Canadian dollars, except per share amounts)

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

Basis of accounting

The Company’s accounting policies and standards of financial disclosure are in accordance with Canadian generally accepted accounting principles (“GAAP”).

Consolidation

The consolidated financial statements include the assets, liabilities and results of operations, after the elimination of intercompany transactions and balances of the Company and its subsidiaries, all of which are wholly owned.

Use of 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 evaluating goodwill, intangible assets and long-lived assets for impairment. Changes in those estimates could materially affect the consolidated financial statements.

Revenue recognition

The Company recognizes revenue at the time goods are sold, net of provisions for returns. Product returns are not significant.

PARAGON PHARMACIES LIMITED

Notes to Consolidated Financial Statements Years Ended August 31, 2011 and 2010

(All amounts in thousands of Canadian dollars, except per share amounts)

2. SIGNIFICANT ACCOUNTING POLICIES *(continued)*

Cash and cash equivalents

Cash and cash equivalents are defined as cash and highly liquid investments, which have maturities of less than three months at the date of acquisition.

Inventory

Inventory is valued at the lower of cost and net realizable value with cost being determined on a weighted average cost basis. Cost includes all direct expenditures and other appropriate costs incurred in bringing inventory to its present location and condition. The Company classifies rebates and other consideration received from a vendor as a reduction to the cost of inventory. At August 31, 2011, there were write-downs of inventory to their net realizable value of \$0.19 million (2010 – \$0.04 million) which are included in cost of goods sold. There were no reversals of write downs during the year.

Capital assets

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

Building	4%
Furniture and fixtures	20%
Automotive	30%
Equipment	30%
Computer equipment	30%

Assets under capital lease are amortized over the term of their respective leases.

Leasehold improvements are recorded at cost and are amortized over the shorter of their estimated useful life or a straight-line basis over the non-cancellable term of the lease.

Deferred rent inducements

The Company leases its store locations and office space. Landlord inducements are deferred and amortized as reductions to rent expense on a straight-line basis over the term of the lease.

PARAGON PHARMACIES LIMITED

Notes to Consolidated Financial Statements Years Ended August 31, 2011 and 2010

(All amounts in thousands of Canadian dollars, except per share amounts)

2. SIGNIFICANT ACCOUNTING POLICIES (*continued*)

Intangible assets

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

Prescription files	5 years
Customer relationships	5 years
Rebranding costs	3 - 5 years
Computer software	100%

Goodwill

Goodwill represents the excess of the acquisition cost of companies over the estimated fair value of the identifiable net assets acquired, including intangible assets, at the date of acquisition.

Goodwill is not amortized but is evaluated for impairment at August 31 or more frequently if there are indications of impairment. In the event of impairment, the excess of the carrying amount over the estimated fair value of the assets would be expensed. As at August 31, 2011 and 2010, the Company conducted a review of the carrying value of goodwill and determined that no impairment needed to be recorded in the corresponding years.

Long-lived assets

The carrying value of the Company's long-lived assets, including intangible assets, is evaluated for recoverability whenever events or circumstances indicate that the carrying value exceeds the estimated fair value, being the sum of the estimated undiscounted cash flows expected from their use and eventual disposal. An impairment loss is measured as the amount by which the long-lived assets' carrying value exceeds the estimated fair value. As at August 31, 2011 and 2010, the Company conducted a review of the carrying value of intangible assets and determined that no impairment needed to be recognized in the corresponding years.

PARAGON PHARMACIES LIMITED

Notes to Consolidated Financial Statements Years Ended August 31, 2011 and 2010

(All amounts in thousands of Canadian dollars, except per share amounts)

2. SIGNIFICANT ACCOUNTING POLICIES (*continued*)

Future income taxes

Income taxes are accounted for by the liability method. Under this method, future income tax assets and liabilities are determined based on temporary differences between the carrying amount of balance sheet items and their tax basis. Future income tax assets and liabilities are measured under this method by using substantively enacted tax rates that are expected to apply when such tax assets or liabilities are either settled or realized. To the extent that the Company does not consider it to be more likely than not that a future tax asset will be recovered, it provides a valuation allowance against the excess.

Stock-based compensation

The Company has a stock option plan and a share unit plan which is described in note 10 to these consolidated financial statements. The Company accounts for grants under these plans in accordance with the fair value based method of accounting for stock-based compensation using the Black-Scholes option pricing model for the stock option plan and the intrinsic method for the share unit plan. Compensation expense is recognized over the period in which the option vests, with a corresponding increase to contributed surplus for the stock option plan and to accounts payable and accrued liabilities and other long-term liabilities for the share unit plan. Upon exercise of options under the stock option plan, an amount is allocated from contributed surplus to share capital together with the proceeds of exercise. Upon exercise of options for common shares of the Company under the share unit plan, an amount is allocated from accounts payable and accrued liabilities to share capital. In the event that vested options expire without being exercised, previously recognized compensation costs associated with such options are not reversed. Forfeitures are accounted for as they occur.

Per share amounts

The loss per share is computed based on the weighted average number of shares outstanding during the period. Diluted per share amounts are calculated giving effect to the potential dilution that would occur if options to purchase common shares were exercised. The Company uses the treasury stock method to determine the dilutive effect of stock options. For the years ended August 31, 2011 and 2010 diluted loss per share is the same as the basic loss per share, as the Company has a loss each year, and any potential dilutive shares would be antidilutive.

PARAGON PHARMACIES LIMITED

Notes to Consolidated Financial Statements Years Ended August 31, 2011 and 2010

(All amounts in thousands of Canadian dollars, except per share amounts)

2. SIGNIFICANT ACCOUNTING POLICIES (*continued*)

Comprehensive income

Comprehensive income is comprised of net loss and other comprehensive income (“OCI”). OCI represents the change in equity for a period that arises from items such as unrealized gains and losses on available-for-sale securities and changes in the fair market value of derivative instruments designated as cash flow hedges. The Company does not currently have any transactions that give rise to OCI; therefore the Company’s loss for the year and comprehensive loss are the same amount.

Financial instruments

A financial asset is cash or a contractual right to receive cash or another financial asset, including equity instruments, from another party. A financial liability is the contractual obligation to deliver cash or another financial asset to another party.

A derivative is a financial instrument whose value changes in response to a specified variable, requires little or no net investment and is settled at a future date. An embedded derivative is a derivative that is a part of a non-derivative contract and not directly related to that contract. Embedded derivatives that are not closely related to the host contract are accounted for as a separate financial instrument. A non-financial derivative is a contract that can be settled net in cash or another financial instrument.

The Company records all financial instruments initially at fair-value and subsequently accounts for the financial instruments based on one of five classifications: held for trading, held-to maturity, other liabilities, loans and receivables or available-for-sale. The classification of a financial instrument depends on its characteristics and the purpose for which it was acquired.

A) Held for trading

Held for trading financial instruments are financial assets or financial liabilities that are purchased with the intention of selling or repurchasing in the near term. Any financial instrument can be designated as held for trading as long as its fair value can be reliably measured. A derivative is classified as held for trading unless designated as and considered an effective hedge. Held for trading instruments are recorded at fair value with any subsequent gains or losses from changes in the fair value included in earnings.

All of the Company’s cash and cash equivalents are designated as held for trading financial instruments.

PARAGON PHARMACIES LIMITED

Notes to Consolidated Financial Statements Years Ended August 31, 2011 and 2010

(All amounts in thousands of Canadian dollars, except per share amounts)

2. SIGNIFICANT ACCOUNTING POLICIES (*continued*)

B) Held-to-maturity

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and a fixed maturity that the Company has the intent and ability to hold to maturity.

These financial assets are measured at amortized cost using the effective interest method. Any gains or losses arising from the sale of a held-to-maturity investment are included in earnings.

The Company has no assets designated as held-to-maturity.

C) Other liabilities

Accounts payable and accrued liabilities, long-term debt and other long-term liabilities are accounted for at amortized cost using the effective interest method. Any gains or losses in the realization of such other liabilities are included in earnings.

D) Loans and receivables

Account receivable are accounted for at amortized cost using the effective interest method. Any gains or losses on the realization of such loans and receivables are included in earnings.

E) Available-for-sale

Available-for-sale assets are those financial assets that are not classified as held for trading, held-to-maturity or loans and receivables. Available-for-sale instruments are recorded at fair value. Any gains or losses arising from the change in fair value are recorded in OCI and upon the sale of the instrument or other-than-temporary impairment, the cumulative gain or loss is included in earnings.

The Company has not designated any financial instruments as available-for-sale assets.

The financial instrument standards require that costs related to obtaining debt financing be expensed as incurred or deducted from the related debt and accreted over the term of the debt as interest expense using the effective interest rate method. The Company has elected to deduct these expenses from the related debt.

PARAGON PHARMACIES LIMITED

Notes to Consolidated Financial Statements Years Ended August 31, 2011 and 2010

(All amounts in thousands of Canadian dollars, except per share amounts)

2. SIGNIFICANT ACCOUNTING POLICIES *(continued)*

The Company utilizes valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible. The Company determines fair value based on assumptions that market participants would use in pricing an asset or liability.

When considering market participant assumptions in fair value measurements, the following fair value hierarchy distinguishes between observable and unobservable inputs, which are categorized in one of the following levels:

- Level 1 Inputs: Unadjusted quoted prices in active markets for identical assets or liabilities accessible to the reporting entity at the measurement date.
- Level 2 Inputs: Other than quoted prices included in Level 1 inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the asset or liability.
- Level 3 Inputs: Unobservable inputs for the asset or liability used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at measurement date.

In summary, the following table outlines the Company's accounting for financial instruments:

Asset / Liability	Category	Subsequent Measurement
Cash and cash equivalents	Held for trading	Fair value
Accounts receivable	Loans and receivables	Amortized cost
Accounts payable and accrued liabilities	Other liabilities	Amortized cost
Long-term debt	Other liabilities	Amortized cost
Other long-term liabilities	Other liabilities	Amortized cost

Hedge accounting is optional and the Company may designate any qualifying hedging instrument as a hedge for accounting purposes. The Company has no qualifying hedging instruments.

PARAGON PHARMACIES LIMITED

Notes to Consolidated Financial Statements Years Ended August 31, 2011 and 2010

(All amounts in thousands of Canadian dollars, except per share amounts)

3. CHANGES IN SIGNIFICANT ACCOUNTING POLICIES

Business combinations and consolidated financial statements

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 International Financial Reporting Standards (“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, however earlier adoption is permitted. The Company adopted these standards on September 1, 2010 and has concluded there is no material impact on its consolidated financial statements.

4. FUTURE ACCOUNTING STANDARDS

International Financial Reporting Standards (IFRS)

In February 2008, the Accounting Standards Board (“AcSB”) of Canada confirmed that International Financial Reporting Standards will replace Canadian GAAP for Canadian publically accountable enterprises effective for fiscal years beginning on or after January 1, 2011. These standards will be effective for the Company beginning in the first quarter of fiscal 2012. Comparative IFRS information for the previous year will also have to be presented.

5. 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 provided 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 29, 2010. Based on the actual prescription volumes during this period the Company made the remaining payment of \$0.34 million, of which \$0.32 million was accrued at August 31, 2010, to the vendor in the first quarter of fiscal 2011.

PARAGON PHARMACIES LIMITED

Notes to Consolidated Financial Statements Years Ended August 31, 2011 and 2010

(All amounts in thousands of Canadian dollars, except per share amounts)

6. CAPITAL ASSETS

August 31, 2011	Cost	Accumulated Amortization	Net Book Value
Land	\$ 112	\$ -	\$ 112
Building	533	32	501
Furniture and fixtures	946	560	386
Automotive	152	79	73
Equipment	2,895	1,400	1,495
Computer equipment	1,505	587	918
Assets under capital lease	77	66	11
Leasehold improvements	5,923	2,576	3,347
	\$ 12,143	\$ 5,300	\$ 6,843

August 31, 2010	Cost	Accumulated Amortization	Net Book Value
Land	\$ 85	\$ -	\$ 85
Building	300	23	277
Furniture and fixtures	931	465	466
Automotive	194	134	60
Equipment	2,510	1,249	1,261
Computer equipment	1,311	225	1,086
Assets under capital lease	77	61	16
Leasehold improvements	4,893	1,758	3,135
	\$ 10,301	\$ 3,915	\$ 6,386

During the year ended August 31, 2011, the Company recorded capital asset amortization expense of \$1.745 million (2010 - \$1.419 million), of which \$0.005 million (2010 - \$0.016 million) is related to amortization on assets under capital lease.

PARAGON PHARMACIES LIMITED

Notes to Consolidated Financial Statements Years Ended August 31, 2011 and 2010

(All amounts in thousands of Canadian dollars, except per share amounts)

7. INTANGIBLE ASSETS

August 31, 2011	Cost	Accumulated Amortization	Net Book Value
Prescription files	\$ 9,395	\$ 8,449	\$ 946
Customer relationships	8,903	6,471	2,432
Computer software	1,131	1,025	106
Rebranding costs	217	169	48
	\$ 19,646	\$ 16,114	\$ 3,532

August 31, 2010	Cost	Accumulated Amortization	Net Book Value
Prescription files	\$ 9,370	\$ 7,345	\$ 2,025
Customer relationships	8,903	4,690	4,213
Computer software	932	356	576
Rebranding costs	217	109	108
	\$ 19,422	\$ 12,500	\$ 6,922

During the year ended August 31, 2011, the Company recorded intangible asset amortization expense of \$3.614 million (2010 - \$3.642 million).

8. OTHER LONG-TERM LIABILITIES

	2011	2010
Other long-term liability	\$ 924	\$ -
Restricted share unit liability (Note 10)	3	-
	\$ 927	\$ -

The Company entered into supply and purchase agreements with certain suppliers during fiscal 2011. The agreements are effective between April 1, 2011 and December 1, 2012 and end between December 31, 2013 and March 31, 2016. Under these agreements, the Company received up-front payments in return for a commitment to make certain minimum quarterly or annual purchases from these suppliers over the term of the agreements. As the required purchases are made by the Company, the up-front payments will be applied as rebates against these purchases. If the required minimum purchase targets are not achieved, the Company would be required to repay a portion of the up-front payments received. These up-front payments have been recorded in other long-term liabilities and accounts payables and accrued liabilities at August 31, 2011.

PARAGON PHARMACIES LIMITED

Notes to Consolidated Financial Statements Years Ended August 31, 2011 and 2010

(All amounts in thousands of Canadian dollars, except per share amounts)

9. LONG-TERM DEBT AND BANK INDEBTEDNESS

	2011	2010
Canadian Imperial Bank of Commerce		
Term loan, net of \$0.13 million financing costs (August 31, 2010 - \$0.19 million), bearing interest at prime plus 1% to prime plus 2% per annum depending on Company specific covenants, repayable in quarterly installments of \$0.30 million (August 31, 2010 - \$0.25 million) plus interest, due April 8, 2013.	\$ 4,374	\$ 4,562
Sunova Credit Union		
Mortgage bearing interest at prime plus 1.0% per annum, repayable in blended monthly installments of \$0.001 million, due October 2031.	195	-
Autonomy Loan		
Loan payable, net of financing costs of \$0.4 million (August 31, 2010 - \$0.4 million), unsecured and repayable over a ten year period ending September 30, 2017. Interest accrues at the rate of 6% per annum, payable in variable amounts annually on August 31 st of each year.	3,202	3,363
Other long-term debt		
Various obligations bearing interest between 0.0% and 6.4%, secured by general security agreements, general assignments of book debts due between January 2012 and September 2013.	65	19
	7,836	7,944
Less current portion	1,144	936
	\$ 6,692	\$ 7,008

PARAGON PHARMACIES LIMITED

Notes to Consolidated Financial Statements Years Ended August 31, 2011 and 2010

(All amounts in thousands of Canadian dollars, except per share amounts)

9. LONG-TERM DEBT AND BANK INDEBTEDNESS *(continued)*

On April 6, 2010, the Company secured a three year credit facility with a \$5.0 million operating line, \$5.0 million term loan and a \$15.0 million acquisition facility. Interest rates on the new credit facility are set at 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 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 facility is to be repaid April 8, 2013.

On May 12, 2011, the Company amended the credit facility to increase the term loan to \$5.8 million from the original \$5.0 million. The amended term loan still bears interest at prime plus 1% to prime plus 2% per annum depending on Company specific covenants and is due April 8, 2013. Quarterly instalment payments will increase to \$0.3 million plus interest to cover the additional \$0.8 million advanced under the term loan subsequent to the end of the quarter. The operating line and acquisition facility have remained unchanged under the Company's amended credit facility.

The credit 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.

At August 31, 2011, 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 million (August 31, 2010 - \$5.0 million) operating line available.

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

2012	\$	1,224
2013		3,325
2014		22
2015		17
2016		11
Thereafter		161
Total	\$	4,760

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

PARAGON PHARMACIES LIMITED

Notes to Consolidated Financial Statements Years Ended August 31, 2011 and 2010

(All amounts in thousands of Canadian dollars, except per share amounts)

10. 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	Share Capital
Balance, August 31, 2009	97,606	\$ 56,589
Purchased through normal course issuer bid and subsequently cancelled	(4,271)	(2,579)
Balance, August 31, 2010	93,335	54,010
Purchased through normal course issuer bid and subsequently cancelled	(4,358)	(2,438)
Balance, August 31, 2011	88,977	\$ 51,572

Normal course issuer bid

On October 8, 2009, the Company announced its intention to make a Normal Course Issuer Bid (“NCIB”) to purchase for cancellation up to a maximum of 4,880,319 shares. The NCIB commenced on October 9, 2009 and terminated on October 8, 2010. On October 8, 2010, the Company received approval for the renewal of the NCIB which allows the Company to purchase up to an additional 4,637,794 common shares until the renewed NCIB expires on October 11, 2011.

As of August 31, 2011, 4.051 million (August 31, 2010 – 4.578 million) common shares have been purchased for cash consideration of \$1.281 million (August 31, 2010 - \$1.457 million) or \$0.31 (August 31, 2010 - \$0.31) per common share, of which 4.358 million (August 31, 2010 – 4.271 million) were cancelled as of that date resulting in a reduction in share capital of \$2.438 million (August 31, 2010 - \$2.579 million) and an increase in contributed surplus of \$1.157 million (August 31, 2010 - \$1.122 million) representing the consideration deficiency to stated capital.

For the period September 1, 2011 to October 11, 2011, the Company has not purchased any shares under the Company’s NCIB. The NCIB expired on October 11, 2011 and was not renewed by the Company. All shares purchased under the Company’s NCIB prior to August 31, 2011 were cancelled at August 31, 2011 (August 31, 2010 – 0.307 million common shares repurchased during the year ended August 31, 2010 were cancelled in fiscal 2011).

PARAGON PHARMACIES LIMITED

Notes to Consolidated Financial Statements Years Ended August 31, 2011 and 2010

(All amounts in thousands of Canadian dollars, except per share amounts)

10. SHARE CAPITAL *(continued)*

Share unit plan

On April 22, 2010, the Company adopted a Share Unit Plan where up to 2.0 million common shares may be issued as Unit Awards and designated as restricted for performance awards. Each common share fair market value will be calculated using the weighted average of the common shares traded on the TSX Venture Exchange for ninety calendar days immediately preceding such date. Each Unit Award granted shall be subject to the terms and conditions of the Share Unit Plan, and be subject to the requirements of the TSX Venture Exchange. Under the terms of the Share Unit Plan, participants are eligible to receive common shares or an equivalent cash value of common shares. For Unit Awards granted for a prior service period, the compensation cost will be recognized in the period the Unit Award is granted. In the case of Unit Awards granted for current or future service periods, the fair value of the grant is based on the intrinsic value of the units and compensation cost is recognized over the expected service period of the stock-based compensation. In the event the service period is not defined, treatment will be consistent with Unit Awards granted for current and future periods. Changes in the amount of the liability due to share price changes are recognized as stock-based compensation expense in the period in which the changes occur.

Restricted Share Units (“RSUs”)	2011	2010
Outstanding, beginning of year	-	-
Issued	72,414	-
Exercised	-	-
Outstanding, end of year	72,414	-
Exercisable, end of year	-	-

During the year ended August 31, 2011, the Company issued 72,414 (August 31, 2010 – Nil) RSUs. Compensation expense related to these units recognized during the year ended August 31, 2011 was \$0.003 million (August 31, 2010 - \$nil). The RSUs outstanding at August 31, 2011 vest on December 9, 2013.

Stock-based compensation

The Company has an incentive stock option plan for certain employees, officers and directors. 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. The total number of common shares reserved for issuance under the stock option plan shall not exceed 2,669,321, as at August 31, 2011, calculated as 3% of the issued and outstanding common shares of the Company. As at August 31, 2011, 1,912,826 (2010 – 2,478,379) common shares remain reserved for issuance under the stock option plan.

PARAGON PHARMACIES LIMITED

Notes to Consolidated Financial Statements Years Ended August 31, 2011 and 2010

(All amounts in thousands of Canadian dollars, except per share amounts)

10. SHARE CAPITAL (continued)

The continuity of the Company's outstanding and exercisable options is as follows:

	2011		2010	
	Number of Options Outstanding	Weighted average exercise price	Number of Options Outstanding	Weighted average exercise price
Outstanding, beginning of year	322	\$ 0.41	627	\$ 0.60
Issued	445	0.29	-	-
Exercised	-	-	-	-
Expired/Cancelled	(10)	0.45	(305)	0.78
Outstanding, end of year	757	\$ 0.34	322	\$ 0.41
Exercisable, end of year	312	\$ 0.41	322	\$ 0.41

The following table summarizes information about stock options outstanding and exercisable at August 31, 2011:

Date Issued	Number of Options Outstanding	Number of Options Vested	Exercise Price	Expiry Date
May 28, 2008	262	262	\$ 0.45	May 28, 2013
October 21, 2008	50	50	\$ 0.21	October 21, 2013
February 11, 2011	145	-	\$ 0.29	December 9, 2015
February 11, 2011	300	-	\$ 0.29	February 11, 2016
Total	757	312		

During the year ended August 31, 2011, \$0.033 million (2010 - \$0.002 million) was recognized as stock-based compensation expense related to options with a corresponding increase to contributed surplus.

PARAGON PHARMACIES LIMITED

Notes to Consolidated Financial Statements Years Ended August 31, 2011 and 2010

(All amounts in thousands of Canadian dollars, except per share amounts)

10. SHARE CAPITAL (continued)

The actual weighted average fair value of the options issued during the year ended August 31, 2011 was \$0.25 per common share (2010 - \$nil per common share) as determined using the Black-Scholes option pricing model. The following weighted average assumptions were utilized to calculate the fair value:

	2011	2010
Total options granted	445	-
Weighted average exercise price	\$ 0.29	-
Risk free interest rate	2.76 %	-
Expected life of options	4.95 years	-
Vesting period	3.91 years	-
Expected annual volatility	133 %	-
Expected dividend rate	nil	-

Contributed surplus arises from the following:

	2011	2010
Balance, beginning of year	\$ 3,694	\$ 2,570
Cancellation of purchased shares	1,157	1,122
Stock-based compensation	33	2
Balance, end of year	\$ 4,884	\$ 3,694

11. INTEREST EXPENSE

Interest expense includes the following:

	2011	2010
Amortization of financing costs	\$ 134	\$ 214
Bank charges and interest	95	149
Interest on long-term debt	592	544
Interest income	(16)	(22)
	\$ 805	\$ 885

PARAGON PHARMACIES LIMITED

Notes to Consolidated Financial Statements Years Ended August 31, 2011 and 2010

(All amounts in thousands of Canadian dollars, except per share amounts)

12. INCOME TAXES

	2011	2010
Net loss	\$ (3,238)	\$ (2,594)
Computed income tax expense at statutory rate of 27.72% (2010 – 29.22%)	(898)	(758)
Stock-based compensation	10	1
Other permanent differences	214	329
Impact of future tax rate differences	51	92
Change in valuation allowance	623	336
	\$ -	\$ -

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

	2011	2010
Undepreciated capital cost	\$ 6,605	\$ 5,687
Cumulative eligible capital	15,811	16,999
Share issue costs and financing costs carried forward	1,146	2,329
	23,562	25,015

Non-capital losses carried forward for tax purposes with expiration dates as follows:

2013	254	254
2014	116	409
2025	204	320
2026	1,234	1,329
2027	4,654	4,831
2028	2,028	2,124
2029	1,806	1,806
2030	3,257	2,451
2031	1,470	-
	15,023	13,524
	\$ 38,585	\$ 38,539

PARAGON PHARMACIES LIMITED

Notes to Consolidated Financial Statements Years Ended August 31, 2011 and 2010

(All amounts in thousands of Canadian dollars, except per share amounts)

12. 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	2011	2010
Capital assets	\$ 64	\$ 310
Intangible assets	(1,648)	(1,253)
Goodwill	828	698
Rebranding	8	19
Deferred rent inducement	(178)	(183)
Capital leases	-	(4)
Share issue costs and financing costs	(173)	(449)
Non-capital tax losses carry forward	(3,862)	(3,476)
	(4,961)	(4,338)
Valuation allowance	4,961	4,338
Future income tax liability (asset)	\$ -	\$ -

13. PER SHARE AMOUNTS

	2011	2010
Weighted average number of shares		
Basic	90,764	95,698
Fully diluted	90,764	95,698

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

14. RELATED PARTY TRANSACTIONS

Canterbury Park Management Inc., an affiliated company of a shareholder, provides advisory services to the Company. Under the current agreement, the Company pays \$0.20 million (2010 - \$0.20 million) a year for these advisory services. During the year, the Company also expensed \$nil (2010 - \$0.18 million) for executive services provided by Canterbury Park Management Inc.

For the year ended August 31, 2011, the Company paid \$0.20 million (August 31, 2010 - \$0.19 million) 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.

PARAGON PHARMACIES LIMITED

Notes to Consolidated Financial Statements Years Ended August 31, 2011 and 2010

(All amounts in thousands of Canadian dollars, except per share amounts)

15. 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 up to two years dependent upon class and are fully portable. The contribution of the Company is between 2% 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 year ended August 31, 2011, the Company expensed \$0.4 million (2010 - \$0.4 million).

16. 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 with the objective of achieving 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 year.

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 capital leases and advances from suppliers (Note 8) when assessing its total capitalization. As at August 31, 2011, the Company believes it has available cash resources, comprised of cash and cash equivalents and availability of long-term debt, to make necessary capital investments and to fund acquisitions. The Company may 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.

PARAGON PHARMACIES LIMITED

Notes to Consolidated Financial Statements Years Ended August 31, 2011 and 2010

(All amounts in thousands of Canadian dollars, except per share amounts)

16. CAPITAL MANAGEMENT *(continued)*

As part of its lending agreement, the Company monitors its net senior debt to earnings before interest expense, income taxes, depreciation and amortization, stock-based compensation and other items as defined (“EBITDA”) ratio as defined in its lending agreement. At August 31, 2011, and for the year then ended the Company is 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 year.

	2011	2010
Cash and cash equivalents	\$ (3,429)	\$ (4,285)
Current portion of long-term debt, capital leases and advances from suppliers	1,254	952
Long-term debt, capital leases, advances from suppliers	7,616	7,008
Net debt	5,441	3,675
Shareholders’ equity	25,037	29,523
Total capitalization	\$ 30,478	\$ 33,198
Net debt: Shareholders’ equity	0.22	0.12
Net debt: Total capitalization	0.18	0.11

17. SUPPLEMENTAL CASH FLOW INFORMATION

CHANGE IN NON-CASH WORKING CAPITAL:	2011	2010
Operating		
Accounts receivable	\$ 217	\$ (1,044)
Inventory	533	(807)
Prepaid expenses and deposits	80	(209)
Accounts payable and accrued liabilities	(842)	(460)
Deferred rent inducements	(19)	440
	\$ (31)	\$ (2,080)
Investing		
Accounts payable and accrued liabilities	\$ (185)	\$ 320
	\$ (185)	\$ 320

PARAGON PHARMACIES LIMITED

Notes to Consolidated Financial Statements Years Ended August 31, 2011 and 2010

(All amounts in thousands of Canadian dollars, except per share amounts)

18. COMMITMENTS AND CONTINGENCIES

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

The Company and its subsidiaries lease premises under operating leases, which expire between 2012 and 2019. Rental payments, excluding operating costs and taxes, over the next five years ending August 31 are as follows:

2012	\$	2,443
2013		2,098
2014		1,984
2015		1,497
2016		1,208
Thereafter		2,078

Two 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 \$1.058 million from 2012 through 2018.

19. FINANCIAL INSTRUMENTS

Fair value

The fair value of financial instruments represents the amount that would be received from or paid to counterparties, calculated at the reporting date, to settle these instruments. The carrying values of cash and cash equivalents, accounts receivable, and accounts payable and accrued liabilities approximate their estimated fair value due to the short-term maturity of these instruments. The fair value of the long-term debt reflect the Company's best estimate based upon estimated interest rates at which the Company believes it could enter into similar instruments at the consolidated balance sheet dates. The carrying amount of other long-term liabilities are determined by estimating future cash flows and discounting these future cash flows using a rate which takes into account the Company's credit risk.

PARAGON PHARMACIES LIMITED

Notes to Consolidated Financial Statements Years Ended August 31, 2011 and 2010

(All amounts in thousands of Canadian dollars, except per share amounts)

19. FINANCIAL INSTRUMENTS *(continued)*

The floating rate debt appropriately reflects rates currently available for debt with similar terms and maturities. Accordingly, the fair value of the floating rate debt is not materially different from the recorded value except for associated financing costs included therein (see note 9). The fixed rate debt, which has a carrying value of \$3.6 million at August 31, 2011 (August 31, 2010 - \$3.9 million), has a fair value of \$3.6 million (August 31, 2010 - \$3.9 million).

For the years ended August 31, 2011 and 2010, the Company's held-for-trading financial assets are cash and cash equivalents which are based on quoted market prices and therefore fall under level 1.

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 Company does not use financial derivatives. There has been no change with respect to the Company's overall risk exposure during the year ended August 31, 2011. The nature of most significant financial risks and how they are managed are described below.

Credit risk

The maximum exposure to credit risk of the Company as at August 31, 2011 is the carrying value of its financial assets. The Company manages credit risk by maintaining bank accounts with reputable financial institutions and only investing in securities that are highly rated, traded in active markets and capable of prompt liquidation.

The Company's exposure to credit risk related to accounts receivable arises from the possibility that a customer, or supplier, does not fulfill its obligations. This is minimized through an accounts receivable customer base which arises primarily in respect of prescription sales billed to government and third party drug plans with short periods of credit.

The Company performs continuous evaluation of its accounts receivable and reduces the carrying value of accounts receivable once amounts are determined to be no longer recoverable.

At August 31 the details of the aging of the Company's accounts receivable is as follows:

	2011	2010
Due within 60 days	\$ 3,611	\$ 4,457
Due 60 – 120 days	755	222
Due later than 120 days	306	210
	\$ 4,672	\$ 4,889

PARAGON PHARMACIES LIMITED

Notes to Consolidated Financial Statements Years Ended August 31, 2011 and 2010

(All amounts in thousands of Canadian dollars, except per share amounts)

19. FINANCIAL INSTRUMENTS *(continued)*

Interest rate risk

Long-term debt is subject to interest rate cash flow risk as the required cash flow to service the debt will fluctuate as a result of the changing bank prime lending rate. The sensitivity of the long-term debt to a 100 basis point change in the interest rate, with all other variables held constant, would result in a change in the Company's loss for the year of approximately \$0.05 million for the year ended August 31, 2011 (August 31, 2010 - \$0.05 million). The Company did not employ interest rate hedging activities during the year ended August 31, 2011.

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

The Company's exposure to liquidity risk is dependent on the sale of inventory, collection of accounts receivable, repayment of financial liabilities or raising of funds to meet commitments and sustain operations. The Company's liquidity objective is to maintain the capacity to fund assets and repay liabilities in a timely and cost-effective manner under adverse market conditions and unforeseen events. This capacity primarily derives from the Company's cash flow from operations and ability to issue debt and equity instruments as well as its ability to generate liquidity from its balance sheet (convert assets, for example inventory, to cash).

The Company controls liquidity risk by management of working capital, cash flows and the availability of borrowing facilities. The Company's undiscounted financial liability expected maturities do not differ significantly from the contractual maturities. The Company's undiscounted financial liability contractual maturities are described in Notes 8, 9 and 18 to these consolidated financial statements. The Company does not anticipate the timing and amounts of these existing contractual obligations will vary significantly from these amounts.

20. COMPARATIVE FIGURES

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