

PARAGON PHARMACIES LIMITED

MANAGEMENT'S DISCUSSION & ANALYSIS FOR THE YEAR ENDED AUGUST 31, 2011

As at November 17, 2011

The following is a discussion of the consolidated financial condition and results of operations of Paragon Pharmacies Limited ("Paragon" or "the Company") for the year ended August 31, 2011. This discussion and analysis should be read in conjunction with the Company's annual audited consolidated financial statements and accompanying notes for the year ended August 31, 2011. The audited 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 or 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 Corporation owns and operates 19 retail pharmacies and three central fill pharmacies in British Columbia, Alberta and Manitoba.

STRATEGIES AND OUTLOOK

The pharmacy industry continues to change in response to the ongoing adjustments that are occurring to generic drug pricing models, shifting consumer needs and aging demographics. Paragon continues to monitor the ongoing generic drug regulatory changes closely. These regulatory changes are discussed further in "REGULATORY CHANGES THAT IMPACT THE COMPANY'S INDUSTRY"

The Company continues to focus on business strategies designed to support revenue growth, build customer loyalty, develop its management team, improve profitability and expand brand awareness. This includes hiring and retaining only pharmacy and front store staff that are committed to provide superior customer service; providing training and support to the Company's pharmacy and front store staff to help them deliver the best possible customer service; expanding Paragon pharmacists' scope of practice to conform with both the emerging regulatory opportunities, and customer needs; developing a market leading in-store diagnostics program; building additional medical clinics; connecting with the community on health issues through organizing in-store clinics and seminars; and developing a health and wellness product offering that addresses the needs of Paragon's customers.

To improve profitability the Company has put significant effort into improving its supply chain process and relationships in order to optimize gross margin rates over the past three quarters. As a part of that effort, the Company has entered into a number of new supply arrangements for both front store and pharmacy products. In addition, wholesale and distribution processes have been updated to provide the Company with direct control over purchasing programs and closer ties to its key vendors.

The Company has also improved service and processes through the adoption of innovative technology in its long term care operations. In 2012, the Company will continue to automate certain processes in its retail pharmacies to enhance quality control and improve efficiencies of those operations.

With the pharmacy industry facing ongoing regulatory change, Paragon believes that opportunities to purchase good stores at reasonable valuations continue to exist in this market. As a result, the Company continues to look at potential acquisition targets and over the last

quarter has continued to increase its pipeline of potential acquisitions. Paragon's capital position and its ability to secure financing will enable it to continue to search for new business development opportunities through acquisitions of pharmacies, prescription files and new store developments in Western Canada. Management believes this pipeline of potential acquisitions will allow the Company to achieve its growth objectives over the coming quarters.

SUMMARY

Key Operating, Investing and Financial Metrics

The following provides a summary of the Company's performance for the year ended August 31, 2011 compared to the year ended August 31, 2010.

- Revenue of \$76.688 million (2010: \$82.217 million), a decrease of 6.7%. (Refer to page 6 for further explanation)
- Comparable store revenue reduction of 6.7%
 - Comparable store pharmacy revenue reduction of 7.9%
 - Comparable store front store revenue¹ reduction of 2.9%
(Refer to page 6 for further explanation)
- Gross margin² as a percentage of revenue of 39.9% (2010: 38.0%), an increase of 1.9%. (Refer to page 7 for further explanation)
- Operating income³ of \$8.336 million (2010: \$8.278 million), an increase of 0.7%. (Refer to page 7 for further explanation)
- EBITDA of \$2.861 million (2010: \$3.559 million), a decrease of 19.6%. (Refer to page 7 for further explanation)

¹ Front store revenue includes all non-pharmacy revenue

² Gross margin is defined as revenue minus cost of sales

³ 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

Fourth Quarter

- In the quarter, the Company launched a health and wellness focused offering in five of its retail locations with an additional twelve retail locations launching the program in the first quarter of fiscal 2012. This new Paragon Naturals line introduces 20 feet of natural health solutions to the Company's front store product mix. This new offering includes a variety of natural health products such as natural vitamins and supplements, body care, homeopathy and food selections. In order to help market and support the new initiative, the Company has also launched its Paragon Naturals health seminars. The Naturals seminars are offered on a monthly basis throughout the year at each of the retail locations carrying the new natural health products, with the objective of driving additional sales to new and existing clientele.
- In the quarter, the Company finalized negotiations for new supply and purchase agreements with certain suppliers. 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. The Company anticipates realizing an improvement in gross margin as a result of the terms of these agreements.
- In the fourth quarter of fiscal 2011 front store comparable store sales, excluding post office and other revenues, increased by 0.5% over the same quarter last year. This improvement in front store revenue is a result of the Company's continued focus on strengthening its merchandising and promotional offerings to customers.
- In the quarter, the Company opened its largest medical clinic to date, a 5,500 square foot clinic adjacent to one of its retail locations in Calgary, Alberta. The clinic opened on June 1, 2011 and once fully staffed will operate with six full time doctors. This clinic also includes an aesthetics clinic that will create significant synergy with the pharmacy's existing strong Botox practice.

The Company also commenced construction of an additional clinic adjacent to one of its retail locations in Kelowna, British Columbia in the fourth quarter. This additional clinic opened in the first quarter of fiscal 2012 and operates with two full time doctors with plans of adding a third doctor and a walk in component to the clinic in the coming months.

- The Company continued to search for potential acquisition and development targets, and currently has several locations under evaluation.

SELECTED ANNUAL INFORMATION

The following table provides a summary of certain selected consolidated annual financial information for the Company. The 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.

(thousands of dollars)	2011 \$	2010 \$	2009 \$
Revenue ¹	76,688	82,217	85,089
Operating income ²	8,336	8,278	8,404
EBITDA	2,861	3,559	3,907
Net loss	(3,238)	(2,594)	(7,257)
- Net loss per share - Basic	(\$0.04)	(\$0.03)	(\$0.08)
- Net loss per share – Diluted	(\$0.04)	(\$0.03)	(\$0.08)
Total assets	42,530	47,149	57,128
Total long-term financial liabilities ³	8,870	7,960	14,190

¹ Revenue and cost of sales were restated in fiscal 2011 (\$1.027 million), 2010 (\$1.022 million) and 2009 (\$1.045 million) to report certain of the Company's revenues on a net basis. The adjustment had no impact on operating income, EBITDA or net loss.

² 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

³ Includes current portion of long-term financial liabilities: 2011: \$1,254; 2010: \$952; 2009: \$10,640 and other long-term liabilities: 2011: \$924; 2010 \$nil; 2009 \$nil.

In fiscal 2011, total revenue decreased 6.7%. This decrease in revenue was mainly the result of a 7.9% decline in pharmacy revenue due to continued generic drug reform and a decrease in script volumes in some regions. Operating income increased 0.7% from fiscal 2010 as a result of stronger gross margin which increased from 38.0% in 2010 to 39.9% in 2011, and a reduction in operating expenses. EBITDA decreased 19.6% from 2010 as a result of increased corporate and other costs, which was offset by improved operating expense control from the prior year. (Refer to page 7)

RESULTS OF OPERATIONS

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

(Thousands of dollars)	2011 \$	2010 \$	2009 \$
Net loss	(3,238)	(2,594)	(7,257)
Add (deduct) the following:			
Interest expense	805	885	6,676
Amortization	5,359	5,061	4,391
Stock based compensation	36	2	68
Other items	(101)	205	29
EBITDA	2,861	3,559	3,907

Management's Discussion and Analysis *(continued)*

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)	2011 \$	2010 \$	\$ Change	% Change
Revenue ¹	76,688	82,217	(5,529)	(6.7%)
Gross margin	30,580	31,252	(672)	(2.2%)
Operating expenses ²	22,244	22,974	(730)	(3.2%)
Operating income	8,336	8,278	58	0.7%
Corporate and other costs	5,475	4,719	756	16.0%
EBITDA ³	2,861	3,559	(698)	(19.6%)
Stock-based compensation	36	2	34	1,700.0%
Amortization	5,359	5,061	298	5.9%
Interest expense ⁴	805	885	(80)	(9.0%)
Other items ⁵	(101)	205	306	149.3%
Net loss	(3,238)	(2,594)	(644)	(24.8%)
EBITDA per common share				
- Basic	\$0.03	\$0.04	(\$0.01)	(25.0%)
- Diluted	\$0.03	\$0.04	(\$0.01)	(25.0%)
Loss per common share				
- Basic	(\$0.04)	(\$0.03)	(\$0.01)	(33.3%)
- Diluted	(\$0.04)	(\$0.03)	(\$0.01)	(33.3%)

¹ Revenue and cost of sales were restated in fiscal 2011 (\$1.027 million) and 2010 (\$1.022 million) to report certain of the Company's revenues on a net basis. The adjustment had no impact on gross margin, operating income, EBITDA or net loss.

² Operating expenses include store level selling, general and administration expenses (excludes corporate expenses, amortization, interest expense and stock-based compensation)

³ EBITDA defined as earnings before interest expense, income taxes, amortization, stock-based compensation and other items as defined.

⁴ Interest expense includes bank charges and interest 2011: \$0.095 million (2010: \$0.149 million); interest on long term debt 2011: \$0.726 million, (2010: \$0.758 million); and interest income of 2011: \$0.016 million (2010: \$0.022 million).

⁵ Other items include gain on disposal of assets 2011 \$0.101 million (2010: loss on disposal of assets of \$0.205 million)

Revenue

Revenue is comprised of sales to customers of the Company's retail pharmacies and central fill pharmacies. Revenue was \$76.688 million in 2011 compared to \$82.217 million in 2010, a decrease of \$5.529 million or 6.7%. Pharmacy revenues were impacted by continued generic drug reform and a decrease in script volumes in some regions. In addition, based on an audit by a provincial health authority of the Company's claims for reimbursement of drug costs and dispensing fees during calendar 2010, the Company repaid certain claims identified by the audit in fiscal 2011 totaling \$0.331 million. Subsequent to these audit findings, the Company has implemented processes and procedures to reduce the risk of future repayment of claims to provincial health authorities, and has initiated internal audit procedures to ensure compliance.

Front store revenue declined 2.9% due to continued competitive pressure. The Company continues to focus on improved pricing strategies and stronger in-store execution.

The Company is working 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

Management's Discussion and Analysis *(continued)*

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 \$30.580 million in 2011 compared to \$31.252 million in 2010, a decrease of \$0.672 million or 2.2%. This is due to a decline in both pharmacy and front store revenue partially offset by an increase in both pharmacy and front store gross margin as a percentage of sales. Gross margin as a percentage of revenue improved to 39.9%, an increase of 1.9% over 2010 mainly as a result of the Company successfully negotiating new supply and purchase agreements with certain suppliers.

Operating Expenses

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

Operating expenses were \$22.244 million in 2011 compared to \$22.974 million in 2010, a decrease of \$0.730 million or 3.2%. This was primarily a result of decreased operating wages and marketing related costs over the same period last year. Operating expenses as a percentage of revenue were 29.0% compared to 27.9% 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 \$8.336 million in 2011 compared to \$8.278 million in 2010, an increase of \$0.058 million or 0.7%. The increase in operating income is a result of lower operating expenses and stronger gross margins for both pharmacy and front store as a percentage of revenue, which was offset by the reduction of pharmacy and front store revenues over the same period in the prior year.

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 \$5.475 million in 2011 compared to \$4.719 million in 2010, an increase of \$0.756 million or 16.0%. The increase was largely a result of increased corporate wages, higher information technology costs and increased legal and advisory expenditures to pursue potential acquisitions.

EBITDA

EBITDA was \$2.861 million in 2011 compared to \$3.559 million in 2010, a decrease of \$0.698 million or 19.6%. The decrease in EBITDA was primarily a result of the reduction in pharmacy and front store revenue, increased corporate expenses, offset by stronger gross margins as a percentage of revenues in pharmacy and front store and a reduction of operating expenses.

Interest expense

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

Management's Discussion and Analysis *(continued)*

Interest expense was \$0.805 million compared to \$0.885 million in 2010, a decrease of \$0.080 million. Bank charges and interest were \$0.095 million (2010 - \$0.149 million); interest and amortization of related financing costs on long-term debt was \$0.726 million (2010 - \$0.758 million); and interest income was \$0.016 million (2010 - \$0.022 million).

Amortization

Amortization of capital and intangible assets was \$5.359 million in 2011 compared to \$5.061 million in 2010, an increase of \$0.298 million or 5.9%. This increase is due to amortization on capital and intangible asset additions in the year.

Stock based compensation

Stock based compensation was \$0.036 million in 2011 compared to \$0.002 million in 2010, an increase of \$0.034 million. The increase in stock based compensation is due to a stock option and restricted share unit grant that occurred in 2011.

Net loss

The net loss was \$3.238 million compared to a net loss of \$2.594 million in 2010, an increase of \$0.644 million or 24.8%. The increase in the net loss is largely due to a reduction in pharmacy and front store revenue, increased corporate expenses, partially offset by stronger gross margins as a percentage of revenues in pharmacy and front store and a reduction of operating expenses.

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	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 and advances from suppliers	7,616	7,008
Net debt ¹	5,441	3,675
Shareholders' equity	25,037	29,523
Total capitalization	30,478	33,198
Net debt: Shareholders' equity	0.22:1	0.12:1
Net debt: Total capitalization	0.18:1	0.11:1
EBITDA: Cash interest expense ²	4.26:1	5.30:1

¹ Net debt is defined as long term debt (including current portion), capital leases (including current portion), advances from suppliers, and is net of cash.

² Cash interest expense excludes amortization of other financing costs and is net of interest income.

OUTSTANDING SHARE DATA

The Company is authorized to issue an unlimited number of common shares and an unlimited number of preferred shares. As at August 31, 2011 the Company had 89.0 million (2010 – 93.3 million) issued common shares outstanding. No preferred shares were outstanding during or at the end of these periods. There was no change in issued and outstanding common shares from August 31, 2011 to November 17, 2011.

The Company has an incentive stock option plan for certain employees, officers and directors. As at November 17, 2011, 0.8 million stock options were outstanding (August 31, 2011 – 0.8 million and August 31, 2010 – 0.3 million) to acquire its common shares. As at August 31, 2011, 1,912,826 (2010 – 2,478,379) common shares remain reserved for issuance under the stock option plan. As of November 17, 2011, no additional stock options have been granted under the plan.

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. For the year ended August 31, 2011 the Company purchased through the NCIB and subsequently cancelled 4.358 million common shares (2010 – 4.271 million). The NCIB expired on October 11, 2011.

LIQUIDITY AND CAPITAL RESOURCES

On April 6, 2010, the Company secured a three year credit facility which includes a \$5.0 million operating line, \$5.0 million term loan and a \$15.0 million acquisition facility. On May 12, 2011, the Company amended the credit facility to increase the term loan to \$5.8 million. The credit facility 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 term loan is payable in quarterly principal installments 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 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 (2010 - \$0.5 million) leaving \$4.5 million (2010 - \$4.5 million) of the \$5.0 million (2010 - \$5.0 million) operating line available. The Company was in compliance with its financial covenants as at August 31, 2011 and for the year then ended.

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 August 31, 2011 the Company had, in addition to its bank facilities, on deposit \$3.4 million available to fund capital projects relating to existing stores subject to bank covenants, as well as for working capital and acquisitions.

Operating Activities

Cash flow from operating activities in 2011 increased to \$2.159 million from \$0.808 million in 2010. The increase in cash flow from operating activities was primarily due to fluctuations in non-cash working capital which was offset by an increased net loss in the year.

Financing Activities

Net cash expenditures used in financing activities was \$0.505 million in 2011 compared to \$7.901 million in 2010. The reduction in cash used in financing activities was due to the repayment of long term debt obligations including the TD credit facility of \$11.184 million in fiscal 2010 and only \$1.304 million in fiscal 2011. This was offset by new long-term debt facilities, net of financing costs of \$1.062 million (2010 - \$4.781 million) and advances from suppliers of \$1.034 million (2010 - \$nil). In addition the Company used cash totaling \$1.281 million (2010 - \$1.457 million) for the repurchase of Company common shares through the normal course issuer bid.

Investing Activities

Net cash used in investing activities was \$2.510 million in 2011 compared to \$3.602 million in 2010. The cash used in investing activities in the current year relates primarily to the purchase of capital assets of \$2.131 million (2010 - 2.515 million) and intangible assets of \$0.224 million (2010 - 1.428 million).

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.

TRANSACTIONS WITH RELATED PARTIES

During 2011, the Company expensed \$0.20 million (2010 - \$0.20 million) for advisory services and \$nil million (2010 - \$0.18 million) for executive services provided by Canterbury Park Management Inc, an affiliated company of a shareholder, in accordance with an advisory services agreement.

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

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 with GAAP.

Thousands of dollars (except per share amounts)	Fourth Quarter		Third Quarter		Second Quarter		First Quarter	
	2011	2010	2011	2010	2011	2010	2011	2010
Revenue ¹	18,650	20,114	18,835	20,795	19,725	20,561	19,478	20,747
EBITDA	808	632	438	890	813	976	802	1,061
- EBITDA per share - Basic	\$0.01	\$0.01	\$0.01	\$0.01	\$0.01	\$0.01	\$0.01	\$0.01
- EBITDA per share - Diluted	\$0.01	\$0.01	\$0.01	\$0.01	\$0.01	\$0.01	\$0.01	\$0.01
Net loss	(685)	(1,063)	(1,148)	(584)	(640)	(464)	(765)	(483)
- Net loss per share - Basic	(\$0.01)	(\$0.01)	(\$0.01)	(\$0.01)	(\$0.01)	(\$0.01)	(\$0.01)	(\$0.00)
- Net loss per share - Diluted	(\$0.01)	(\$0.01)	(\$0.01)	(\$0.01)	(\$0.01)	(\$0.01)	(\$0.01)	(\$0.00)

¹ Revenue and cost of sales were restated in fiscal 2011 and 2010 to report certain of the Company's revenues on a net basis. The adjustment had no impact on gross margin, operating income, EBITDA or net loss.

The Company experienced a loss of \$0.685 million in the fourth quarter as compared to a loss of \$1.063 million in the same period in 2010. This decrease in the net loss in the fourth quarter of fiscal 2011 is mainly a result of stronger operating income discussed below.

In the fourth quarter, the Company realized operating income of \$2.313 million (2010 - \$2.107 million). This increase in operating income is a result of continued store operating cost containment which resulted in a \$0.232 million or 4.1% decrease in store operating costs and continued strength in gross margin as a percentage of revenue. This strength was slightly offset by a 7.3% decline in total revenues in the fourth quarter.

Corporate costs were consistent period over period at \$1.505 million for the fourth quarter (2010 - \$1.475 million).

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

Adverse changes to the economic conditions in Canada and around the world could impact the Company's ability to execute upon its strategies, which could have a material adverse impact on its sales and financial position.

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. The inability to attract and retain pharmacists that fit well with our business model could adversely affect the Company's business and earnings.

Ability to Manage Growth and Maintain Profitability

The Company may make acquisitions of other pharmacies or develop greenfield opportunities from time to time. Growth transactions will increase the size of operations, increase the amount of indebtedness that may need to be serviced by the Company, and place additional demands on the Company's management resources. Although the Company has enhanced its systems to effectively manage growth, there is no assurance that the Company will be able to successfully integrate any future acquisitions and failure to do so 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. If a significant disruption to its information technology were 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 international, 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.

Alternative Arrangements for Generic Drug Supply

As the utilization rate of generic drugs increases, the guaranteed supply from the Company's current providers may be at risk. The Company's inability to source the required generic drug supply could adversely affect the Company's ability to maximize gross margin dollars, operating results and profits.

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 aspects 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 are not considered to be material. The Company may use derivative financial instruments to manage 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 dollars.

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

In British Columbia in 2010, the Ministry of Health Services executed a long term agreement which lowered the cost of generic prescription drugs in 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 fiscal year ended August 31, 2011 the limits decreased for generic drugs to 40% from 70% of the brand name equivalent in two phases. An additional reduction for generic drug prices to 35% of the brand equivalent will impact the Company in April 2012. 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 \$10.00 per prescription to \$10.50 on April 2, 2012. The British Columbia government has committed to a \$35 million dollar expansion of new clinical pharmacy services effective April 1, 2012.

In Alberta, effective April 2010, the prices of existing generic drugs at 75% of the equivalent brand name price have been limited to 56% of such price. Alberta has provided certain transitional and regional relief which will mitigate the effect of the changes announced from April 2010 to March 2013. The Company, 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 announcements in Alberta and British Columbia; however, no change has been announced at this time.

While regulatory changes do pose risks to the Company'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. We believe companies such as Paragon with capital to implement changes to take advantage of these opportunities are positioned to succeed.

CRITICAL ACCOUNTING 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. The Company bases its estimates and assumptions on historical experience, current trends and other factors that management believes to be important at the time the consolidated financial statements are prepared. The Company reviews its accounting policies and how they are applied on a regular basis. While the Company believes that the historical experience, current trends and other factors considered support the preparation of its consolidated financial statements in accordance with Canadian GAAP, actual results could differ from its estimates and such differences could be material.

The Company's significant accounting policies are discussed in note 2 to the consolidated financial statements of the Company. The following accounting policies incorporate a higher degree of judgement and/or complexity and, accordingly, are considered to be critical accounting policies.

Inventory

Inventory is valued at the lower of cost and net realizable value, with cost being determined on a weighted average cost basis. Significant estimation or judgement is required in the determination of estimated provisions for slow moving inventory and provisions for inventory losses, or shrinkage, occurring between the date of the last physical inventory count and the balance sheet date.

Shrinkage is estimated as a percentage of sales for the period from the date of the last physical inventory count to the balance sheet date. Such estimates are based on experience and recent physical inventory count results. To the extent that actual inventory losses experienced vary from estimates, both inventories and operating income could be impacted.

Estimates for slow moving inventory provisions are based on inventory activity with no sales over the last twelve month rolling period. The estimates for this provision are also based on past experience of required sales activities to sell through these items. To the extent that actual slow moving inventory costs vary from estimates, both inventories and operating income could be impacted.

Income and Other Taxes

The Company accounts for income taxes using the liability method of accounting. 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. To the extent that the Company does not consider it more likely than not that a future tax asset will be recovered, it provides a valuation allowance against the excess. At August 31, 2011 and 2010, the Company has provided a full valuation allowance against the future income tax asset. The determination of the income tax provision requires management to interpret regulatory requirements and to make certain judgements. While income and commodity tax filings are subject to audits and reassessments, management believes that adequate provisions have been made for all tax obligations. However, changes in the interpretations or judgements may result in an increase or

decrease in the Company's tax provisions in the future. The amount of any such increase or decrease cannot be reasonably estimated.

Goodwill

The Company records as goodwill the excess amount of the purchase price of an acquired business over the fair value of the underlying net assets at the date of acquisition. Goodwill is evaluated for impairment annually. The process of evaluating goodwill involves the determination of fair value. Inherent in such fair value determinations are certain judgements and estimates including, but not limited to, projected future sales, earnings and capital investment, discount rates and terminal growth rates. These judgements and estimates may change in the future due to uncertain competitive, market and general economic conditions, or as a result of changes in the business strategies and outlook of the Company.

A goodwill impairment loss would be recognized to the extent that the carrying value of goodwill exceeds the implied fair value. Any goodwill impairment would result in a reduction in the carrying value of goodwill on the consolidated balance sheets of the Company and the recognition of a non-cash impairment charge in operating income. Based on the analysis performed, the Company has not identified any goodwill impairment.

Long-lived Assets

The Company's long-lived assets are comprised of prescription files, customer relationships, rebranding costs, computer software, buildings, furniture and fixtures, automotive, equipment and computer equipment. These long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. The process for evaluating long-lived assets involves the determination of fair value based on undiscounted cash flows under Canadian GAAP. Inherent in such fair value determinations are certain judgements and estimates including, but not limited to, projected future sales, earnings, discount rates and terminal growth rates. These judgements and estimates may change in the future due to uncertain competitive, market and general economic conditions, or as a result of changes in the business strategies and outlook of the Company.

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 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.

FUTURE ACCOUNTING PRONOUNCEMENTS

Convergence with 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. 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 continues to report its results in accordance with Canadian GAAP.

Although the conceptual framework of IFRS is similar to that of Canadian GAAP, there are some significant differences on recognition, measurement, and disclosure that are being addressed during our implementation plan.

Project Status

The Company commenced its process to transition to IFRS and developed an implementation plan of five phases, which in certain cases are carried out 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. 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 has substantially completed this phase in fiscal 2011. This phase involved: (1) evaluating the IFRS standards, including the transitional provisions of IFRS 1, First-time Adoption of International Financial Reporting Standards; (2) assessing policy alternatives allowed under the standards and any resulting impact to the Company; (3) selecting accounting policies when alternatives are available; and (4) developing draft IFRS consolidated financial statements and note disclosures. Any potential choices of policies and optional exemptions recommended during this phase will be reviewed by the Company's Audit Committee.

Management's Discussion and Analysis *(continued)*

3. Solution development phase. The Company commenced this phase concurrent with the phase 2 activities in fiscal 2011. This phase involved considering 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) developing and documenting solutions to each business process; and (3) quantifying the impact of accounting policies chosen under IFRS at the date of transition and thereafter. The Company continues to finalize the quantification of the impacts of the accounting policy choices made under IFRS. Once this analysis is complete, any significant impacts identified will be reviewed by the Audit Committee.
4. Integration phase. The Company has commenced this phase concurrent with the second and third phases in fiscal 2011. This phase of the work plan includes: (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 once complete.
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.

The Company is in the process of finalizing the full effects of adopting IFRS, the significant areas identified, where the Company expects accounting policies to differ or where accounting policy decisions are required. The commentary below is intended to highlight those areas the Company believes to be most significant but should not be regarded as a complete account of the changes that will result from the IFRS transition.

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.

More specifically, Canadian GAAP generally uses a two-step approach to impairment testing for long-lived assets: first, comparing asset carrying values with undiscounted future cash flows to determine whether impairment exists; if this first step is not conclusive then the next step would be to measure any impairment by comparing asset carrying value with fair values. Under IAS 36, Impairment of Assets, uses a one-step approach to testing for measurement of impairment for long-lived assets, with asset carrying values compared directly with the higher of fair value less cost to sell and value in use (which uses discounted future cash flows). This may

potentially result in more write-downs where carrying values of long-lived assets were previously supported under Canadian GAAP on an undiscounted cash flow basis. The Company is in the process of finalizing the impact of impairment model differences resulting from the transition to IFRS. The Company is currently reviewing the implications of IAS 36 on its long-lived assets and goodwill.

Presentation of Financial Statements (IAS 1)

The Company has noted several changes to the format of the consolidated financial statements and note disclosure upon adoption of IAS 1. In accordance with IAS 1, the Company will be required to present a separate statement of equity, classify our operating expenses by nature or function, adopt new financial reporting terminology, and be required to increase the financial statement disclosure, especially around the basis for measurement and judgements.

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.

Other Standards

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 that may be significant. Final conclusions could change as the Company progresses through its implementation plan.

The International Accounting Standards Board ("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 Director of Finance 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.

Management's Discussion and Analysis *(continued)*

Based on that evaluation and in light of the control weaknesses discussed below, the CEO and Director of Finance concluded that the disclosure controls and procedures as at the end of the period covered by the annual filings are effective in providing reasonable assurance that material information relating to the Corporation 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 Director of Finance 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.