



Afexa Life Sciences Inc.

Q3

**THIRD
QUARTER
REPORT**

**MANAGEMENT'S DISCUSSION
AND ANALYSIS**

For the three and nine months ended
December 31, 2010

Management's Discussion and Analysis

for the three and nine months ended December 31, 2010

The following Management's Discussion and Analysis ("MD&A") for Afexa Life Sciences Inc. ("Afexa" or "the Company") was prepared as of February 9, 2011 to assist readers in understanding our consolidated financial performance for the three and nine months ended December 31, 2010. This MD&A should be read in conjunction with the accompanying unaudited interim consolidated financial statements for the three and nine months ended December 31, 2010 and the notes contained therein. In addition, this MD&A should be read in conjunction with the MD&A and audited consolidated financial statements for the six months ended March 31, 2010. The accompanying consolidated financial statements are prepared in accordance with Canadian generally accepted accounting principles ("GAAP") and are reported in Canadian dollars. These accounting principles require us to make certain estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, expenses, and related disclosure of contingent assets and liabilities. We believe these estimates and assumptions are reasonable based on the information available at the time that these estimates and assumptions are made. Actual results may differ under different assumptions and conditions.

This MD&A contains forward-looking statements. Please see the section "Advisory Regarding Forward-looking Statements" for a discussion of the risks, uncertainties and assumptions used to develop our forward-looking statements. This MD&A also refers to certain non-GAAP financial measures to assist users in assessing our performance. Non-GAAP financial measures do not have any standard meaning prescribed by GAAP and may not be comparable to similar measures presented by other issuers. These measures are identified and described under the section "Non-GAAP Financial Measures".

Additional information on Afexa, including our most recently filed Annual Information Form dated June 24, 2010, MD&A and audited financial statements, is available on the System for Electronic Document Analysis and Retrieval ("SEDAR") website at www.sedar.com.

OUR BUSINESS

We are a life sciences and technology company founded in 1992 and headquartered in Edmonton, Alberta, Canada. We have developed, commercialized and patented a proprietary technology, known as ChemBioPrint, which is used in the discovery and biological standardization of natural products that deliver consistent, verifiable and provable health benefits. Using the ChemBioPrint® product discovery and standardization platform, our scientists are able to identify precisely the chemical profile and biological activity of natural products. The process involves a combination of chemical and biological fingerprinting to ensure that the creation and scientific substantiation of our natural health products are safe, effective and consistent. We are committed to using a pharmaceutical model (involving rigorous drug discovery and testing methods) to develop natural medicines for health maintenance and disease prevention. Our efforts in scientific research and product innovation are key factors in enabling us to secure the trust of consumers, trade professionals, healthcare practitioners and government.

Our lead commercial product, COLD-FX®, is designed to aid in the prevention and relief of colds and flu by strengthening the immune system. COLD-FX continues to be the number one selling cold and flu remedy in Canada (source: The Nielsen Company MarketTrack National all channel dollar sales for the categories of Cold Remedies and Supplements and Products, 52 weeks ended December 18, 2010).

QUARTER OVERVIEW

- Revenue for the three months ended December 31, 2010 was \$12.6 million reflecting a decrease of \$16.9 million from the same quarter in 2009. The unusually high revenue reported during the three months ended December 31, 2009 was largely driven by the presence of H1N1, a pandemic strain of the flu, during that period;
- We reported net earnings of \$0.9 million or \$0.01 per share during the quarter compared to net earnings of \$6.8 million or \$0.06 per share in the comparative three-month period ended December 31, 2009;
- In October 2010, we signed an in-license agreement whereby we were granted the exclusive Canadian rights to use, market, sell and distribute a proprietary natural health product for the treatment of cold sores. This product has been clinically proven to shorten the healing time and relieve the pain associated with cold sores. We plan to launch this product into the Canadian marketplace in the summer of 2011;
- We recently launched a multi-centre clinical trial to explore the potential application of COLD-FX in a pediatric population. The randomized, double-blind, placebo-controlled trial is rare in the field and is designed to assess the potential benefit of COLD-FX in reducing cold and flu symptoms and the burden of disease on children. We recently expanded the recruiting for this clinical trial to a fourth site in Toronto, Ontario;
- In October 2010, we renewed our normal course issuer bid ("NCIB") with the Toronto Stock Exchange. During the quarter ended December 31, 2010, we repurchased an additional 259,508 common shares at a weighted average trading price of \$0.51 per share; and
- We exited the quarter ended December 31, 2010 with \$9.1 million in cash. With the exception of an obligation under capital lease of \$0.8 million, we are essentially debt free.

Summary of Consolidated Financial Results

(in thousands except for per share amounts)	Three months ended December 31		Nine months ended December 31	
	2010	2009	2010	2009
Revenue	\$ 12,628	\$ 29,547	\$ 33,575	\$ 51,298
EBITDA ¹	1,551	10,274	4,039	13,377
Net earnings	934	6,816	1,983	8,478
Earnings per share – basic and diluted	0.01	0.06	0.02	0.08
Cash flow prior to working capital changes ¹	1,510	6,987	3,994	10,034
		As at December 31, 2010		As at March 31, 2010
Working capital ¹		\$ 15,373		\$ 17,503
Total assets		40,083		44,077
Total long-term debt and obligations under capital lease (including current portion)		869		6,027
Shareholders' equity		27,883		25,795

¹ These financial measures are identified and defined under the section "Non-GAAP Financial Measures".

OVERALL PERFORMANCE

Revenue during the quarter ended December 31, 2010 was modest as the incidence of cold and flu was relatively low and retailers entered the quarter well stocked with COLD-FX product. In contrast, we believe revenue during last year's quarter ended December 31, 2009 was unusually high, largely driven by the presence of H1N1, a pandemic strain of the flu. As a result, revenue declined to \$12.6 million during the quarter ended December 31, 2010 from \$29.5 million achieved in the same quarter last year.

Despite much lower revenue achieved during the quarter, we were able to maintain a relatively strong gross margin of 70.2% for the three months ended December 31, 2010. This compares to a gross margin of 72.5% achieved in the same quarter of the prior year. On a year-to-date basis, gross margin increased to 71.9% from 70.9% in the same nine-month period of 2009 as we continued to improve our inventory management processes and achieve cost efficiencies.

Consistent with the decline in our revenue, net earnings decreased to \$0.9 million or \$0.01 per share during the quarter. This compares to net earnings of \$6.8 million or \$0.06 per share achieved in the comparative quarter ended December 31, 2009.

Moving into the fourth quarter ending March 31, 2011, our revenue will be dependent on the incidence of cold and flu in Canada and the related consumer demand for COLD-FX. So far this quarter, the incidence of cold and flu among the Canadian population has been tracking above the same period last year according to FAN Canada, a third-party organization that tracks the incidence of cold and flu among the Canadian population. Based on these encouraging signals, we currently expect revenue for the upcoming quarter will exceed the revenue reported in the comparative three-month period ended March 31, 2010. On a year-over-year basis, however, revenue for our fiscal year ending March 31, 2011 is expected to be more comparable to the Canadian derived revenue for the twelve-month period ended March 31, 2009, which did not include the H1N1 anomaly (see "Advisory Regarding Forward-looking Statements").

We continue to maintain a strong balance sheet with a cash position at December 31, 2010 of \$9.1 million. Except for an obligation under capital lease of \$0.8 million, we are essentially debt free. We believe our strong financial position will provide us significant flexibility to pursue our growth strategies over the coming years (see "Advisory Regarding Forward-looking Statements").

COLD-FX continues to be the number one pharmacist and doctor recommended natural cold remedy as reported by Drugstore Canada's and L'actualite Pharmaceutique's 2009 / 2010 Survey on OTC Counseling and Recommendations and The Medical Post's 2009 / 2010 Survey on OTC Counseling & Recommendations, respectively. In addition, COLD-FX remains the number one selling cold and flu remedy in Canada for the 52 week period ended December 18, 2010, per point of sales data received from the Nielsen Company.

VISION AND STRATEGY

Our vision is to deliver the most trusted health brand on the planet. We plan to achieve our vision by pioneering evidence-based natural medicines that empower people to achieve their health potential. However, to achieve this vision, we must grow. This means growing our product offering to consumers and expanding our geographic presence.

By the end of the next five years, our strategic plan is designed to deliver to our shareholders average annual revenue growth in excess of 10% (see "Advisory Regarding Forward-looking Statements"). Our growth strategies are well underway to achieving this goal.

EXECUTING OUR GROWTH STRATEGIES – PRODUCT DIVERSIFICATION

We continue to invest in scientific and clinical research to identify and develop new and effective natural medicines. Through a strong scientific research and development team, we are expanding our product offering through the following initiatives:

- Developing existing product candidates beyond COLD-FX;
- Advancing multiple product candidates through clinical trials and targeted development;
- Increasing discovery research and development on new product candidates; and
- In-licensing third-party products that align with our vision.

COLD SORE

In October 2010, we signed an exclusive in-license agreement with Lisoma International Ltd. and Lisoma Canada Ltd. (collectively “Lisoma”) whereby we were granted the exclusive Canadian rights to use, market, sell and distribute Lisoma’s proprietary natural health product for the treatment of cold sores.

The product was recently granted a Natural Product Number (“NPN”) from Health Canada’s Natural Health Products Directorate, allowing the product to be sold in Canada as an over-the-counter remedy to relieve the pain of cold sores and to speed healing time. This product has been clinically proven to shorten the healing time and relieve the pain associated with cold sores. We believe this product will be beneficial to the significant number of Canadians that suffer from recurring cold sores (see “Advisory Regarding Forward-looking Statements”).

We are currently finalizing our sales and marketing programs to launch this product into the Canadian marketplace with shipments to retail customers expected to commence in the summer of 2011 (see “Advisory Regarding Forward-looking Statements”).

IMMUNITY-FX®

In the fall of 2009, we launched a new product, IMMUNITY-FX. IMMUNITY-FX is designed as a daily immune booster to help consumers stay healthy and is comprised of a special formulation to help the immune system fight germs and pathogens that are foreign to the body. A number of public relations, social media and marketing events are being conducted to broaden consumer awareness of IMMUNITY-FX.

CHOLESTEROL MANAGEMENT

Using our ChemBioPrint technology, we have discovered a prototype product designed to manage cholesterol levels. Pre-clinical studies of this proprietary formulation have shown that it has the potential to manage abnormal cholesterol. A pilot clinical trial is currently underway and is designed to identify optimum dosing levels and determine safety and tolerability. Preliminary data signals from a pilot clinical trial demonstrating similar efficacy to our pre-clinical studies have been presented at the Canadian Cardiovascular Congress (Montreal, November, 2010), and recently won an award at the Scripps Evidence-based Supplements scientific meeting (San Diego, January, 2011) (see “Advisory Regarding Forward-looking Statements”).

COLD-FX PEDIATRICS

A multi-centre clinical trial was recently launched to explore the potential application of COLD-FX in a pediatric population. The randomized, double-blind, placebo-controlled trial is rare in the field and is designed to assess the potential benefit of COLD-FX in reducing cold and flu symptoms and the burden of disease on children. Volunteers will take a special formulation of COLD-FX for children or a placebo at the first onset of symptoms. A total of 500 children 3-11 years of age are being recruited for the study, with an estimated 300 children developing an infection and entering the trial. A fourth site based in Toronto has recently been added, joining research sites in Halifax, Edmonton, and Saint John. The study is a follow-up to a positive randomized controlled trial demonstrating the safety of COLD-FX in this population and providing early indications of efficacy, which was used in designing the current study.

SEASONAL ALLERGIC RHINITIS

Positive pre-clinical lab studies examining the potential of CVT-E002, the core active ingredient in COLD-FX and IMMUNITY-FX, in asthma and allergy-related indications have been completed. The recruitment phase has also been completed on a randomized, placebo-controlled, double-blind clinical trial involving 200 participants with seasonal allergic rhinitis. We are targeting to receive results from this study within the next nine months (see "Advisory Regarding Forward-looking Statements").

CANCER – CHRONIC LYMPHOCYTIC LEUKEMIA

Positive pre-clinical lab studies in viral-induced leukemia have been conducted in collaboration with McGill University. A National Cancer Institute supported and Wake Forest University ("WFU") led multi-centre clinical trial in chronic lymphocytic leukemia is currently undergoing final analysis, with encouraging initial signals showing some acute respiratory infection symptom and serious adverse event reduction. Further clinical study is in the planning stages with WFU.

BRAIN HEALTH

We are continuing to investigate the core active ingredient in REMEMBER-FX[®] and MEMORY-FX[®], HT1001[™], in healthy aging adults. In previous clinical trials, HT1001 intake was associated with improvements in memory in generally healthy adults and schizophrenia patients, and reduced oxidative stress which is associated with many diseases, including neurodegeneration. We are now planning an additional clinical trial for oxidative stress and brain function.

OTHER RESEARCH AND DEVELOPMENT

Our research has discovered potential polymolecular botanical toll-like receptor ("TLR") modulators. These are a class of molecules that can target multiple organs and tissues, including specific immune cells, and have the potential to fight a variety of diseases including cancer and some chronic viral infections. We are now evaluating the opportunities for advancing the development of these potential therapeutics.

We have also discovered a potential polymolecular formulation that has shown synergistic effects on increasing glucose uptake in cultured skeletal muscle cells, indicating therapeutic potential in diabetes prevention and management. This formulation is now ready for testing in a pilot open-label dose-ranging clinical trial exploring safety and efficacy.

EXECUTING OUR GROWTH STRATEGIES – MARKET DIVERSIFICATION

Canada remains the engine of our business and the primary showcase for our products. However, we are advancing several initiatives to expand our market penetration both within Canada and internationally.

CANADA

Despite the strong success of our lead product, COLD-FX, its household penetration generally across Canada is still small. We continue to invest in marketing initiatives and public relations programs to increase the exposure of COLD-FX in Canada.

In addition, consumer surveys show that COLD-FX is underdeveloped in the Province of Quebec relative to other provinces in Canada. We have increased our pharmacist and doctor education programs in this province and have designed specific marketing programs for the Quebec consumer. Due to the unique nature of this market and the way pharmacy stores are owned and operated in Quebec, we have also engaged sales personnel specifically dedicated to developing our market in this province. These dedicated personnel are directly visiting retailers and pharmacists in the Quebec market. We expect to achieve significant revenue growth over the next year in this geographic location (see "Advisory Regarding Forward-looking Statements").

UNITED STATES

We believe that certain Afexa products potentially fit the criteria for development under a relatively new “Botanical Drug” category defined by the United States Food and Drug Administration (“FDA”). Market approval as a Botanical Drug follows the same process as for non-botanical drugs, with the important difference that unique FDA expertise in botanical medicine is involved in the regulatory review process. Approval of a New Drug Application (“NDA”) is based on pre-clinical and toxicology data, adequate information on chemistry manufacturing and controls, and previous human experience. The latter includes clinical trials, which may be conducted after the approval of an Investigational New Drug (“IND”) application. The eventual approval of the NDA by the FDA will permit the marketing of a polymolecular based botanic product as a drug.

While this is potentially a faster route to approval and commercialization than the traditional drug pathway, it is still a multi-year process. We are considering seeking botanical drug approval in the United States. This may allow us to make expanded therapeutic health claims in the United States and better position ourselves in this large cold, flu, and immunotherapy related pharmaceutical market (see “Advisory Regarding Forward-looking Statements”).

OVERSEAS

We continue to meet with regulatory experts and companies in geographic locations outside Canada and the United States to better understand how to sell our products internationally. For example, we are currently assessing business opportunities and have commenced the regulatory approval process in China. In Hong Kong, we have established a distributor agreement with a local company and are now selling small amounts of COLD-FX into that market.

OTHER GROWTH STRATEGIES

Our strategic plan also contemplates other potential growth initiatives, such as business acquisitions, strategic partnerships, and international licensing arrangements.

RESULTS OF OPERATIONS FOR THE THREE AND NINE MONTHS ENDED DECEMBER 31, 2010

REVENUE

Revenue and Gross Profit Summary

	Three months ended December 31		Nine months ended December 31	
(in thousands)	2010	2009	2010	2009
Revenue	\$ 12,628	\$ 29,547	\$ 33,575	\$ 51,298
Cost of goods sold	3,766	8,115	9,449	14,931
Gross profit	8,862	21,432	24,126	36,367
Gross margin %	70.2%	72.5%	71.9%	70.9%

Revenue during the three and nine months ended December 31, 2010 declined by \$16.9 million and \$17.7 million, respectively, from the same three and nine month periods last year.

Revenue from our lead product, COLD-FX, is highly dependent on the frequency and severity of colds and flu experienced in Canada. As mentioned earlier in this MD&A, revenue during the quarter ended December 31, 2010 was modest as the incidence of cold and flu was relatively low and retailers entered the quarter well stocked with COLD-FX product. This contrasts with last year’s quarter ended December 31, 2009 where management believes that public awareness of the presence of H1N1, a pandemic strain of the flu, resulted in higher sales of COLD-FX.

We believe consumer demand for COLD-FX will continue to exhibit a seasonal pattern tied to the frequency and severity of colds and flu, as well as other factors including weather. These patterns will continue to fluctuate in the future and contribute to quarter-to-quarter volatility in our revenue (see “Advisory Regarding Forward-looking Statements”).

GROSS MARGIN

Our costs of goods sold include both variable components that fluctuate with revenue as well as fixed costs that remain relatively constant from period to period. In addition, certain customer discounts and allowances (recognized as a deduction in reported revenue) are also fixed in nature and therefore reduce our gross margin in periods of lower sales. Despite much lower revenue achieved during both the three and nine months ended December 31, 2010, we were able to maintain a relatively strong gross margin of 70.2% for the quarter ended December 31, 2010 and increase our gross margin to 71.9% on a year-to-date basis from 70.9% in the prior year.

We continue to improve our inventory management processes to achieve lower production costs and reduce obsolescence-related inventory write-downs. Improvements in these areas caused our gross margin to improve during the nine months ended December 31, 2010. Through improved inventory management and purchasing practices, we are targeting to achieve annual gross margins in excess of 70% in the future (see "Advisory Regarding Forward-looking Statements").

SALES AND MARKETING

Sales and marketing expenses declined by \$2.3 million to \$4.5 million during the quarter ended December 31, 2010 from the same three-month period in the prior year. During the quarter ended December 31, 2009, additional expenditures were incurred in connection with our sponsorship of the 2010 Winter Olympic Games that did not reoccur this year. Also contributing to lower expenses during the quarter was a reduction in sales commission expense due to lower revenue. In addition, we curtailed discretionary marketing spend to better align our marketing expenses with expected revenue results for the quarter.

Similarly, on a year-to-date basis, sales and marketing expenses also declined by \$1.9 million to \$9.3 million from \$11.2 million reported in the same nine-month period of 2009.

We have been expanding our sales and marketing resources to further our presence in the Canadian marketplace and to prepare for the launch of new product candidates. To further enhance our skill sets and manage succession in this area, we have recently hired a person for the position of Chief Marketing Officer and Senior Vice President Sales.

GENERAL AND ADMINISTRATION

General and administration expense decreased by \$0.3 million to \$2.4 million during the third quarter of fiscal 2011 from \$2.7 million reported in the same period of the previous year. Contributing to this decline was a reduction in our employee variable short-term incentive expense from the prior year. As a result of lower revenue achieved during the three months ended December 31, 2010, certain revenue and EBITDA related targets were not met in the current quarter that were achieved in the prior year.

On a nine-month basis, general and administration costs declined by \$0.6 million to \$7.4 million from the same nine-month period in 2009. Contributing to the decline were costs totalling \$1.1 million in the prior fiscal year related to legal, professional and settlement costs associated with an agreement reached with the Alberta Securities Commission. These costs did not reoccur in the nine months ended December 31, 2010. Offsetting this decrease were additional investments in corporate development activities and new management personnel over the past twelve months to further our business development and growth strategies.

RESEARCH AND DEVELOPMENT

Research and development ("R&D") costs decreased to \$0.2 million during the quarter ended December 31, 2010 from \$1.5 million in the previous year. Offsetting R&D costs for the quarter were \$0.8 million (three months ended December 31, 2009 – \$0.1 million) of scientific research and development ("SRED") tax credits. During the quarter, we received audit confirmation on certain SRED credit balances owing to the Company and then revised our estimates of the total amount of SRED tax credits realizable to the Company from fiscal years 2008 to present.

R&D expenses, excluding SRED tax credits was \$1.0 million during the quarter ended December 31, 2010 compared to \$1.6 million in the same quarter last year. The reduction of \$0.6 million is mainly attributable to the timing of certain clinical trial costs incurred during the quarter ended December 31, 2009 that did not reoccur to the same degree in the same quarter this year.

On a year-to-date basis, research and development costs decreased to \$2.7 million from \$3.3 million in the prior year. R&D expenses, excluding SRED tax credits of \$1.0 million (nine months ended December 31, 2009 – \$0.3 million), were \$3.7 million for the nine months ended December 31, 2010 compared to \$3.6 million for the same nine-month period in the previous year, representing an increase of \$0.1 million.

We continue to fund all of our research and development activities from internal cash flow generated from operating activities in addition to funds received from SRED tax credits and grants.

STOCK-BASED COMPENSATION

We recognized stock-based compensation expense of \$0.2 million during the three months ended December 31, 2010, which was comparable to the expense recognized in the same three-month period of 2009. On a year-to-date basis, stock-based compensation expense declined to \$0.6 million from \$0.8 million in the same nine-month period of 2009. Additional stock-based compensation expense occurred in the prior year because of accelerating the expensing of certain options related to severance.

EBITDA

For the three months ended December 31, 2010, we achieved EBITDA (see “Non-GAAP Financial Measures”) of \$1.6 million compared to EBITDA of \$10.3 million reported in the three months ended December 31, 2009. Significantly lower revenue recognized during the quarter caused this decrease.

On a year-to-date basis, EBITDA of \$4.0 million achieved during the nine months ended December 31, 2010 was also less than EBITDA of \$13.4 million achieved in the same nine-month period of 2009, again driven almost fully from a reduction in revenue in the current quarter.

INTEREST AND BANK CHARGES

Interest and bank charges declined to \$22 thousand during the quarter from \$95 thousand in the corresponding quarter of the prior year as we paid out our long-term mortgage in September 2010. On a year-to-date basis, interest expense of \$0.3 million for the nine months ended December 31, 2010 remained consistent with the same period of the prior year. Offsetting the interest savings achieved during the current quarter were additional interest charges and penalties incurred in September 2010 related to the early mortgage pay-out.

AMORTIZATION

We incurred amortization expense of \$0.3 million and \$1.0 million, respectively, during the three and nine months ended December 31, 2010, which approximate the amounts reported in the same periods of the prior year. Additional amortization on new equipment purchased over the past twelve months has been offset by older assets becoming fully amortized.

INCOME TAXES

During the quarter, we recognized income tax expense of \$0.3 million, representing an effective income tax rate of 21.4% on earnings before income taxes of \$1.2 million. During the nine months ended December 31, 2010, we recognized income tax expense of \$0.8 million, representing an effective income tax rate of 28.5% on earnings before income taxes of \$2.8 million. We experienced a lower effective tax rate during the quarter ended December 31, 2010 due to a favourable tax resolution recognized during the period that relates to prior years of \$0.1 million. Excluding the favourable tax resolution, our effective tax rate for the three months ended December 31, 2010 would have been 33.2% (nine months ended December 31, 2010 – 33.6%).

During the comparative nine months ended December 31, 2009, we incurred income tax expense of \$3.7 million, representing an effective tax rate of 30.3%. We experienced a higher effective tax rate during the nine months ended December 31, 2010 because of non-deductible expenses having a proportionately larger impact on income tax expense as a percentage of earnings before income taxes than they did for the nine months ended December 31, 2009.

NET EARNINGS

We reported net earnings of \$0.9 million during the quarter ended December 31, 2010, reflecting a decrease of \$5.9 million from the comparative quarter ended December 31, 2009. On a year-to-date basis, we recognized net earnings of \$2.0 million, reflecting a decline of \$6.5 million from the nine-month period ended December 31, 2009. Significantly lower revenue and gross profit reported during these respective periods caused these declines.

QUARTERLY INFORMATION

(in thousands except for per share amounts)	For quarters ended							
	Dec. 31 2010	Sep. 30 2010	Jun. 30 2010	Mar. 31 2010	Dec. 31 2009	Sep. 30 2009	Jun. 30 2009	Mar. 31 2009
Revenue	\$ 12,628	\$19,189	\$ 1,758	\$ 4,827	\$29,547	\$15,557	\$ 6,195	\$ 6,119
Net earnings (loss)	934	5,124	(4,075)	(4,027)	6,816	2,782	(1,120)	(3,168)
Earnings (loss) per common share – basic and diluted	0.01	0.05	(0.04)	(0.04)	0.06	0.03	(0.01)	(0.03)

Most of our revenue is from the sale of COLD-FX. Sales of this product exhibit a seasonal pattern tied to the frequency and severity of colds and flu, as well as other factors including weather. This affects the volume and timing of sales. The quarter ended September 30 corresponds to the time that most of our major customers commence stocking up on cold and flu products in anticipation of demand in the late fall and winter months when, historically, the incidence of colds and flu rises. Further orders are made for restocking of product once the cold and flu season commences, which typically corresponds to our quarter ended December 31. Our quarter ended March 31 corresponds to the time that the incidence of colds and flu are on the decline. The quarter ended June 30 is historically the quarter with the lowest revenue as the incidence of colds and flu is typically at its lowest.

We believe that, due to the uncertain economic conditions that prevailed in the quarter ended March 31, 2009, many of our retail customers reduced levels of store inventories. As a result, lower revenue was achieved in the quarter ended March 31, 2009, thus resulting in a higher than expected loss for that quarter. Starting in the quarter ended June 30, 2009, public awareness of flu increased with a higher incidence of flu and the associated World Health Organization announcement, and media coverage thereon, of H1N1, a pandemic strain of the flu. Revenue and net earnings increased in the quarters ended June 30, 2009, September 30, 2009 and December 31, 2009 as compared to the corresponding prior year's quarters because of an increase in demand for COLD-FX during this period. In the quarters ended March 31, 2010 and June 30, 2010, concerns over H1N1 declined and retailers were well stocked with cold and flu products. Fewer incidents of flu resulted in lower retailer sale volumes of cold and flu products and as a result, restocking orders for COLD-FX were relatively low in these periods. During the quarter ended September 30, 2010, revenue again increased as retail customers began stocking up on cold and flu products prior to the fall and winter cold and flu season. During the quarter ended December 31, 2010, revenue was lower than normal for this time of year as retailers entered the quarter well stocked with COLD-FX and the incidence of cold and flu was significantly lower than in the same quarter last year.

LIQUIDITY AND CAPITAL RESOURCES

Our main source of capital during the nine months ended December 31, 2010 was our cash on hand provided from operating activities in prior periods. The primary use of our cash during the nine-month period was to fund working capital needs and pay out our mortgage in September 2010.

Our working capital and capital expenditure requirements depend upon numerous other factors including, but not limited to, the success and timing of the introduction of new products or entry into new markets, consumer demand, risk of sales returns, timing of market development programs, and long-term focus on product research and development activities. We believe that future cash generated from operating activities and the availability of our operating line of credit (see "Aggregate contractual obligations and off-balance sheet financing") will be sufficient to fund both our future working capital needs and research and development activities beyond the next twelve months (see "Advisory Regarding Forward-looking Statements").

Selected Cash Flow and Capitalization Data

(in thousands)	Three months ended December 31		Nine months ended December 31	
	2010	2009	2010	2009
Cash flow prior to working capital changes ¹	\$ 1,510	\$ 6,987	\$ 3,994	\$ 10,034
Cash provided by (used in) operating activities	5,303	13,327	(2,213)	9,092
		As at December 31, 2010		As at March 31, 2010
Cash		\$ 9,108		\$ 17,685
Working capital ¹		15,373		17,503
Long-term debt and obligations under capital lease (including current portion)		869		6,027

¹ These financial measures are identified and defined under the section "Non-GAAP Financial Measures".

CASH AND WORKING CAPITAL

At December 31, 2010, we had \$9.1 million of cash on hand. This compares to \$17.7 million in cash at March 31, 2010. During the nine months ended December 31, 2010, we utilized cash on hand to fund our working capital needs, complete capital expenditures, and repay our outstanding mortgage.

Our working capital position at December 31, 2010 was \$15.4 million (March 31, 2010 – \$17.5 million). The decrease of \$2.1 million from March 31, 2010 is primarily due to paying out our long-term mortgage in September 2010.

CASH USED IN OPERATING ACTIVITIES

Cash flow prior to working capital changes was \$4.0 million during the nine months ended December 31, 2010 compared with \$10.0 million in the same period of the prior year. Lower earnings during the nine-month period ended December 31, 2010 caused this decline. Including changes in working capital items, we utilized \$2.2 million in cash from operating activities during the nine months ended December 31, 2010 as we used cash on hand to build inventory levels and pay required income tax instalments.

CASH USED IN INVESTING ACTIVITIES

Capital expenditures for the nine months ended December 31, 2010 included purchases of property and equipment of \$0.4 million and additions to intangible assets of \$0.4 million. These expenditures were incurred primarily for lab and computer equipment as well as for patent and trademark costs associated with new product development.

CASH USED IN FINANCING ACTIVITIES

During the nine months ended December 31, 2010, we repaid our mortgage in full and repurchased common shares under our NCIB resulting in net cash used in financing activities of \$5.5 million.

AGGREGATE CONTRACTUAL OBLIGATIONS AND OFF-BALANCE SHEET FINANCING

During the prior quarter ended September 30, 2010, we paid out the remaining mortgage on our Edmonton facility of \$5.0 million. We also entered into a credit facility agreement with a new bank that consists of a demand operating line of credit of \$15.0 million, with interest at the bank's prime lending rate plus 0.75%. The portion of the line of credit that is available to Afexa is based on: (i) 65% of the Edmonton, Alberta head office and research centre's appraised value to a maximum limit of \$6.8 million (maximum limit to be reduced annually based on an amortization period of 15 years), (ii) 75% of accounts receivable aged less than 90 days, and (iii) 50% of finished goods inventory to a maximum limit of \$4.1 million. The credit facility will be collateralized by a General Security Agreement constituting a first ranking security interest in all personal property of the Company and a demand collateral mortgage constituting a first fixed charge on our head office and research facility. The credit facility is currently undrawn.

We also have an obligation under capital lease related to land on which our Edmonton, Alberta head office and research facility is located. The capital lease expires on November 15, 2015, and provides us an option to purchase the land on or before that time. We expect to exercise this option on or before the expiration of the lease (see "Advisory Regarding Forward-looking Statements").

In addition, we enter into operating and capital leases and purchasing agreements in the ordinary course of our business. To encourage a contract manufacturer organization ("CMO") to invest in specific equipment required to produce our products, we signed on May 26, 2010 a commitment to purchase a minimum of \$3.0 million of inventory from this CMO over a three-year period.

We project that capital expenditures for the year ending March 31, 2011 will approximate \$1.0 million to \$1.3 million, which will primarily consist of lab, office, and computer equipment as well as patent and trademark costs associated with new product development (see "Advisory Regarding Forward-looking Statements").

CLASS ACTION LAWSUIT

In 2007, two concurrent and coordinated class action lawsuits were commenced in Alberta and Ontario against the Company and certain of our officers and former directors. These lawsuits sought compensatory damages, costs, and expenses in the amount of \$110 million each. On September 16, 2009, we announced we had reached an agreement in principle, subject to court approval, to settle the proposed class action lawsuits. On August 5, 2010, we announced that the Ontario Superior Court of Justice had dismissed the proposed Ontario class action lawsuit in conjunction with its approval of the settlement of all related claims. As part of the settlement and in conjunction with the Ontario Court Order, the Alberta Court of Queen's Bench dismissed the related proposed Alberta class action lawsuit.

The settlement agreement provides for the settlement, release and dismissal of all claims asserted against the Company, our former auditors and the individual proposed defendants and does not in any way constitute any admission of liability by Afexa or our officers, directors or employees. Our portion of the settlement amounts to \$6.6 million, which has been funded through insurance coverage. The settlement is now final.

RELATED PARTY TRANSACTIONS

Included in general and administration expenses during the three and nine months ended December 31, 2010, were management consulting fees of \$nil and \$32 thousand, respectively (three and nine months ended December 31, 2009 – \$nil) incurred from a company controlled by a director of Afexa. These expenses occurred in the normal course of operations and were measured at their exchange amounts, which were established and agreed to as consideration by the related parties.

OUTSTANDING SHARES AND STOCK OPTIONS

We are authorized to issue an unlimited number of common shares and an unlimited number of preferred shares. As at February 9, 2011, 103,999,306 common shares were outstanding (December 31, 2010 – 103,999,306 and March 31, 2010 – 104,504,670). No preferred shares were outstanding during or at the end of these periods. Certain of our employees, officers, contractors and directors were granted options to purchase common shares under our stock option plan. At February 9, 2011, 5,101,184 options were outstanding (December 31, 2010 – 5,101,184 and March 31, 2010 – 5,658,684).

NORMAL COURSE ISSUER BID

Effective October 18, 2010, we renewed our NCIB with the Toronto Stock Exchange. Under the NCIB, we are entitled to repurchase up to 5,212,941 common shares, representing 5% of our then issued and outstanding common shares. The NCIB will terminate on October 17, 2011. During the quarter ended December 31, 2010, we repurchased 259,508 common shares at a weighted average trading price of \$0.51 per share.

OUTLOOK

Moving into the fourth quarter ending March 31, 2011, our revenue will be dependent on the incidence of cold and flu in Canada and the related consumer demand for COLD-FX. So far this quarter, the incidence of cold and flu among the Canadian population has been tracking above the same period last year according to FAN Canada, a third-party organization that tracks the incidence of cold and flu among the Canadian population. Based on these encouraging signals, we currently expect revenue for the upcoming quarter will exceed the revenue reported in the comparative three-month period ended March 31, 2010. On a year-over-year basis, however, revenue for our fiscal year ending March 31, 2011 is expected to be more comparable to the Canadian derived revenue for the twelve-month period ended March 31, 2009, which did not include the H1N1 anomaly (see “Advisory Regarding Forward-looking Statements”).

By the end of the next five years, our strategic plan is designed to deliver to our shareholders average annual revenue growth in excess of 10% (see “Advisory Regarding Forward-looking Statements”). Our growth strategies are well underway to achieving this goal. Please see discussions under “Executing our Growth Strategies – Product Diversification” and “Executing our Growth Strategies – Market Diversification” earlier in this MD&A for further details surrounding our growth initiatives.

RISKS AND UNCERTAINTIES

Our business is subject to certain risks and uncertainties related to financial risks (including liquidity, interest rate, foreign exchange, credit and litigation risk); operational risks (including market, product, seasonality of demand, product development, material supply and reliance on third-party risks); regulatory approvals, and health and safety risks. Further discussion regarding these and other risks can be found in our March 31, 2010 annual MD&A and Annual Information Form dated June 24, 2010 available on the SEDAR website at www.sedar.com.

Prior to making any investment decision regarding Afexa, investors should carefully consider, among other things, the risks described within this MD&A and the business risks and factors set forth in our March 31, 2010 annual MD&A and Annual Information Form dated June 24, 2010. Other than as discussed elsewhere in this MD&A, our business risks and factors for the three and nine months ended December 31, 2010 are substantially the same as disclosed in our annual MD&A, and are incorporated by reference herein. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also adversely affect our business and operations.

DISCLOSURE CONTROLS AND PROCEDURES ("DC&P") AND INTERNAL CONTROLS OVER FINANCIAL REPORTING ("ICFR")

We have evaluated whether there were changes in our internal controls over disclosure and financial reporting during the most recent interim period ended December 31, 2010 that have materially affected, or are reasonably likely to materially affect our DC&P and ICFR. No material changes were identified for the period.

We continue to work on implementing control enhancements to address the material weaknesses described in our 2010 year-end MD&A. To estimate the value of trade promotions offered to our customers, we previously relied on end-user computing tools which lacked sufficient application controls. To remediate this weakness, we licensed and implemented a trade promotion management application. Throughout the period we continued to improve internal review processes to minimize the risk of error in trade promotion estimation processes.

We have completed redesign and implementation of our financial estimation processes related to accrued liabilities, and our information technology processes relating to logical access and change management.

Further discussion regarding DC&P and ICFR can be found in our March 31, 2010 annual MD&A.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Critical accounting policies and estimates are those policies, assumptions and estimates that are most important in the preparation of our consolidated financial statements. The selection of policies requires our subjective and complex judgment from many alternatives and estimates involving matters that are inherently uncertain. Those policies, assumptions and estimates affect the reported amounts of assets and liabilities and revenue and expenses during the period represented at the date of the financial statements. Actual results could differ from these estimates.

Our significant estimates include provisions for customer discounts and incentives, allowances for uncollectible accounts, risk of return, inventory provisions, the realizing of future income taxes, useful lives of long-lived intangible assets and property and equipment, expected future cash flows used in evaluating long-lived assets for impairment, percentage completion of contracted service expenditures and stock-based compensation fair values. On an ongoing basis, we review our estimates to ensure that these values appropriately reflect changes in our business and new information as it becomes available.

During the nine months ended December 31, 2010, we reviewed the useful lives and consumption patterns of amortization applied to our long-lived intangible assets and property and equipment. As a result of our review, we prospectively revised the rates and methods of amortization applied to certain of these items.

During the nine months ended December 31, 2010 we provided for amortization on our intangible assets and property and equipment using the following methods and rates:

Patents	20 years straight-line
Computer software	3 years straight-line
Website development	3 to 5 years straight-line
Registered trademarks	10 years straight-line

Building and building improvements	15 to 25 years straight-line
Lab equipment	5 to 10 years straight-line
Furniture and equipment	5 years straight-line
Computer hardware	4 years straight-line
Leasehold improvements	Straight-line over term of lease

The impact of the above changes to the statement of earnings and comprehensive income during the nine months ended December 31, 2010 was not significant.

Further discussion regarding our critical accounting policies and estimates can be found in our annual MD&A for the six months ended March 31, 2010.

RECENT ACCOUNTING PRONOUNCEMENTS

CONVERGENCE WITH INTERNATIONAL FINANCIAL REPORTING STANDARDS ("IFRS")

Effective for fiscal years beginning on or after January 1, 2011, IFRS will replace Canadian GAAP for Canadian publicly accountable enterprises. We will implement these standards for Afexa beginning on April 1, 2011.

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

(a) Project Status

During the fiscal year ended September 30, 2009, we commenced our process to transition to IFRS. We developed an implementation plan of five phases, which are outlined in the MD&A for the six months ended March 31, 2010.

The preliminary diagnostic and scoping phase was completed in May 2010 and we are currently in the final stage of completing our detailed evaluation and design and solution development phases. Our project is progressing on schedule and we expect to file our first quarter financial statements under IFRS within the required timeframe.

(b) Accounting Policies and Financial Statement Preparation

We will make most adjustments required on transition to IFRS retrospectively, against opening retained earnings on April 1, 2010. Transitional adjustments relating to those standards, where restatement of comparative figures is not required, will be made on the first day of the fiscal year of adoption being April 1, 2011.

Although we have not yet finalized the full effects of adopting IFRS, the significant areas identified to date, where we expect accounting policies to differ or where accounting policy decisions are required, are discussed below. These changes in accounting policies could impact our consolidated financial statements and have been reviewed by our Audit Committee. These comments should not be regarded as a complete account of changes that will result from IFRS transition. These comments are intended to highlight those areas we believe to be the most significant.

- **IFRS 1 Exemptions**

IFRS 1, First-time Adoption of International Financial Reporting Standards, applies only at the time of changeover to IFRS. This standard requires a first-time adopter to select accounting policies that comply with each pronouncement in effect at the start of its first IFRS reporting period, being April 1, 2011 for Afexa, and retrospectively apply those policies as if they were always in effect. However, IFRS 1 provides a number of optional exemptions and mandatory exceptions, in certain areas, to the general requirement for full retrospective application of IFRS. The following are our initial conclusions with respect to the IFRS 1 optional exemptions. Note that these options are subject to ongoing assessment throughout the implementation plan and could still change.

- **Intangible assets.** We expect to use the historical cost method for each class of our intangible assets.
- **Property and equipment.** We expect to use the historical cost model for all of our property and equipment, except for our land under capital lease and building located in Edmonton, Alberta.

For our land under capital lease and building, we expect to elect to measure such assets at their respective fair values (as determined by a professional valuator) and use that amount as their deemed cost at April 1, 2010. By electing these assets at their respective fair values, we anticipate the aggregate cost of our land under capital lease and building to approximate \$10.7 million compared to the aggregate \$10.2 million net book value of these assets recognized under Canadian GAAP at April 1, 2010.

- **Cumulative translation differences on foreign exchange.** We expect to elect the cumulative translation difference, arising on translating our foreign subsidiaries into the Canadian dollar, to be zero at April 1, 2010.
- **Share-based payments.** We expect to elect not to retrospectively apply IFRS 2, Share-Based Payments, to our equity instruments granted on or before November 7, 2002, or granted after November 7, 2002 that vested before April 1, 2010. For our cash-settled share-based payment transactions, or deferred share units and restricted share units, we expect not to retrospectively apply IFRS 2 to any liabilities previously settled before April 1, 2010.
- **Business combinations.** We will apply the business combination exemption in IFRS 1 not to apply IFRS 3, "Business Combinations" retrospectively to past business combinations. Accordingly, we will not restate any business combination that took place prior to April 1, 2010.

- **Presentation of Financial Statements (IAS 1)**

We anticipate several changes to the format of our consolidated financial statements and expanded note disclosure upon adoption of IAS 1. In accordance with IAS 1, we 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 our financial statement disclosure, especially around the basis for measurements and judgments.

- **Property, Plant and Equipment (IAS 16)**

Under IAS 16, we are required to choose for each class of asset, the historical cost model or the revaluation model for subsequent measurement. We will use the cost model for each class of our assets. In addition, IAS 16 requires depreciation expense to be determined separately for each significant component of an item of property, plant and equipment. This will require us to review our current stratification of property and equipment for depreciation purposes.

In addition to the fair value adjustment described above, upon transition to IFRS, we expect to make certain changes to the depreciation categories and residual values that are applicable to components of our building. As a result, all other things remaining equal, we anticipate that during the year ending March 31, 2011, amortization expense under IFRS could be approximately \$30 thousand lower on a quarterly basis than what we currently recognize under Canadian GAAP.

- **Impairment of Assets (IAS 36)**

Under IAS 36, an entity must assess at the end of each reporting period whether there is an indication that an asset may be impaired. When there is an indication of impairment, an impairment test is required. Under IAS 36, the impairment test for finite-lived intangible assets is only one-step – comparing the recoverable amount of an asset (on a discounted basis) with the carrying amount.

Under Canadian GAAP, the impairment of intangible assets with finite lives is a two-step process. In the first step, the carrying amount of an asset is compared to the expected undiscounted cash flows for the asset. If the carrying amount is more than the undiscounted cash flows, the fair value of the asset is determined. An impairment loss is recorded if the carrying amount is more than the fair value. We are currently in the process of conducting our transitional impairment test under IFRS.

- **Share-based Payment (IFRS 2)**

Both IFRS 2 – Share-based Payment and CICA 3870 – Stock-based Compensation and Other Stock-based Payments are based on the concept that the fair value of share-based transactions should be recorded in the financial statements. Although these sections are substantially converged, they have certain differences related to how share-based payments are recognized that will affect Afexa. The most significant differences are:

- **Graded vesting** – Under IFRS, each vesting period is treated as a separate award with compensation cost for each tranche recognized on a straight-line basis over its own distinctive vesting period. Under Canadian GAAP, we currently pool all options within a specific grant and recognize compensation cost of the entire grant straight-line over the vesting period. This change in recognition pattern will accelerate the expensing of our option grants;
- **Forfeitures** – IFRS requires that measurement of share-based transactions be based on the best estimate of the number of equity instruments expected to vest at the end of each reporting period, including estimating forfeitures. Under Canadian GAAP, entities have the option of estimating forfeitures each reporting period or recognizing forfeitures as they occur. We currently recognize forfeitures as they occur; and
- **Disclosure** – IFRS has expanded disclosure requirements over Canadian GAAP.

We are currently in the process of finalizing the quantitative impact of this accounting policy change.

- **Revenue (IAS 18)**

The current general principles for revenue recognition are very similar between IFRS and Canadian GAAP and the concepts of IAS 18 are mainly consistent with Canadian standards. However, IAS 18 contains less detailed rules than Canadian GAAP. Given the lack of detailed rules and guidance under IAS 18, judgment is required in defining our IFRS policies for revenue recognition.

In substantially all aspects of revenue recognition, our current accounting policies under Canadian GAAP will continue to be acceptable under IFRS. As a result, we do not expect any significant quantitative differences to exist in regards to revenue recognition upon adoption of IFRS.

However, in June 2010, the International Accounting Standards Board (“IASB”) and Financial Accounting Standards Board (“FASB”) published a joint exposure draft on revenue recognition that could significantly impact the accounting for, and presentation of, revenue if implemented in its current form. The future effect on us has not yet been determined. We will continue to monitor developments in this area.

- **Intangible Assets (IAS 38)**

Although many of the basic underlying principles of IAS 38 are similar to those under Canadian GAAP for intangible assets, there are some predominant differences. Under IFRS, entities may only capitalize website development costs if they can demonstrate how a website will generate probable and measurable future economic benefit (i.e. website is capable of generating revenues directly). As Afexa’s websites are primarily used for promotional and marketing activities, our capitalized website costs with a carrying value at April 1, 2010 of \$0.2 million will be derecognized upon transition to IFRS. In addition, \$0.1 million of website development costs capitalized under Canadian GAAP during the nine months ended December 31, 2010 will be characterized as an expense.

- **Leases (IAS 17)**

Lease accounting under IFRS and Canadian GAAP follow similar approaches whereby leases are either capitalized and amortized over the life of the lease (finance leases) or lease payments are expensed as incurred (operating leases). Under both IFRS and Canadian GAAP, a lease is classified as a finance lease if it transfers substantially all of the risks and rewards incidental to ownership. We do not expect any financial impact to Afexa upon adopting IAS 17.

In August 2010, the IASB and FASB issued a joint exposure draft relating to leases. They are proposing that the finance lease approach be adopted for all leases, meaning all leases would be shown as an asset and liability on the statement of financial position and amortized over the life of the lease. The impact on Afexa could be significant given the length of some of our property leases. The Boards continue to receive comments on the proposed standard and plan on issuing the new standard by June 30, 2011. We continue to monitor developments in this area.

- **Income Taxes (IAS 12)**

The application of IFRS and Canadian GAAP accounting for income taxes to Afexa are similar. However, various changes in accounting policies under IFRS will impact the corresponding deferred tax asset or liability. In addition, under IAS 12, we will be required to reclassify deferred tax assets and liabilities from current to non-current presentation.

The IASB currently has several projects underway in its work plan with anticipated completion dates in calendar years 2011 and 2012. These projects are expected to result in new or amended IFRS pronouncements. We will continue to monitor standard developments issued by IASB and regulatory developments issued by the Canadian Securities Administrators, and assess their impact on our first and subsequent IFRS reporting periods.

Finalization of our implementation plan is necessary before we can fully quantify the impact of adopting IFRS on our consolidated financial statements.

(c) Information Technology and Data Systems

Information technology and data system changes may be required to support any changes made to our recognition and measurement of financial information and compilation of disclosure information due to adopting IFRS. We currently expect minimal changes will be required to our information technology systems.

(d) Internal Control over Financial Reporting and Disclosure Controls and Procedures

As we adopt accounting policies under IFRS, we are reviewing our ICFR and DC&P controls to ensure the integrity of such controls will remain under the new IFRS reporting environment. We currently expect minimal changes to our ICFR and DC&P upon transition to IFRS.

(e) Financial Reporting Expertise

As part of Phase 1 of our implementation plan, we conducted initial IFRS awareness training of key finance and operational staff. During this session, external consultants provided an overview of IFRS and potential implications of IFRS on our business.

In addition, all members of the project team have attended external training seminars on IFRS and we are continuing to provide ongoing training and education to our staff on IFRS throughout the implementation plan. Regular progress reporting within the project team and the Audit Committee on the status of the implementation project is also ongoing.

(f) Business Activities

Throughout our implementation plan, we are considering business activities that may be impacted by the conversion to IFRS, including covenant compliance, compensation arrangements and tax planning. At this time, we have not discovered any current or future anticipated business activity significantly impacted by the transition to IFRS. Minimal changes will be required to align our budgeting and forecasting processes and presentation for IFRS requirements.

NON-GAAP FINANCIAL MEASURES AND RECONCILIATIONS

We use both GAAP and certain non-generally accepted accounting principles ("non-GAAP") measures to assess performance. We believe these non-GAAP measures provide useful supplemental information to investors so they may evaluate our financial performance using the same measures as management. We believe that, as a result, information provided to the investor is more transparent in assessing the financial performance of the Company. Investors should not consider these non-GAAP financial measures as a substitute or superior to the measures of financial performance prepared in accordance with GAAP.

Normally, a non-GAAP financial measure is a numerical measure of our performance, financial position or cash flow that either excludes or includes amounts not normally excluded or included in the most directly comparable measure calculated and presented in accordance with GAAP. Working capital, EBITDA, and cash flow prior to working capital changes are not measures of financial performance (nor do they have standardized meanings) under GAAP. In evaluating these measures, investors should consider that the methodology applied in calculating such measures may differ among companies and analysts.

WORKING CAPITAL

The definition of working capital is current assets less current liabilities. We use working capital as a supplemental financial measure of our liquidity and operational performance.

(in thousands)	As at December 31, 2010	As at March 31, 2010
Current assets	\$ 26,346	\$ 29,838
Current liabilities	10,973	12,335
Working capital	\$ 15,373	\$ 17,503

EBITDA

EBITDA is defined as earnings before interest, income taxes, depreciation and amortization. We use EBITDA as a supplemental financial measure of our operational performance. We believe EBITDA to be an important measure as it excludes the effects of items that primarily reflect the impact of long-term investment decisions, rather than the performance of our day-to-day operations and is used by our lenders in computing certain bank covenants. As compared to net earnings according to GAAP, this measure is limited in that it does not reflect the periodic costs of certain capitalized tangible and intangible assets used in generating revenues in our business. We evaluate such items through other financial measures such as capital expenditures and cash flow provided by operating activities. We believe this measurement is useful to assess a company's ability to service debt and to meet other payment obligations and as a valuation measurement.

The following is a reconciliation of EBITDA to net earnings, the most directly comparable financial measure calculated and presented in accordance with GAAP for the three and nine months ended December 31, 2010 and 2009:

(in thousands)	Three months ended December 31		Nine months ended December 31	
	2010	2009	2010	2009
Net earnings	\$ 934	\$ 6,816	\$ 1,983	\$ 8,478
Current income taxes	238	3,359	497	4,021
Future income taxes (recovery)	17	(324)	295	(343)
Amortization	349	340	1,037	1,021
Interest and bank charges	22	95	264	268
Interest income	(9)	(12)	(37)	(68)
EBITDA	\$ 1,551	\$ 10,274	\$ 4,039	\$ 13,377

CASH FLOW PRIOR TO WORKING CAPITAL CHANGES

We use cash flow prior to working capital changes as a supplemental financial measure in our evaluation of liquidity. We believe adjusting principally for the swings in non-cash working capital items due to seasonality assists management in making long-term liquidity assessments. We also believe this measurement is useful as a liquidity and valuation measurement.

Below is a reconciliation of "cash flow prior to working capital changes" to cash provided by (used in) operating activities, the most directly comparable financial measure calculated and presented in accordance with GAAP.

(in thousands)	Three months ended December 31		Nine months ended December 31	
	2010	2009	2010	2009
Cash provided by (used in) operating activities	\$ 5,303	\$ 13,327	\$ (2,213)	\$ 9,092
Change in non-cash operating working capital	(3,793)	(6,340)	6,270	962
Change in deferred revenue	-	-	180	-
Change in non-current inventory	-	-	(243)	(20)
Cash flow prior to working capital changes	\$ 1,510	\$ 6,987	\$ 3,994	\$ 10,034

ADVISORY REGARDING FORWARD-LOOKING STATEMENTS

This MD&A contains certain forward-looking information and statements within the meaning of applicable securities laws. The use of any of the words "expect", "anticipate", "continue", "estimate", "objective", "ongoing", "may", "will", "would", "project", "could", "should", "contemplate", "potential", "depend", "forecast", "believe", "plans", "targets", "intends" and similar expressions are intended to identify such forward-looking statements. These forward-looking statements reflect our beliefs and are based on information currently available to us. These statements require us to make assumptions that we believe are reasonable and are subject to inherent risks and uncertainties. Actual results and developments may differ materially from the results and developments discussed in the forward-looking statements as certain of these risks and uncertainties are beyond our control. The forward-looking information and statements included in this MD&A are not guarantees of future performance and should not be unduly relied upon.

Examples of such forward-looking statements in this MD&A include, but are not limited to, our:

- expectation that revenue for the upcoming quarter ending March 31, 2011 will be dependent on the incidence of cold and flu in Canada and revenue will exceed that reported in the comparative three-month period ended March 31, 2010;
- expectation that on a year over year basis, revenue for our fiscal year ending March 31, 2011 will be more comparable to the Canadian derived revenue for the twelve-month period ended March 31, 2009, which did not include the H1N1 anomaly.
- belief that our strong financial position will provide us significant flexibility to pursue our growth strategies over the coming years;
- strategic plan being designed to deliver to our shareholders average annual revenue growth in excess of 10% by the end of the next five years;
- belief that our new cold sore product will be beneficial to the significant number of Canadians that suffer from recurring cold sores and that we will launch this product into the Canadian marketplace with shipments to retail customers commencing in the summer of 2011;
- belief that our preclinical studies and preliminary signals from our pilot clinical study indicate that our proprietary formulation related to cholesterol management may have potential to manage abnormal cholesterol;

- expectation that we will receive results from our clinical trial involving 200 participants with seasonal allergic rhinitis within the next nine months;
- expectation that we will achieve significant revenue growth over the next year in the Province of Quebec through additional marketing efforts;
- ability to apply for FDA botanical drug registration and whether such application would lead to registration and, if successful, whether such registration would help better position us in the United States marketplace;
- belief that we will continue to experience quarter-to-quarter volatility in our revenue results;
- expectation that through improved inventory management and purchasing practices, we are targeting to achieve annual gross margins in excess of 70% in the future;
- belief that our future cash generated from operating activities and the availability of our operating line of credit will be sufficient to fund both our working capital needs and research and development activities beyond the next twelve months;
- intention to exercise our option to purchase our land held under capital lease on or before the expiration of the lease; and
- projection that capital expenditures for the year ending March 31, 2011 will approximate \$1.0 million to \$1.3 million.

KEY ASSUMPTIONS

Our forward-looking statements involve a number of significant assumptions. Key assumptions utilized in developing forward-looking statements related to our future growth expectations include:

- consumer demand for COLD-FX within Canada (including within the Province of Quebec) will experience continued growth on an annual basis;
- customer pricing and related discounts and allowances remain comparable with historical levels;
- raw material and production costs remain comparable with historical experience;
- timing of required regulatory approvals for new products is received within a reasonable timeframe;
- we are able to successfully launch certain products contained within our product pipeline into the Canadian marketplace; and
- the incidence of cold and flu among the Canadian population will remain above last year for the upcoming quarter and that retailers will replenish COLD-FX stock on a normalized basis.

RISKS

In addition to the risks outlined in the “Risks and Uncertainties” section of our annual MD&A, our forward-looking statements are subject to the following risks and uncertainties:

- the incidence of illnesses in the general population;
- the impact of competition;
- consumer confidence and spending levels;
- general economic conditions;
- interest and currency exchange rates;
- unseasonable weather patterns;
- the cost and availability of capital;
- the cost and availability of grants/funding;
- product development;
- lawsuit final settlement expectations within insurance limits;
- reliance on third parties;
- dependence on a small number of major customers;
- adequate cash position to mitigate potential tightening of credit terms;
- success and adequacy of our long-term strategic objectives; and
- risk that actual results may differ from management’s assumptions and estimates.

We believe the expectations and assumptions reflected in the forward-looking information and statements contained herein are reasonable. However, no assurance can be given that these expectations and assumptions are correct and that the results, performance or achievements expressed in, or implied by, forward-looking statements within this disclosure will occur, or if they do, whether any benefits may be derived from them. All forward-looking statements are expressly qualified in their entirety by this cautionary statement.

The forward-looking information and statements contained in this MD&A speak only as at the date of this MD&A, and we assume no obligation to publicly update or revise them to reflect new events or circumstances, except as may be required pursuant to applicable laws.