



Afexa Life Sciences Inc.

Q1

**FIRST
QUARTER
REPORT**

**CONSOLIDATED FINANCIAL
STATEMENTS (UNAUDITED)**

For the three months ended
June 30, 2010

Consolidated Balance Sheets

(in thousands of Canadian dollars)
(unaudited)

As at	June 30, 2010	March 31, 2010
ASSETS		
Current		
Cash	\$ 8,575	\$ 17,685
Accounts receivable (note 3)	737	998
Inventory	11,497	9,676
Prepaid expenses and deposits	963	502
Income taxes receivable	2,732	239
Future income tax assets	435	738
	24,939	29,838
Inventory, non-current	108	243
Intangible assets	1,570	1,504
Property and equipment	12,293	12,492
	\$ 38,910	\$ 44,077
Liabilities		
Current		
Accounts payable and accruals	\$ 8,856	\$ 9,531
Current portion of long-term debt	704	710
Customer deposits	1,726	2,094
	11,286	12,335
Long-term debt	4,367	4,528
Obligations under capital lease	802	789
Deferred revenue	180	180
Future income tax liabilities	63	69
Other long-term liabilities	347	381
	17,045	18,282
Shareholders' Equity		
Share capital (note 4)	23,011	23,011
Contributed surplus (note 5)	8,405	8,260
Deficit	(9,551)	(5,476)
	21,865	25,795
	\$ 38,910	\$ 44,077

Contingencies (note 12)

See accompanying Notes to the Consolidated Financial Statements

Consolidated Statements of Loss and Comprehensive Loss and Deficit

(in thousands of Canadian dollars except per share amounts)
(unaudited)

For the three month periods ended	June 30, 2010	June 30, 2009
Revenue	\$ 1,758	\$ 6,195
Cost of goods sold	988	867
	770	5,328
Operating expenses		
General and administration	2,338	3,343
Sales and marketing	2,093	1,699
Research and development	1,246	929
Amortization (note 6)	383	326
Stock-based compensation (note 4)	148	360
Interest and bank charges (note 7)	80	94
Gain on foreign exchange	(2)	(195)
	6,286	6,556
Loss before other items and income taxes	(5,516)	(1,228)
Other items		
Interest income	17	43
Impairment of intangible assets	(4)	(10)
Other (expense) income	(4)	–
	9	33
Loss before income taxes	(5,507)	(1,195)
Income tax (recovery) expense		
Current	(1,730)	(182)
Future	298	107
	(1,432)	(75)
Net loss and comprehensive loss	(4,075)	(1,120)
Deficit, beginning of period	(5,476)	(9,927)
Deficit, end of period	\$ (9,551)	\$ (11,047)
Loss per share, basic and diluted	\$ (0.04)	\$ (0.01)
Weighted average number of shares outstanding:		
Basic and diluted	104,504,670	105,303,268

See accompanying Notes to the Consolidated Financial Statements

Consolidated Statements of Cash Flows

(in thousands of Canadian dollars)
(unaudited)

For the three month periods ended June 30, 2010 June 30, 2009

Operating activities

Net loss and comprehensive loss	\$ (4,075)	\$ (1,120)
Items not affecting cash:		
Stock-based compensation	148	360
Future income taxes	298	107
Amortization	383	326
Amortization of lease inducement	(7)	–
Accreted interest on long-term debt and land under capital lease	23	24
Loss on disposal of property and equipment	4	9
Impairment of intangible assets	4	10

(3,222) (284)

Change in non-cash operating working capital	(5,540)	(2,653)
Change in non-current inventory	135	12

Cash used in operating activities (8,627) (2,925)

Investing activities

Purchase of property and equipment	(183)	(165)
Purchase of intangible assets	(126)	(11)
Proceeds on disposal of property and equipment	3	18
Redemption of short-term investment	–	5,042

Cash (used in) provided by investing activities (306) 4,884

Financing activities

Repayment of long-term debt	(177)	(174)
Repayment of obligations under capital lease	–	(2)
Share purchase under normal course issuer bid	–	(20)

Cash used in financing activities (177) (196)

(Decrease) increase in cash (9,110) 1,763

Cash, beginning of period 17,685 4,213

Cash, end of period \$ 8,575 \$ 5,976

Supplemental cash flow information:

Interest paid	\$ 80	\$ 94
Interest received	21	128
Income taxes paid	1,846	769
Income taxes received	1,155	1,656
Property and equipment additions		
– included in accounts payable and accruals at year end	27	348

See accompanying Notes to the Consolidated Financial Statements

Notes to the Consolidated Financial Statements

Three month period ended June 30, 2010

All amounts are in thousands of Canadian dollars, except share and per share amounts
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1. NATURE OF OPERATIONS AND BASIS OF PRESENTATION

Afexa Life Sciences Inc. ("Afexa" or "the Company") is a publicly owned company that develops and sells biopharmaceutical products. The Company is incorporated under the Business Corporations Act (Alberta). Afexa's common shares are traded on the Toronto Stock Exchange under the symbol FXA. The head office and research centre for the Company is located in Edmonton, Canada.

These unaudited interim consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP") on a basis consistent with those used in the preparation of the most recent annual consolidated financial statements. These unaudited interim consolidated financial statements do not include all the information and disclosures required for annual financial statements and should be read in conjunction with the Company's audited consolidated financial statements for the six months ended March 31, 2010. In management's opinion, these interim consolidated financial statements include all adjustments necessary to present fairly such interim financial information.

In preparing consolidated financial statements in conformity with Canadian GAAP, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent liabilities at the date of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting period presented. Actual results could differ from these estimates.

The consolidated statements of loss and comprehensive loss and deficit, and cash flows, for the three months ended June 30, 2010, are not indicative of results on an annual basis due to seasonal and short-term variations. Revenue from the Company's lead product is greater in the second and third quarters of the fiscal year. The sales of this product exhibit a seasonal pattern tied to the frequency and severity of colds and flu.

2. FUTURE ACCOUNTING STANDARDS

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 publicly accountable enterprises effective for fiscal years beginning on or after January 1, 2011. Afexa will implement these standards on April 1, 2011.

In accordance with IFRS, Afexa will be required to report its results commencing with its 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, Afexa will continue 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 will be addressed during the Company's implementation plan.

The Company commenced its process to transition to IFRS and developed an implementation plan of five phases, which in certain cases will be in process concurrently. The five phases are: (1) preliminary diagnostic and scoping; (2) detailed evaluation and design; (3) solution development; (4) integration; and (5) post-implementation review. To date, the Company has completed the first phase and has commenced the second and third phases.

Most adjustments required on transition to IFRS will be made by Afexa 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 for Afexa.

Notes to the Consolidated Financial Statements

Three month period ended June 30, 2010

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

IFRS 1, First-time Adoption of International Financial Reporting Standards, applies only at the time of changeover to IFRS. This standard requires first-time adopters to select accounting policies that comply with each pronouncement in effect at the end of its first IFRS reporting period, being the quarter ending June 30, 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 International Accounting Standards Board ("IASB") currently has several projects underway in its work plan with anticipated completion dates in calendar years 2010 and 2011. These projects are expected to result in new or amended IFRS pronouncements. The Company will continue to monitor standard developments issued by IASB and regulatory developments issued by the Canadian Securities Administrators and assess their impact on the Company's first IFRS reporting period.

Differences between Canadian GAAP and IFRS may have a significant impact on the Company's consolidated financial statements; however, the Company has not yet quantified the impact to its financial position or results of its operations.

3. ACCOUNTS RECEIVABLE

	June 30, 2010	March 31, 2010
Trade receivables	\$ 3,870	\$ 3,043
Allowance for doubtful accounts	(45)	(33)
	3,825	3,010
Other receivables	447	552
Discount and incentive provisions	(7,109)	(6,528)
Return allowances	(498)	(1,053)
Other provisions	(14)	(9)
	(3,349)	(4,028)
Reclass net credits in trade receivables	4,086	5,026
	\$ 737	\$ 998

4. SHARE CAPITAL

Authorized:

Unlimited number of voting common shares with no par value.

Unlimited number of preferred shares with no par value, voting rights to be determined prior to first issue.

(a) Issued and Outstanding:

	Number of shares	Share capital
Voting common shares:		
Balance, June 30, 2010 and March 31, 2010	104,504,670	\$ 23,011

On October 14, 2009, the Company received approval from the Toronto Stock Exchange to renew its normal course issuer bid ("NCIB") to repurchase its common shares from the market. The NCIB allows the Company to acquire up to an additional 5,245,645 common shares until the renewed NCIB expires on October 15, 2010. During the three months ended June 30, 2010, no common shares were repurchased pursuant to the Company's NCIB.

Notes to the Consolidated Financial Statements

Three month period ended June 30, 2010

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(b) Stock Option Plan

The Company has an incentive stock option plan for certain employees, contractors, officers and directors. Options issued under the plan vest over a period which generally extends between four and five years. Options vest annually in proportion to the number of vesting periods, based on the anniversary date of the options granted. The total number of common shares reserved for issuance under the stock option plan shall not exceed 22,170,442. At June 30, 2010, 7,201,766 (March 31, 2010 – 7,036,766) common shares remain reserved for issuance under the stock option plan.

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

	3 months ended June 30, 2010	
	Number of options outstanding	Weighted average exercise price
Outstanding, beginning of period	5,658,684	\$ 0.78
Granted	200,000	0.46
Expired, cancelled, and forfeited	(365,000)	1.12
Outstanding, end of period	5,493,684	\$ 0.75
Exercisable, end of period	1,236,250	\$ 1.07

The following table summarizes information about stock options outstanding and exercisable at June 30, 2010:

Exercise price	Number outstanding	Weighted average remaining term (in years)	Options vested	Options not vested
\$ 0.40	1,050,000	4.7	266,250	783,750
\$ 0.46	200,000	6.0	–	200,000
\$ 0.48	600,000	4.2	150,000	450,000
\$ 0.64	1,190,000	5.7	–	1,190,000
\$ 0.68	1,200,000	3.5	480,000	720,000
\$ 0.76	698,684	5.6	–	698,684
\$ 1.24	220,000	2.5	88,000	132,000
\$ 1.25	25,000	3.1	10,000	15,000
\$ 2.62	250,000	0.1	200,000	50,000
\$ 3.42	10,000	0.7	8,000	2,000
\$ 4.04	30,000	1.2	18,000	12,000
\$ 4.32	20,000	0.4	16,000	4,000
	5,493,684		1,236,250	4,257,434

During the three months ended June 30, 2010, \$145 (June 30, 2009 – \$226) was recognized as stock-based compensation expense related to options with a corresponding increase to contributed surplus.

Notes to the Consolidated Financial Statements

Three month period ended June 30, 2010

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

The actual weighted average fair value of the options issued during the three months ended June 30, 2010 was \$0.46 per common share as determined using the Black-Scholes option pricing model. The following weighted average assumptions were utilized to calculate the fair value:

	3 months ended June 30, 2010
Total options granted	200,000
Weighted average exercise price	\$ 0.46
Risk-free interest rate	2.15%
Expected life	4 years
Vesting period	4 years
Expected annual volatility	79%

(c) Deferred Share Units ("DSUs")

	3 months ended June 30, 2010
Balance, beginning of period	251,246
Issued	94,864
Exercised	-
Outstanding and exercisable, end of period	346,110

During the three months ended June 30, 2010, the Company issued DSUs, with intrinsic value of \$44 and recognized stock-based compensation expense of \$33 (three months ended June 30, 2009 – \$69), with a corresponding increase to accounts payable and accruals. All outstanding DSUs are considered vested at the date of grant. As at June 30, 2010, \$166 (March 31, 2010 – \$133) was recorded in accounts payable and accruals related to the outstanding DSUs.

(d) Restricted Share Units ("RSUs")

	3 months ended June 30, 2010
Balance outstanding, beginning and end of period	743,421
Balance exercisable, end of period	-

During the three months ended June 30, 2010, the Company did not issue any RSUs and recognized a stock-based compensation recovery of \$30, with a corresponding decrease to other long-term liabilities (three months ended June 30, 2009 – expense of \$65 with a corresponding increase to other long-term liabilities). As at June 30, 2010, the RSUs outstanding had a vesting period that extends between one and three years. As at June 30, 2010, \$138 (March 31, 2010 – \$168) was recorded in other long-term liabilities related to the outstanding RSUs.

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5. CONTRIBUTED SURPLUS

	3 months ended June 30, 2010
Balance, beginning of period	\$ 8,260
Stock-based compensation recognition of fair value of stock options granted	145
Balance, end of period	\$ 8,405

6. AMORTIZATION

Three months ended	June 30, 2010	June 30, 2009
Intangible assets	\$ 56	\$ 25
Property and equipment	327	301
	\$ 383	\$ 326

7. INTEREST AND BANK CHARGES

Three months ended	June 30, 2010	June 30, 2009
Interest on long-term debt	\$ 54	\$ 55
Other interest and bank charges	26	39
	\$ 80	\$ 94

8. RELATED PARTY TRANSACTIONS

Included in general and administration expenses during the three months ended June 30, 2010, were management and consulting fees of \$32 (June 30, 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. As at June 30, 2010, \$32 remained in accounts payable and accrued liabilities due to the related party.

9. CAPITAL DISCLOSURES

The Company's objective in managing capital is to safeguard the entity's ability to continue as a going concern so that it can continue to develop and commercialize evidence-based natural health products to increase shareholder value. Capital is defined by the Company as shareholders' equity, long-term debt, and obligations under capital lease.

The Company has externally imposed capital requirements as governed through its mortgage and demand operating line of credit. These requirements are to ensure the Company continues to operate in the normal course of business and to ensure the Company manages its debt relative to tangible net worth. These capital requirements are congruent with the Company's management of capital. The Company met all externally imposed capital requirements at the end of the period.

The Company monitors capital on the basis of the current ratio and debt to tangible net worth ratio which are both financial covenants of its facilities agreement. The current ratio is calculated as current assets (as shown on the balance

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Three month period ended June 30, 2010

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

sheet) over current liabilities (as shown on the balance sheet) and is to be maintained above 1.25:1. At June 30, 2010, this ratio has decreased to 2.21:1 from the March 31, 2010 ratio of 2.42:1. The unfavourable decrease in this ratio from March 31, 2010 is largely due to the net loss incurred in the period.

Debt to tangible net worth is calculated as total liabilities (as shown on the balance sheet) over tangible net worth. Tangible net worth is defined as the sum of share capital, contributed surplus and deficit less intangible assets and leasehold improvements. This ratio is to be maintained below 2.00:1. At June 30, 2010, this ratio was 0.85:1 (March 31, 2010 – 0.76:1). The unfavourable increase in this ratio is primarily due to in the net loss incurred during the period.

10. FINANCIAL INSTRUMENTS

FAIR VALUE OF FINANCIAL INSTRUMENTS

The fair value of financial instruments represents the amount that would be received from or paid to counterparties, calculated at the reporting date, to settle these instruments. The carrying values of cash, accounts receivable, and accounts payable and accruals approximate their estimated fair value due to the short-term maturity of these instruments. The fair value of long-term debt reflects the Company's best estimate based upon estimated interest rates at which the Company believes it could enter into similar instruments at the consolidated balance sheet dates. The Company's long-term debt, which is measured at amortized cost, and the fair value thereof, as determined by Level 2 financial measurements using valuation models that employ observable inputs, are shown below:

	June 30, 2010		March 31, 2010	
	Carrying amount	Fair value	Carrying amount	Fair value
Long-term debt	\$ 5,071	\$ 5,077	\$ 5,238	\$ 5,254

MANAGEMENT OF RISKS ARISING FROM FINANCIAL INSTRUMENTS

The Company does not use financial derivatives. There has been no change with respect to the Company's overall risk exposure during the three months ended June 30, 2010.

MARKET RISK

(a) Interest Rate Risk

The Company's mortgage is subject to interest rate cash flow risk as the required cash flow to service the debt will fluctuate as a result of the changing bank prime lending rate. The sensitivity of the mortgage to a 100 basis point change in the interest rate, with all other variables held constant, would result in a change in the Company's earnings before income taxes of approximately \$13 for the three months ended June 30, 2010. The Company did not employ interest rate hedging activities during the period. The Company has the option to fix the interest rate on its mortgage for the balance of the term or enter into interest rate swaps for terms not exceeding three years.

(b) Foreign Exchange Risk

The Company has assets and liabilities that are denominated in foreign currencies and thus is exposed to the financial risk of earnings fluctuations arising from changes in foreign exchange rates and the degree of volatility of these rates. The sensitivity of these monetary assets and liabilities, as at June 30, 2010, to a 10% increase in the United States dollar, with all other variables held constant, would result in a decrease in the Company's loss before income taxes of approximately \$11 for the three months ended June 30, 2010. The Company does not use derivative instruments to reduce its exposure to foreign currency risk.

Notes to the Consolidated Financial Statements

Three month period ended June 30, 2010

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

CREDIT RISK

The maximum exposure to credit risk of the Company as at June 30, 2010 is the carrying value of its financial assets. The Company manages credit risk by maintaining bank accounts with reputable financial institutions and only investing in securities that are highly rated, traded in active markets and capable of prompt liquidation.

The Company's exposure to credit risk related to accounts receivable arises from the possibility that a customer does not fulfil its obligations. This is minimized through a customer base predominantly comprised of well established retailers and wholesalers, a program of credit evaluation of new customers and limits on the amount of credit extended as deemed necessary. The Company performs continuous evaluation of its accounts receivable and records an allowance for doubtful accounts. The failure of a large customer would have a significant effect on the Company. As at June 30, 2010, one customer (March 31, 2010 – one) represented 34% of total accounts receivable (March 31, 2010 – 38%). Included in accounts receivable is an allowance for doubtful accounts of \$45 (March 31, 2010 - \$33).

LIQUIDITY RISK

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

The Company controls liquidity risk by managing its working capital, cash flows and the availability of borrowing facilities. The Company's undiscounted commitments have not changed significantly from March 31, 2010, with the exception of a new purchase agreement. To encourage a contract manufacturer organization ("CMO") to invest in specific equipment required to produce the Company's products, the Company signed, on May 26, 2010, a commitment to purchase \$3,000 of inventory from this CMO over a three-year period. As at June 30, 2010, the Company has financial assets that are expected to generate sufficient cash inflows to meet cash outflows on financial liabilities.

11. SEGMENTED INFORMATION

The Company operates in one operating segment - biopharmaceutical products. Management assesses performance and makes resource decisions based on the consolidated results of operations of this operating segment. Substantially all of the operations of the Company are directly engaged in or support this operating segment. Other operations are not material and share many of the same economic and operating characteristics as biopharmaceutical products and, accordingly, they are included with biopharmaceutical products for purposes of segment reporting.

The Company derives significant revenue from certain customers. During the three months ended June 30, 2010, three Canadian customers (three months ended June 30, 2009 – two) accounted for \$1,034 or 59% (three months ended June 30, 2009 – \$1,807 or 30%) of the Company's consolidated revenue. Substantially all of the Company's revenue is generated in Canada.

All of the Company's property and equipment is located in Canada.

12. CONTINGENCIES

The Company and certain of its officers and former directors were named as defendants in two concurrent class action lawsuits. These two actions were filed in the Ontario Superior Court of Justice and the Alberta Court of Queen's Bench. The lawsuits, brought on behalf of shareholders who purchased the Company's common shares between

Notes to the Consolidated Financial Statements

Three month period ended June 30, 2010

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December 11, 2006 and March 23, 2007, alleged primarily that the audited consolidated financial statements for the year ended September 30, 2006 and unaudited consolidated financial statements for the quarter ended December 31, 2006 were false and misleading and claimed damages of \$110,000 each. A national law firm, Stikeman Elliott LLP, was retained to represent the Company and certain officers and directors.

On September 16, 2009, the Company announced it has reached an agreement in principle, subject to court approval, to settle the proposed class action lawsuits. On August 5, 2010, Afexa announced that the Ontario Superior Court of Justice 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, its former auditors and the individual proposed defendants, and does not in any way constitute any admission of liability by Afexa or its officers, directors or employees. Afexa's portion of the settlement amounts to \$6,600, which will be funded through insurance coverage.

At June 30, 2010, the Company was involved in various other legal claims in the normal course of operations. Management has reviewed the claims and believes the ultimate resolution of such legal claims will not have a material adverse effect on the Company's financial position and that it has adequately provided, where required, for these legal claims.

13. COMPARATIVE FIGURES

Certain of the comparative figures were reclassified from statements previously presented to conform to the current period presentation.

14. SUBSEQUENT EVENTS

In July 2010, the Company signed a commitment letter with a new bank. The Company's new credit facility anticipates a demand operating line of credit of \$15,000, with interest at the bank's prime lending rate plus 0.75%. The portion of the line of credit that will be available to the Company will be based on 65% of the Company's Edmonton, Alberta building's appraised value to a maximum limit of \$6,750, 75% of accounts receivable aged less than 90 days, plus 50% of finished goods inventory to a maximum limit of \$4,125. The outstanding term mortgage with the existing bank is intended to be repaid upon finalizing arrangements with the new bank.