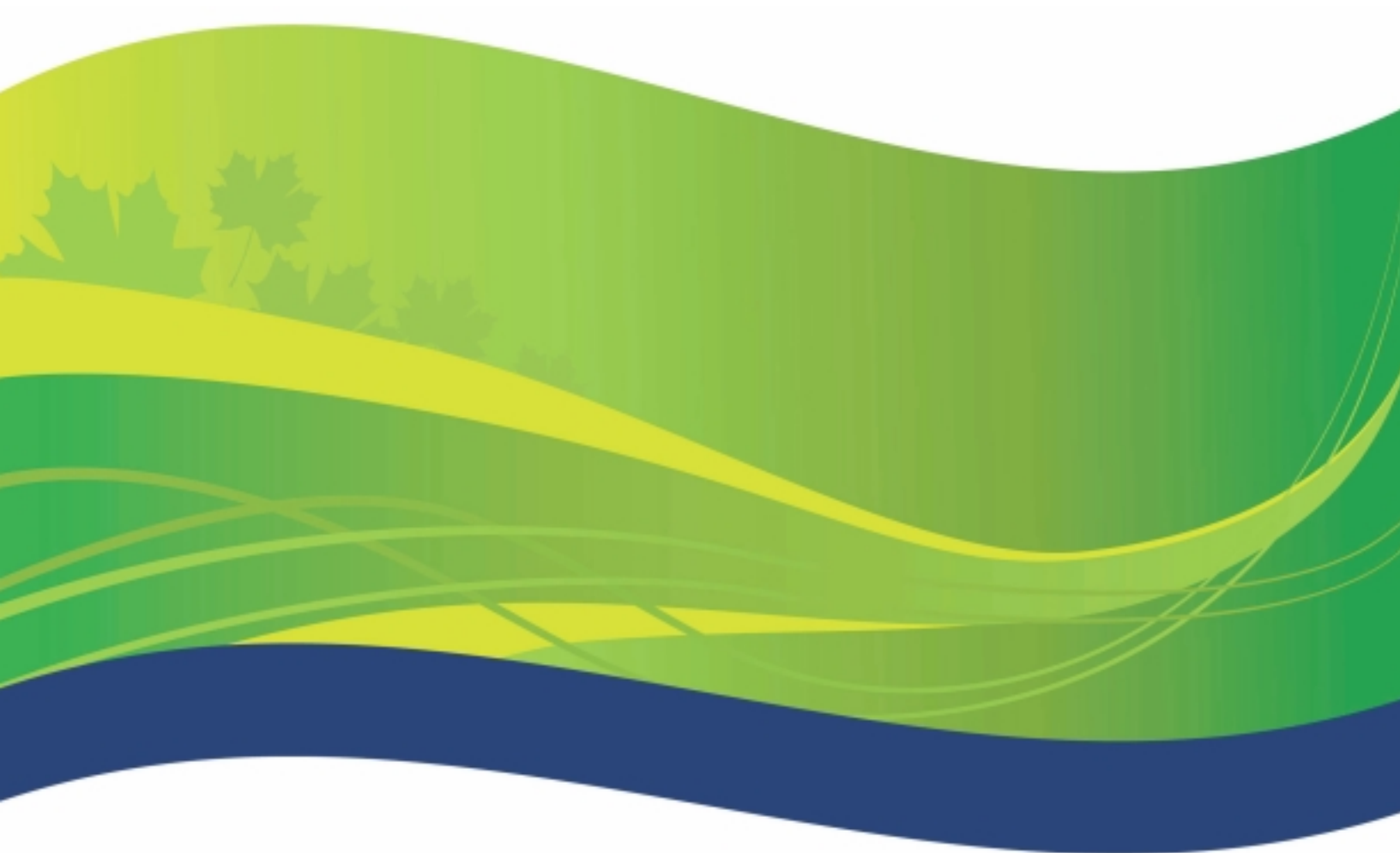


Annual Report 2009



Afexa Life Sciences Inc.



**Management's Discussion and Analysis**  
For the year ended September 30, 2009

Annual Report 2009



## Management's Discussion and Analysis

### For the Year Ended September 30, 2009

#### Advisory Regarding Forward-looking Statements

Management's discussion and analysis ("MD&A") contains certain forward-looking information and statements within the meaning of applicable securities laws. The forward-looking information and statements included in this MD&A are not guarantees of future performance and should not be unduly relied upon. Such information and statements involve known and unknown risks, uncertainties and other factors that may cause actual results or events to differ materially from those anticipated in such forward-looking information or statements including, without limitation: those comments predicting the timing and/or initiation of clinical trials, clinical trial results, and associated regulatory clearances, financing and acceptance of COLD-FX® and other of the Company's products in the marketplace. 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 forward-looking statements. Forward-looking statements include discussions regarding customer orders in the first weeks of fiscal 2010, anticipated revenue derived from the United States as well as comments regarding increased Olympic related and research and development related expenditures. In addition to the risks outlined in the Risks and Uncertainties section, this MD&A contains forward-looking information and statements pertaining to the following: the impact of competition; consumer confidence and spending levels; general economic conditions; interest and currency exchange rates; unseasonable weather patterns; the incidence of illnesses in the general population; the cost and availability of capital; the cost and availability of grants/funding; and product development. The Company believes that the expectations and assumptions reflected in the forward-looking information and statements contained herein are reasonable but 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, that 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 none of the Company or its subsidiaries assumes any obligation to publicly update or revise them to reflect new events or circumstances, except as may be required pursuant to applicable laws.

#### Other Advisories Regarding this Report

The following MD&A for Afexa Life Sciences Inc. ("Afexa" or the "Company"), prepared as at December 10, 2009, should be read in conjunction with the Company's audited consolidated financial statements for the year ended September 30, 2009 and accompanying notes. The MD&A contains disclosure of material changes occurring up to and including December 10, 2009. The consolidated financial statements of Afexa Life Sciences Inc. are prepared in accordance with Canadian generally accepted accounting principles ("GAAP") and are reported in Canadian dollars. All references to GAAP refer to Canadian generally accepted accounting principles. These accounting principles require the Company to make certain estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, expenses, and related disclosure of contingent assets and liabilities. Management believes that the estimates and assumptions, which it relies upon, are reasonably based on information available at the time that these estimates and assumptions were made. These estimates and assumptions have been discussed with the Audit Committee of the Board of Directors of Afexa Life Sciences Inc. Actual results may differ under different assumptions and conditions.

Additional information on the Company, including the Company's most recently filed Annual Information Form and audited financial statements, is available at [www.sedar.com](http://www.sedar.com).

## COMPANY OVERVIEW

Afexa Life Sciences Inc. is a life sciences and technology company, founded in 1992 and headquartered in Edmonton, Alberta, Canada. The Company has 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, the Company's 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 its natural health products is safe, effective and consistent. The Company is committed to using a pharmaceutical model (involving rigorous drug discovery and testing methods) to develop natural therapeutics for health maintenance and disease prevention. Its efforts in scientific research and product innovation are key factors in enabling the Company to secure the trust of consumers, trade professionals, healthcare practitioners and government. The Company's lead 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 ending September 26, 2009).

The vision of the Company is to develop and promote evidence-based, safe and effective natural medicines for disease prevention and health maintenance. This vision continues to be a basic premise for the business, and management's intent is to become a leader in Canada in preventative health care.

## RECENT EVENTS

### IMMUNITY-FX™ launch

On October 30, 2009, the Company announced the official launch of IMMUNITY-FX for year round immune health support. 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. IMMUNITY-FX is believed to be the only product of its kind and contains two immune strengthening ingredients: CVT-E002, the active ingredient in COLD-FX, which is a clinically proven proprietary extract from the North American ginseng plant, and Reishi mushroom, another natural product recognized worldwide for its effect in strengthening the immune system. Scientific research has uncovered the unique molecular mechanisms of both these ingredients, which work together in a complementary manner to stimulate and balance the immune system.

Initial shipments to the Company's customers commenced in the fourth quarter of 2009, however, as per the Company's revenue recognition policy, for certain new product launches, revenue will only be recorded on a sell-through basis until such time as a reasonable history is developed to estimate return allowances. The initial shipments in the fourth quarter of 2009 of IMMUNITY-FX will therefore only be recorded as revenue once point of sale information confirms the product is sold to end consumers.

### Normal course issuer bid

On October 14, 2009, the Company announced that it had renewed its normal course issuer bid ("NCIB") with the Toronto Stock Exchange ("TSX"). The Company is entitled to purchase up to 5,245,645 of the Company's common shares, representing 5% of its then issued and outstanding common shares. The NCIB commenced on October 16, 2009 and will terminate on October 15, 2010. Under the Company's most recent NCIB, which ended October 15, 2009, Afexa repurchased 2,810,580 common shares at a weighted average trading price of \$0.40 per share. All common shares repurchased were cancelled prior to September 30, 2009.

### **Class action lawsuits**

On September 16, 2009, the Company announced that, subject to court approval, a conditional settlement had been reached to settle two proposed class action lawsuits commenced in Ontario and Alberta in August of 2007 against the Company, certain of its officers, former directors and former auditors. The agreement in principle provides for the settlement, release and dismissal of all claims asserted against the Company, its former auditors and the individual proposed defendants. Afexa's anticipated contribution to the settlement amount is to be funded through insurance coverage. The agreement in principle remains subject to final settlement documents and receipt of court approval. The settlement does not constitute any admission of liability by Afexa or its officers, directors and employees.

### **International distribution**

On June 22, 2009, the Company announced it entered into an agreement with a Hong Kong based health care company to market and distribute its COLD-FX product exclusively in the Hong Kong and Macau markets. The Company made its first shipments to the Hong Kong marketplace in September 2009.

### **Corporate re-branding**

On April 1, 2009, the Company announced that it changed its name from CV Technologies Inc. to Afexa Life Sciences Inc. The change was approved by shareholders at the Company's Annual General and Special Meeting held on March 26, 2009. In conjunction with the change in name, the ticker symbol the Company's common shares trade on the Toronto Stock Exchange also changed from CVQ to FXA. The name change is part of a broader branding plan, which will leverage the brand equity associated with COLD-FX.

### **Olympic sponsorship**

On January 20, 2009, the Company announced it entered into an agreement with the Vancouver Organizing Committee for the 2010 Olympic and Paralympic Winter Games ("VANOC"). The agreement provides the Company exclusive sponsorship rights in Canada in the "Over the Counter Cold and Flu Remedy" product category. The Company's four-year Official Supplier partnership with VANOC provides sponsorship rights for the 2010 Winter Games. As part of the sponsorship, the Company will make a financial contribution to the Games and will also provide COLD-FX to VANOC for its distribution. During the 2010 Winter Games, COLD-FX will be available at general stores within the Olympic and Paralympic Villages in Vancouver and Whistler, British Columbia. COLD-FX will also serve as an Official Supplier for the Canadian Olympic Teams competing at the 2010 Winter Games and the London 2012 Olympic Games.

To leverage the sponsorship agreement, in addition to the Company's ongoing relationship with the seven Olympic sport centers across Canada, the Company has also sponsored a number of Olympic athletes. These include Clara Hughes, five time Olympic medalist and world champion speed skater, Joannie Rochette, five time Canadian figure skating champion and world championship silver medalist, Paul Rosen, Olympic gold medalist and four time ice sledge hockey world champion, Chandra Crawford, Olympic gold medalist cross country skier, Steve Omischl, three time Canadian champion and world cup freestyle aerial skier and Ashleigh McIvor, Canadian Olympic ski cross team member. The Company has also entered into official supplier arrangements with Alpine Canada, the Canadian Snow Sports Association, the Canadian Ski Cross Team and commissioned David Arrigo as an official painter to capture the Olympic events while promoting the Company's product.

The Company has recently amended its sponsorship agreement with VANOC to allow IMMUNITY-FX to be an Official Olympic supplied product. This will allow the Company to leverage its marketing dollars to further promote this new product.

## HIGHLIGHTS

Revenue for the fiscal year ended September 30, 2009 was \$47.6 million, representing a decrease of \$1.8 million (3.6%), as compared to \$49.4 million for the fiscal year ended September 30, 2008. The year-over-year decrease is due to decreased orders from Canadian customers, which management attributes to retail customers reducing shelf and warehouse inventory positions due to economic uncertainty particularly in the first quarter of the 2009 calendar year. Margin increased from 65.5% in fiscal 2008 to 67.6% in 2009 primarily due to lower inventory provisions required for fiscal 2009 as compared to the prior fiscal year. The increased margin percentage resulted in gross profit approximating the prior year's amount, despite the lower year-over-year revenue.

Net earnings decreased by \$3.3 million to \$1.3 million in 2009 as compared to \$4.6 million in 2008. The decrease is primarily due to higher selling, general and administration expenditures as well as additional investment in research and development. Selling, general and administration costs are \$3.9 million higher than the prior year due to several factors, including costs of \$2.0 million related to legal and professional costs associated with reaching a conditional settlement for two class action lawsuits, legal, professional and settlement costs associated with an agreement reached with the Alberta Securities Commission, and other legal and severance costs. Research and development costs increased \$1.1 million to \$3.4 million in fiscal 2009 as Afexa continues to increase its product development activities, including clinical verification of the benefits of new products. There were also additional marketing and public relations costs associated with the Company's involvement with the 2010 Winter Olympics.

The Company continues to maintain a positive cash position of \$3.5 million at September 30, 2009, and together with its operating line has sufficient access to cash to finance its operating activities. Inventory levels increased \$2.7 million to \$12.4 million at September 30, 2009 from \$9.7 million at the end of the prior fiscal year, as the Company prepared for an anticipated increase in shipments for the upcoming cold and flu season.

## Summary of consolidated financial results

The following table summarizes key financial data and should be read in conjunction with the audited consolidated financial statements of the Company as at and for the year ended September 30, 2009. Such financial statements are prepared in accordance with GAAP and are reported in Canadian dollars.

### Summary of consolidated financial results

(in thousands except for per share amounts)

	Fiscal year ended September 30	
	2009	2008
Revenue	\$47,592	\$49,389
EBITDA <sup>1</sup>	3,761	9,007
Net earnings	1,301	4,592
Earnings per common share - basic	0.01	0.04
Earnings per common share - diluted	0.01	0.04
Cash flow prior to working capital changes <sup>1</sup>	3,216	6,156
	As at	As at
	September 30, 2009	September 30, 2008
Working capital <sup>1</sup>	\$15,135	\$13,742
Total assets	37,887	42,046
Total long-term debt and obligations under capital lease (including current portion)	6,359	7,021
Shareholders' equity	23,060	21,282

There was no income or loss caused by discontinued operations and/or extraordinary items.

<sup>1</sup> Earnings before interest, income taxes, depreciation and amortization ("EBITDA"), cash flow prior to working capital changes and working capital are non-GAAP measures and may not be comparable to similar measures presented by other issuers. Reconciliations of these measures to the most directly comparable financial measure calculated and presented in accordance with GAAP along with explanations as to why they are used is provided in the "Non-GAAP Financial Measures and Reconciliations" section.

## **RESULTS OF OPERATIONS FOR THE YEAR ENDED SEPTEMBER 30, 2009**

### **Revenue**

Revenue for the fiscal year ended September 30, 2009 was \$47.6 million, a decrease of \$1.8 million (3.6%), as compared to \$49.4 million for the fiscal year ended September 30, 2008. The year-over-year decrease is primarily due to decreased orders from Canadian customers, which management attributes to retail customers reducing shelf and warehouse inventory due to economic uncertainty, particularly in the first quarter of the 2009 calendar year.

The Company's four largest Canadian customers contributed 76% of Afexa's consolidated revenue in fiscal 2009 compared to 70% in fiscal 2008. The increased weighting to these larger customers is attributed to promotional activities, including Olympic programs.

Revenue from the Company's United States customers was \$2.4 million, \$0.3 million higher than the \$2.1 million recorded in the 2008 fiscal year. United States revenue in the year primarily relates to the recognition of sell-through sales to end consumers for product that was shipped in prior periods. The Company continues to focus its marketing and sales activities in Canada and management continues to expect a reduction in revenue from the United States, however, an acceleration of revenue recognition did occur in the fourth quarter of fiscal 2009, as the Company negotiated a no right of return agreement with a major United States customer. The Company may focus future United States revenue and marketing activity through internet channels.

### **Cost of goods sold and gross profit**

Gross margin for fiscal 2009 increased to 67.6% from 65.5% in fiscal 2008. Inventory obsolescence expensed through cost of goods sold in fiscal 2009 was \$1.7 million as compared to \$2.7 million in fiscal 2008. In fiscal 2008, inventory obsolescence expense was higher primarily due to the write down of a new line extension that did not pass the Company's quality standards.

### **Selling, general and administration**

Selling, general and administration costs increased \$3.9 million to \$23.9 million in fiscal 2009 as compared to \$20.0 million in fiscal 2008. Contributing to the increase in expenditures were increases in legal and professional fees related to various activities including the class action law suit, a settlement agreement with the Alberta Securities Commission, and severance and recruiting costs as the Company continued to structure for the future. There were also additional marketing and public relations costs associated with the sponsorship of the 2010 Winter Olympics.

### **Research and development**

Research and development costs of \$3.4 million are \$1.1 million higher than the \$2.3 million incurred in fiscal 2008. The Company continues to focus more resources towards research and development activities. The increase in expenses is due to an increase in staff and an increase in clinical trial activity. The Company is working towards reducing the time required to complete research on new product development and to commence additional research on new compounds that may potentially become commercial products. Partially offsetting the increase in expenses is the recording of \$0.5 million of scientific research and experimental development tax credits ("SR&ED"). SR&ED credits in fiscal 2008 were comparable to the amount recorded in fiscal 2009.

### **Stock-based compensation**

Stock-based compensation increased by \$0.2 million in fiscal 2009, as compared to the same period in 2008. The increase is largely due to the adoption of a deferred share unit ("DSU") plan for non-employee directors, a restricted share unit ("RSU") plan for eligible employees and an acceleration of expensing of certain options related to severance. During the 2009 fiscal year, 242,864 DSU's were issued resulting in an expense of \$0.2 million and 175,000 RSU's were issued resulting in an expense of \$0.1 million. The expenses realized with the adoption of the DSU and RSU plans were offset partially by

the forfeiture of unvested stock options by individuals who have left the Company. On January 21, 2009, the Company's Board of Directors approved amendments to 2,050,000 options to remove performance-based vesting provisions. As originally granted, the options were subject to both performance-based vesting provisions and time-based vesting provisions. The performance-based vesting provisions related to the achievement of certain financial milestones by the Company. Such performance-based vesting provisions had not been consistently applied to all grants of options by the Company, and a decision was made by the Company's Board of Directors to standardize and simplify the vesting of options through the removal of performance-based vesting provisions from all options. The relevant options will remain subject to time-based vesting provisions set in accordance with the relevant provisions of the stock option plan.

### **EBITDA**

The fiscal 2009 EBITDA decreased by \$5.2 million to \$3.8 million as compared to fiscal 2008, due to a decrease in revenue and an increase in selling, general and administration costs and research and development costs as described earlier in this report.

### **Amortization**

In the second quarter of fiscal 2008, the Company completed and moved into a new Corporate Headquarters and Research Centre in Edmonton, Alberta. For fiscal 2009 amortization is \$0.3 million higher than the corresponding period in fiscal 2008, primarily due to the new facility.

### **Interest expense and interest revenue**

Interest expense of \$0.4 million in fiscal 2009 is \$0.4 million lower than the \$0.8 million incurred in the prior year, primarily due to a lower bank prime lending rate. The majority of the Company's utilized bank financing is for a mortgage collateralized by the Company's facilities in Edmonton, Alberta. In the third quarter of 2009, the Company renegotiated its credit agreement, which resulted in an increase in the interest rate from the bank's prime lending rate plus 1.0% to prime plus 1.25%. The bank's prime lending rate has fallen and therefore the interest rate on the mortgage has reduced and principle payments of \$0.7 million have been made on the Company's long-term debt throughout the year, furthering a reduction in interest expense. In addition, a reduction in fees has been experienced due to the elimination of a 0.5% per month fee paid to a shareholder and former director of the Company. As part of the Company's former credit agreement negotiated in 2007 with its lenders, this shareholder provided the Company with a guarantee of \$5.0 million, at a fee of 0.5% per month. This fee was expensed as interest, bank charges and fees. The Company negotiated with its lender the removal of this guarantee in July 2008 and at that time, the fee to the shareholder ceased.

### **Foreign currency gains and losses**

The Company is invoiced for certain services and materials in foreign currencies (primarily United States dollars) and has foreign operations whose statutory accounts are denominated in United States dollars. These foreign operations are integrated with the Company's consolidated operations. Under GAAP, monetary items are translated at the exchange rate in effect at the balance sheet date; non-monetary items are translated at historical exchange rates; revenue and expense items are translated at the exchange rate in effect on the dates they occur; depreciation or amortization of assets are translated at historical exchange rates using the same historical exchange rate as the assets to which they relate. The Company did not enter into any foreign currency hedge instruments in either fiscal 2009 or fiscal 2008. Canadian/United States exchange rates have fluctuated from \$Cdn1.00:\$U.S.0.94 at the beginning of the current fiscal year to \$Cdn1.00:\$U.S.0.93 at the end of fiscal 2009, resulting in a foreign exchange loss of \$0.2 million. In fiscal 2008 Canadian/United States exchange rates fluctuated from \$Cdn1.00:\$U.S.1.01 at the beginning of the fiscal year to \$Cdn1.00:\$U.S.0.94 at the end of the 2008 fiscal year, resulting in a foreign exchange loss of \$0.5 million.

### Income taxes

Income tax expense of \$0.9 million in fiscal 2009 is \$2.1 million lower than in fiscal 2008 due to earnings before income taxes being \$5.4 million higher in fiscal 2008 as compared to fiscal 2009. In fiscal 2008, the Company reorganized part of its international structure allowing for a recovery of \$2.6 million in Canadian taxes in that year.

### RESULTS OF OPERATIONS FOR THE FOURTH QUARTER ENDED SEPTEMBER 30, 2009

Revenue in the fourth quarter of 2009 was \$15.6 million, a \$1.5 million or 11% increase from the 2008 fiscal year's fourth quarter. Investments in additional marketing efforts during September, and the increased level of flu activity in the general population contributed to the increase.

Gross margin as a percentage of revenue increased to 61.8% in the fourth quarter of 2009 as compared to the 50.6% margin achieved in the fourth quarter of 2008 due primarily to the avoidance of significant inventory write-downs as was incurred in the prior fourth quarter. The combination of fourth quarter increases in revenue and margin percentages resulted in an increase of \$2.5 million in gross margin in the fourth quarter of 2009 as compared to the fourth quarter of 2008.

Selling, general and administration costs in the fourth quarter of 2009 declined by \$0.4 million as compared to the fourth quarter of 2008. The decline was achieved even with an increase in costs related to Olympic sponsorship and additional severance. Also in the fourth quarter a number of television and print ads were run to raise the awareness that COLD-FX has been clinically proven to be effective in helping reduce flu by boosting the immune system as well as for colds. Offsetting these increased costs was a reduction in consulting and professional fees incurred in the fourth quarter of 2009.

Research and development costs in the fourth quarter of fiscal 2009 are \$0.6 million higher than in the fourth quarter of 2008 due to an increase in staff and an increase in clinical trial activity. The Company continues to focus on reducing the time required to complete research on new product development and to commence additional research on new compounds that may potentially become commercial products. Also contributing to the increase in costs in the fourth quarter of fiscal 2009 as compared to the same period in 2008 is the timing of recording of SR&ED credits, with more being recorded in the fourth quarter of fiscal 2008 as compared to the fourth quarter of fiscal 2009. On a year-to-date basis, SR&ED credits were comparable amounts in both years.

Stock-based compensation increased in the fourth quarter of 2009 as compared to the fourth quarter of 2008 due to the implementation of DSU and RSU plans earlier in the year and due to the quarter's proportional expensing of the issuance of 1.3 million options through a companywide option grant earlier in the year.

Interest expense decreased in the fourth quarter of 2009 as compared to the fourth quarter of 2008 primarily due to a lower bank prime lending rate. The majority of the Company's utilized bank financing is for a mortgage collateralized by the Company's facilities in Edmonton, Alberta. The interest rate was renegotiated in fiscal 2009 resulting in an increase in the interest rate from the bank's prime lending rate plus 1.0% to prime plus 1.25%. The bank's prime lending rate has fallen and, therefore, the interest rate on the mortgage has reduced and principal payments of \$0.7 million have been made on the Company's long-term debt throughout the year, further reducing interest expense.

Net income in the fourth quarter of 2009 increased by \$2.3 million to \$2.8 million as compared to \$0.5 million in the same period in 2008. The increase in net income is primarily due to an increase in revenue and gross margin as a percentage of revenue in the quarter, and a decrease in selling, general and administration, offset partially by an increase in research and development costs and stock-based compensation.

## Management's Discussion and Analysis *(continued)*

### Quarterly information

*(in thousands except for per share amounts)*

	Year ended September 30, 2009				Year ended September 30, 2008			
	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
Revenue	\$15,557	\$6,195	\$6,119	\$19,721	\$14,044	\$3,355	\$10,715	\$21,275
Net earnings (loss)	2,782	(1,120)	(3,168)	2,807	531	(1,970)	(768)	6,799
Earnings (loss) per common share - basic	0.03	(0.01)	(0.03)	0.03	0.00	(0.02)	(0.01)	0.07
Earnings (loss) per common share - diluted	0.03	(0.01)	(0.03)	0.03	0.00	(0.02)	(0.01)	0.06

*There was no income or loss caused by discontinued operations and/or extraordinary items.*

The most significant portion of the Company's 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. Consumer purchases are affected by factors that also include the weather. This affects the volume and timing of sales. The fourth quarter of the Company's fiscal year corresponds to the time that most of the Company's major customers commence stocking up on cold and flu products in anticipation of demand in the late fall and winter months when, historically, cold and flu incidence rises. Further orders are made for restocking of product once the cold and flu season commences, which typically corresponds to the Company's first quarter. The Company's second quarter corresponds to the time that cold and flu incidence is on the decline and the third quarter is historically the quarter with the lowest revenue as cold and flu incidence is typically at its lowest. The Company aims to time marketing expenditures with anticipated increases in cold and flu activity; however, depending on specific marketing programs, these expenditures may not fall within the quarters for which revenue is derived. Revenue in the second quarter of 2009 decreased significantly compared to the same period in 2008. Management believes that many of the Company's retail customers reduced levels of store inventories when faced with uncertain economic conditions, which was reported widely in the media during this period. Revenue in the third quarter of 2009 increased significantly compared to the same period in 2008 and management believes that many of the Company's retail customers were holding reduced levels of store inventories at the end of the second quarter of 2009 compared to the same period of the prior year. Additional orders were required to be placed in the third quarter of 2009 by the Company's customers to meet the end consumers' anticipated demand.

### LIQUIDITY AND CAPITAL RESOURCES

The Company's main source of capital is the Company's cash on hand arising from operating activities in prior periods. The Company's operating line of credit was not utilized in the year. The Company's primary use of cash was for funding of working capital, including a build up of inventory for sale. In addition to supporting operating activities, capital was used in the year to finance capital expenditures, make principal payments on long-term debt, and purchase shares under a normal course issuer bid.

The Company's third quarter historically generates lower revenue due to the seasonality of sales of its main product, COLD-FX. Cash flow fluctuates because of cash out-flow requirements for inventory production, with higher activity in the third quarter required to build up inventories prior to the cold and flu season. Cash in-flows from the collection of receivables are higher in the first and second quarter as customers pay for invoices issued in the previous months' peak sale periods.

The Company's 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, rights of return held by customers, timing of market development programs, and long-term focus on product research and development activities. The Company anticipates that cash generated from operations and availability of its bank operating line will be sufficient to meet its cash requirements beyond the next twelve months.

## Management's Discussion and Analysis *(continued)*

### Selected cash flow and capitalization data

*(in thousands)*

	Fiscal year ended September 30	
	2009	2008
Cash flow prior to working capital changes <sup>1</sup>	\$3,216	\$6,156
Cash (used in) provided by operating activities	(2,676)	9,103
	As at	As at
	September 30, 2009	September 30, 2008
Cash and cash equivalents and short-term investments combined	\$3,495	\$9,396
Working capital <sup>1</sup>	15,135	13,742
Long-term debt and obligations under capital lease (including current portion)	6,359	7,021

<sup>1</sup> Cash flow prior to working capital changes and working capital are non-GAAP measures and may not be comparable to similar measures presented by other issuers. Reconciliations of these measures to the most directly comparable financial measure calculated and presented in accordance with GAAP along with explanations as to why they are used is provided in the "Non-GAAP Financial Measures and Reconciliations" section.

### Cash and working capital

At September 30, 2009, the Company had \$3.5 million of cash and cash equivalents on hand and a short-term investment of nil. This compares to \$4.3 million and \$5.1 million, respectively, for the year ended September 30, 2008. The short-term investment in 2008 consisted of a cashable guaranteed investment certificate that carried an interest rate of 3.25%. The guaranteed investment certificate matured on June 30, 2009 and was not re-invested. The Company's working capital at September 30, 2009 was \$15.1 million (September 30, 2008 - \$13.7 million). The increase in working capital is due to several factors including: an increase in inventory, primarily due to an increase in work-in-progress as the Company built additional capsules of COLD-FX to reduce the lead time required to build finished product; a reduction in customer deposits due to the recognition of revenue in the 2009 fiscal year for which these deposits relate; and a reduction of accounts payable due to the timing of payment of invoices. Cash and cash equivalents and short-term investments combined decreased by \$5.9 million due to the increase in net working capital, the purchase of \$1.4 million in property and equipment and intangible assets, primarily related to lab equipment and patents, \$0.7 million in principal payments on long-term debt, and \$1.1 million used to purchase shares under a normal course issuer bid.

### Cash provided by operating activities

Cash flow prior to working capital changes of \$3.2 million in fiscal 2009 decreased \$2.9 million from the amount in fiscal 2008 primarily due to the lower net earnings achieved in the 2009 fiscal year. Cash used in operating activities in fiscal 2009 was \$2.7 million compared to cash provided by operating activities of \$9.1 million in fiscal 2008. The fiscal 2008 cash provided by operating activities is higher primarily due to a higher net earnings in that year as well as the Company's use of inventories built in prior fiscal years and therefore did not need to expend as much cash in 2008 to finance the build up of inventory to that year's shipments.

The Company manages supply risk by continuously evaluating the supply chain and lead times required to procure raw materials and build finished goods. Quality assurance and control procedures and time requirements to complete these tasks are also factored in. The Company has established and is maintaining a scheduling program aimed at ensuring that approximately a six-month supply of bulk ingredients, three months of capsules, and three months seasonal forecasted finished product requirements are maintained to meet demand. Inventory levels vary with the introduction of products or new entry into markets. In 2008, a significant portion of the inventory located in the United States was moved to Canada and repackaged for sale in Canada. During fiscal 2008, the Company sold inventory and returned deposits totaling \$6.1 million for product shipped in prior fiscal periods to United States customers for which a right of return existed.

## Management's Discussion and Analysis *(continued)*

During fiscal 2009, the majority of the remaining United States product was also shipped to Canada and converted for sale in Canada. At September 30, 2009, the United States operations held less than \$0.1 million in inventory (2008 - \$0.9 million). On a consolidated basis, the Company has \$12.4 million (2008 - \$9.7 million) of inventories.

### Cash flow used in investing activities

Capital expenditures on property and equipment for fiscal 2009 of \$0.9 million are primarily for additional lab equipment for the Company's corporate office and research facility. Construction of this facility was completed in the second quarter of fiscal 2008. Capital expenditures in fiscal 2008 of \$4.0 million were primarily related to the construction cost of the facility. On June 30, 2009, the guaranteed investment certificate purchased in the third quarter of 2008 matured resulting in an increase in cash and cash equivalents of \$5.1 million.

### Cash flow from financing activities

In 2008, the Company completed the construction of a new facility in Edmonton, Alberta. The construction of the facility was partially financed by a term facility provided under the Company's credit agreement with \$2.3 million of the facility drawn in the first quarter of fiscal 2008, with the proceeds used primarily to repay short-term borrowings drawn to fund payables associated with the construction. During fiscal 2009, financing activities are primarily limited to a \$0.7 million repayment of long-term debt and a \$1.1 million purchase of Company shares through a normal course issuer bid.

### Capital requirements and capitalization

At September 30, 2009, the Company had obligations to repay within one year \$0.7 million of long-term debt and obligations under capital leases and make \$2.5 million of payments under operating lease agreements for premises and sponsorships. The Company projects capital expenditures in fiscal 2010 to be approximately \$1.6 million consisting of lab, office and computer equipment. Also included in this total is leasehold improvement costs for the relocation of the Company's sales and marketing office to a new location in the first quarter of 2010 as well as an estimate of additional capitalized patent and trademark costs.

### Aggregate contractual obligations and off-balance sheet financing

The Company has entered into operating and capital lease and purchasing agreements in the ordinary course of its business. In addition, the Company has entered into various agreements to provide financial assistance in research and development activities and clinical studies as well as for the purchase of raw material used in the manufacture of product for sale. Payment commitments relating to these agreements and under the Company's credit agreement over the next five years are as follows:

#### Contractual obligations

*(in thousands)*

	2010	2011	2012	Fiscal year			Total
				2013	2014	Thereafter	
Long-term debt <sup>1</sup>	\$ 706	\$ 681	\$ 4,220	\$ -	\$ -	\$ -	\$ 5,607
Obligations under capital lease	15	9	2	1	-	1,155	1,182
Leased premises <sup>2</sup>	126	181	162	162	162	895	1,688
Other lease payments and sponsorships <sup>3</sup>	2,406	746	281	-	-	-	3,433
<b>Total contractual obligations</b>	<b>\$ 3,253</b>	<b>\$ 1,617</b>	<b>\$ 4,665</b>	<b>\$ 163</b>	<b>\$ 162</b>	<b>\$ 2,050</b>	<b>\$ 11,910</b>

<sup>1</sup> Long-term debt includes a term mortgage that is subject to an adverse events clause under which the lender may demand payment of the loan.

<sup>2</sup> The Company recognizes rental expense on premises on a straight-line basis over the initial term of the lease. Lease inducements received by the Company as free rent periods are deferred and amortized on a straight-line basis over the term of the lease as a reduction in rental expense or as a reduction in leasehold improvements depending on contractual terms.

<sup>3</sup> The Company has entered into a number of office equipment leases and contractual obligations related to future advertising, marketing, research and development, clinical and material expenditures.

Long-term debt primarily consists of a three-year term mortgage facility related to the Company's Edmonton, Alberta facility. The Company may repay the mortgage at any time, in whole or in part, subject to a three month interest penalty. The Company also has a capital lease related to land on which the Company's Edmonton, Alberta facilities are located. The capital lease expires on November 15, 2015, and the Company expects to exercise its option to purchase the land at that time.

### **Class action lawsuit**

On September 16, 2009, the Company announced it had reached an agreement in principle, subject to court approval, to settle two proposed class action lawsuits that were commenced in July 2007. The agreement in principle provides for the settlement, release and dismissal of all claims asserted against the Company, its former auditor and the individual proposed defendants. The Company's anticipated contribution to the settlement amount is to be funded through its insurance coverage. The agreement in principle remains subject to final settlement documents and receipt of court approval. The settlement does not constitute any admission of liability by the Company or its officers, directors and employees.

### **Related party transactions**

Until October 2008, the Company had as part of its management team an individual who was also related to the principal owners of a vendor. During the time the related party relationship existed, the Company expensed as selling, general and administration costs \$56 thousand and \$555 thousand respectively for the years ended September 30, 2009 and 2008.

From July 16, 2007 to July 23, 2008, a shareholder, who was also a director, was provided a fee of 0.5% per month related to a \$5.0 million personal guarantee that was given to the Company's lender as part of the security position provided under the Company's credit agreement. During the year ended September 30, 2008, the Company expensed in interest and bank charges \$0.2 million related to the fee on this guarantee. The Company's credit agreement was amended on July 23, 2008, whereby the requirement for this personal guarantee was eliminated. No further expenses were recognized during the year ended September 30, 2009.

All transactions with related parties have occurred in the normal course of operations and are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

### **Outstanding shares and stock options**

The Company is authorized to issue an unlimited number of common shares and an unlimited number of preferred shares. As at December 10, 2009, 104,912,918 common shares were outstanding compared to 107,723,498 at September 30, 2008. No preferred shares were outstanding during or at the end of either of these periods. Certain employees, officers, contractors and directors of the Company have been granted options to purchase common shares under the Company's stock option plan. At September 30, 2009, 4,035,000 (2008 - 8,585,443) options were outstanding.

The pool of options available for grants at September 30, 2009 was 8,660,450 (2008 - 4,110,007).

On October 14, 2009, the Company announced the renewal of its NCIB to purchase up to 5,245,645 of the Company's common shares, representing 5% of its then issued and outstanding common shares. The NCIB commenced on October 16, 2009 and will terminate on October 15, 2010.

## **OUTLOOK**

On January 20, 2009, the Company announced jointly with the Vancouver 2010 Olympic and Paralympic Winter Games that it has been chosen as the official cold and flu remedy of the 2010 Olympic and Paralympic Winter Games. The official supplier designation will become the focus of much of the Company's marketing efforts for the next few years as

the four year Official Supplier partnership with VANOC also provides sponsorship rights for COLD-FX to serve as the Official Supplier for the Canadian Olympic Teams competing at both the 2010 Winter Games and the London 2012 Olympic Games.

In the fourth quarter of 2009, initial shipments of a new product, IMMUNITY-FX, have been strong, however, as per the Company's revenue recognition policy, for certain new product launches, revenue will only be recorded on a sell-through basis until such time as a reasonable history is developed to estimate return allowances. The initial shipments in the fourth quarter of 2009 of IMMUNITY-FX will therefore only be recorded as revenue once point of sale information confirms the product is sold to end consumers. Marketing campaigns for this product launch will commence in the first quarter of 2010. The Company has recently amended its sponsorship agreement with VANOC which allows IMMUNITY-FX to be an Official Olympic supplied product to the 2010 Olympic Winter Games and will also serve as an official supplier for the Canadian Olympic Teams competing at the 2010 Winter Games and the London 2012 Olympic Games. This official supplier status will allow the Company to leverage its marketing dollars to further promote this new product.

Management believes that a recent increase in incidences of colds and seasonal flu along with heightened public awareness of flu incidences may result in an increase in revenue for the Company's lead product COLD-FX. The Company has experienced an increase in retail customer orders of COLD-FX in the first weeks of fiscal 2010.

Management continues to expect a reduction in revenue from the United States and will be focusing its marketing efforts in Canada.

Scientific and clinical research is core to the Company's vision and is the way in which the Company develops safe products with health benefits that can be trusted. The Company has the ability to conduct cost effective trials when compared with pharmaceutical drug trials. One reason relates to the nature of the studies – using ingredients that are isolated from natural sources with a history of safe traditional use, and looking at effects on naturally occurring physiological processes in the body for disease prevention and recovery. In addition to providing third-party credibility, collaboration with academic institutions and government has also been highly cost effective, relative to the typical pharmaceutical model that uses contract research organizations. Several clinical studies are in progress examining the potential application of the core active ingredient in COLD-FX and IMMUNITY-FX in immune-related fields including seasonal allergic rhinitis and cancer. The previously announced United States National Cancer Institute approved and Wake Forest University led multi-centre study examining COLD-FX for colds and flu, and other immune related effects in chronic lymphocytic leukemia is currently in analysis and proceeding according to schedule. Other studies are also in various stages including investigation of the core active ingredient in REMEMBER-FX<sup>®</sup> and MEMORY-FX<sup>®</sup> in healthy aging adults, and the application of new formulations in metabolic syndrome, particularly cholesterol and blood sugar management. The fiscal 2010 research and development expenditures are planned to increase over the 2009 actual expenditures as the Company plans to continue to focus and invest in new innovative research and development for potential product launches in the ensuing years.

Several alternatives for growth outside the Company's Canadian core business area could be pursued, including the potential for strategic partnerships or an international license agreement of the Company's products. On June 22, 2009, the Company announced one such agreement with a Hong Kong based health care company to market and distribute its COLD-FX product exclusively in the Hong Kong and Macau markets. The Company's first shipment of product under this arrangement was in the fourth quarter of 2009 and the official launch of the product in the Hong Kong marketplace started in the first quarter of fiscal 2010.

The Company intends to continue to increase its focus on research and development, with a number of new products already under development. A test launch of a new product, MEMORY-FX, was initiated at the end of fiscal 2009 and the Company will be determining its strategy for this product over the next several months.

The Company will continue to increase its expenditures on research and development and for clinical trials as it continues to develop new innovative products, which the Company plans to bring to market in the ensuing years.

The 2009 fiscal year included a number of changes in senior management and the Board of Directors. During fiscal 2010, the Company will continue to position its senior management team and Board of Directors to maximize effectiveness and execute its strategic plan.

On December 10, 2009, the independent Directors appointed Mr. Jack Moffatt as Chief Executive Officer ("CEO") of Afexa Life Sciences Inc., in addition to his position as Chairman. Mr. Moffatt had been serving the Board and management in an advisory capacity and in September 2008 had been appointed Executive Chairman with day-to-day oversight responsibility for the Company. This announcement brings closure to the Company's search for a new CEO.

## **MANAGEMENT'S REPORT ON DISCLOSURE CONTROLS AND PROCEDURES AND INTERNAL CONTROL OVER FINANCIAL REPORTING**

### **Disclosure controls and procedures ("DC&P") and Internal controls over financial reporting ("ICFR")**

In accordance with National Instrument 52-109, management is responsible for establishing and maintaining disclosure controls and procedures to provide reasonable assurance that material financial and non-financial management information required to be disclosed is recorded, processed, summarized and reported within the time periods specified in the securities legislation, and that it is communicated to the CEO, Chief Financial Officer and Disclosure Committee to allow for timely decisions regarding required disclosure.

The system of disclosure controls and procedures includes, but is not limited to, the Company's Public Disclosure Policy, Core Values and Code of Conduct, Employee and Business Protection Guide (e.g. Whistle Blower protocols), the effective functioning of the Disclosure Committee, and the review and verification of material disclosures by senior management, the Board of Directors and committees of the Board.

An evaluation of the effectiveness of the Company's disclosure controls and procedures was completed as at September 30, 2009 under the supervision of the chief executive and financial officers. The evaluation included a documentation review, enquiries and observation of process and control performance.

Management is also responsible for establishing and maintaining policies and procedures which provide reasonable assurance regarding the reliability of public financial reporting that reflect the transactions and dispositions of the Company; provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP; ensure that receipts and expenditures are made only in accordance with authorizations of management; and provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of Company assets that could have a material effect on financial statements.

The Company's DC&P and ICFR are evaluated using the framework established in the Internal Control – Integrated Framework, issued by the Committee of Sponsoring Organizations of the Treadway Commission. Information Technology controls are evaluated using the Control Objectives for Information and Related Technology (COBIT®) framework.

As a result of the control evaluation, management has identified the following material weaknesses:

- To estimate the value of trade promotions offered to its customers, the Company relies on end user computing tools which lack sufficient application controls. To remediate this weakness, management has licensed a trade promotion management application and is in the process of implementation, which is scheduled to be completely implemented by the second quarter of 2010.

- During fiscal 2009, the Company went through a number of changes in senior management and other key financial reporting personnel. While these changes resulted in some disruption of ICFR, following these changes, management has identified a number of ways in which its estimation processes and supporting ICFR systems and processes can be improved and continues to work towards implementing such enhancements.

Management has been actively working on improving the ICFR, however, control enhancements have not been fully implemented as of September 30, 2009.

As a result, of the above-noted weaknesses in internal controls over financial reporting, management has concluded that DC&P and ICFR were ineffective in providing them with material information relating to the Company in a timely manner, to a reasonable standard of assurance. Throughout the period, management has continued to implement manual review processes to mitigate risk of error to an acceptable level.

### **Changes in internal control over financial reporting**

Effective October 1, 2008, management has upgraded its financial accounting application to reduce reliance on paper based processes and spreadsheets, and to enhance internal controls over financial reporting.

Also, over the last year, several changes were implemented at the Board and senior management levels to better position the Company for future growth, and to ensure ongoing development of the Company's control culture.

In September 2008, the Company began the process of recruiting a Chief Executive Officer, after the then Chief Executive Officer relinquished the position in September 2008. As part of the Company's strategy for growth, she continues in her role as Chief Scientific Officer. Mr. Jack Moffatt joined the Board as Executive Chair, and assumed interim oversight responsibility for operations of the Company, effective October 1, 2008. He assumed responsibility as the Chairman and Chief Executive Officer, effective December 10, 2009. In addition, on November 24, 2009, Mr. John Rogers and Mr. William White joined Afexa's Board of Directors and subsequently joined the Company's Audit Committee to fill vacancies from departures of previous Board members.

### **Limitations on the effectiveness of internal controls**

Material misstatements due to error or fraud may not always be prevented or detected on a timely basis because of the inherent limitation of DC&P and ICFR, including the possibility of collusion or improper management override of controls. Inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple errors or mistakes. In addition, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Management will continue to monitor and improve internal controls as necessary and appropriate for the business.

### **RISKS AND UNCERTAINTIES**

The Company is subject to risks and uncertainties inherent in the operation of the business. The Company partially mitigates these risks through a combination of sound risk-management practices, insurance and systems of internal control. The following risks and uncertainties are those that management currently believes may materially affect its operations. Additional risks and uncertainties that the Company is unaware of or currently deems immaterial may subsequently become important factors, which may materially affect the business. A more complete discussion on risk factors is available in the Company's Annual Information Form available on SEDAR.

### **Market and product**

Management considers the Company to be in its growth stage with its lead product, COLD-FX. To achieve a successful market share, the Company anticipates significant and ongoing expenditures for marketing, advertising and public awareness programs. The Company also has plans to introduce new products to the market and significant expenditures

for marketing, advertising and public relations programs will be required to launch these products. Future success of product revenue is dependent on those activities including the successful results of clinical trials, regulatory review and approval for its products, the degree of patent protection afforded to particular products and seasonality of demand for its products.

The Company is reliant on relatively few customers for the majority of its revenue. A loss of one of these customers could adversely affect revenues and business operations. During the year ended September 30, 2009, four Canadian customers accounted for 76% (2008 - 70%) of the Company's consolidated revenue.

### **Seasonality of demand**

COLD-FX sales exhibit a seasonal pattern tied to the frequency and severity of colds and flu. Consumer purchases are affected by factors that also include weather. This affects the volume and timing of sales. The Company aims to time marketing expenditures with increases in cold and flu activity, and as such, expenditures and results may vary.

### **Risks associated with new product development**

One of the Company's core competencies is in the area of research and development of new natural health products. A number of products are under development. Considerable costs are incurred at every stage of identifying, developing, manufacturing and marketing of new products.

There can be no assurance during any given research or development stage that any viable new products will be developed for which a market demand exists. The costs of conducting basic and clinical research to identify potential new product opportunities can be significant. There can be no assurance during any development stage that any new products developed will receive regulatory approval to make the marketing claims necessary to make the product commercially viable. Some of these products will compete with established products of proven safety and efficacy, the manufacturers of which may employ intellectual property challenges against the Company's commercialization of the products. There can be no assurance that the Company's product will be commercialized or, if commercialized, that consumers will accept them in lieu of established products. Accordingly, there can be no assurance that these products can be manufactured successfully and/or marketed profitably. Prospects for the Company's new technologies and future products are uncertain and should be regarded as highly speculative.

Expectations about the Company's financial and scientific results could have a significant effect on the trading price of the Company's shares. Certain risks exist in the timing of scientific and regulatory reviews, filings and approvals, and the Company's ability to commercialize products in its pipeline and sell current products.

### **Health and safety risks**

The Company produces products for human ingestion. Products produced by the Company may be found to be, or to contain substances that are harmful to the health of its clients which in extreme cases may cause serious health conditions or death. This sort of finding may expose the Company to substantial risk of litigation and liability. Further, the Company could be forced to discontinue production of certain products, which would harm the profitability of the Company. To mitigate this risk, the Company takes substantial precautions such as laboratory and clinical testing, toxicology studies, quality control and assurance testing and controlled production methods. The Company also maintains product liability insurance coverage; however, there is no guarantee that coverage can be secured in the future at commercially viable rates or with the appropriate limits.

### **Risks associated with raw material supply**

The Company is dependent upon the supply of raw materials derived from natural resources. The supply of ginseng, cordaitin sulphate and other natural materials used by the Company may be limited, lost or affected by events such as changes in weather patterns and growing seasons, disease and pathogens to which the natural resources are vulnerable,

natural or man-made disasters and environmental regulations. There can be no assurance that these or other factors will not affect the supply of materials. The Company maintains relationships with a number of suppliers to mitigate this risk.

### **Reliance on third parties**

The Company relies on contract manufacturing organizations for extraction, encapsulation, packaging and warehousing of its products. Dependence upon third parties for the manufacturing of its products may affect the Company's earnings and ability to make and deliver such products on a timely and competitive basis. Deficiencies could result from, among other things, the disruption of product supply. Some contract manufacturing organizations may be located in foreign countries and may be subject to import and export regulations in these countries. To mitigate this risk, management establishes collaborative arrangements, alliances or partnerships, negotiates favorable terms and establishes alternate supply arrangements.

### **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. Liquidity risk could arise from the Company's inability to meet obligations when due in a timely manner, including, but not limited to, an inability to fulfill its contractual arrangements with suppliers and customers. 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, 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's operations are seasonal in nature. Typically, sales are lowest in the third quarter and incoming cash flows are lowest in the fourth quarter. Customers may request product returns and the Company may, at its discretion, agree to the return. This could result in unscheduled payments, which may have a material adverse effect.

The Company currently has a large cash reserve from collections of its accounts receivable; however, availability of cash is also dependent upon the earnings, availability of existing or alternate financing facilities, contractual commitments, timing and extent of product returns and repayment terms. The outcome of these activities and events are difficult to predict.

The Company controls liquidity risk by management of working capital, cash flows and the availability of borrowing facilities.

### **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 twelve month period ended September 30, 2009.

### **Market risk**

#### **a) Interest rate risk**

Bank indebtedness and term mortgage are 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 tax of approximately \$58 thousand for the year ended September 30, 2009 (2008 - \$51 thousand). The Company entered into Bankers Acceptance agreements during the year to manage interest rate risk. As at September 30, 2009, no such agreements were in place. 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 a term not to exceed July 31, 2012.

**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 to a 10% increase in the United States dollar, with all other variables held constant, would result in a decrease in the Company's earnings before income tax of approximately \$3 thousand for the year ended September 30, 2009 (2008 - \$400 thousand). The Company does not use derivative instruments to reduce its exposure to foreign currency risk.

**Credit risk**

The maximum exposure to credit risk of the Company as at September 30, 2009 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.

**Litigation risk**

In 2007, two concurrent and coordinated class action lawsuits were commenced in Alberta and Ontario against the Company and certain of its officers and former directors. These lawsuits sought compensatory damages, costs, and expenses in the amount of \$110 million. 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. The Company's anticipated contribution to the settlement amount is to be funded through its insurance coverage.

At September 30, 2009, the Company was involved in various other legal claims related to the normal course of operations. Management has reviewed the claims and believes that it has adequately provided for these legal claims.

**CRITICAL ACCOUNTING POLICIES, CHANGES AND ESTIMATES**

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.

Significant estimates made by management include provisions for customer discounts and incentives, allowances for uncollectible accounts, rights of return, the realizable portion of inventory during the Company's normal business cycle, inventory provisions, the realizability of future income taxes, useful lives of long-lived assets, 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, Management reviews its estimates to ensure that these values appropriately reflect changes in the Company's business and new information as it becomes available.

Management believes the following critical accounting policies affect the more significant judgments and estimates used in the preparation of the consolidated financial statements:

- Revenue recognition,
- Intangible assets,
- Accrued liabilities,
- Contingencies,

- Income taxes,
- Inventory valuation,
- Stock-based compensation, and
- Foreign currency translation of foreign subsidiaries

### Revenue recognition

The Company recognizes revenue in accordance with the Canadian Institute of Chartered Accountants ("CICA") handbook section 3400 Revenue and Emerging Issues Committee ("EIC") Abstract 141 Revenue Recognition. This guidance states that revenue recognition should take place when realized or realizable and earned. Revenue recognition occurs upon meeting all of the following criteria:

- evidence of an arrangement exists;
- upon delivery of the product or rendering of services;
- the seller's price to the buyer is fixed and determinable; and
- collection is reasonably assured.

EIC-141 also states that revenue recognition occurs at the time of the sales transactions where the buyer has the right to return the product only if:

- the seller's price to the buyer is substantially fixed or determinable at the date of sale;
- the buyer has paid the seller, or the buyer is obligated to pay the seller and the obligation is not contingent on resale of the product;
- the buyer's obligation to the seller would not be changed in the event of physical destruction, loss or damage of the product;
- the buyer acquiring the product for resale has economic substance apart from that provided by the seller;
- the seller does not have significant obligations for future performance to directly bring about resale of the product by the buyer; and
- the amount of future returns can be reasonably estimated.

The Company recognizes revenues when the title and risk of ownership transfers to the customer, and the above criteria are satisfied, which is generally at the time of delivery of products to customers. Net revenue represents total gross revenues less allowances for customer credits, including estimates of discounts and allowances, rebates, charge-backs, and product returns.

The Company establishes allowances for estimated rebates, charge-backs and product returns based on numerous qualitative and quantitative factors, which include:

- the number of and specific terms of arrangements with customers;
- estimated levels of inventory in the distribution channel;
- historical rebates, coupon redemption rates, charge-backs and returns of products;
- direct communication with customers;
- anticipated introduction of competitive products;
- anticipated pricing strategy changes by the Company and/or its competitors;
- analysis of sales data gathered by a third-party data provider;
- the effect of regulatory changes; and
- the estimated remaining shelf life of products.

The Company uses internal forecasts, historical sales data, information gathered from customers and external data providers and judgment, to determine the estimated amount of product sold to customers, product in the sales channel or customer inventories, and to assess risk of returns. Consistent with industry practice, we periodically offer promotional

discounts or allowances to the existing customer base. Where product is sold into new markets, the Company's policy is to recognize revenue when the risk of return is substantially eliminated, which is typically based on estimates of sell-through to the end consumer.

Customer discounts and allowances are typically a percentage of the current published list price or may be a fixed amount, and treated as off-invoice allowances. Accordingly, discounts reduce revenue in the period of offering the program. Discounts and allowances vary by customer, marketing program and time of the year. Discounts in excess of recognized revenue are charged to either costs of goods sold or to selling, general and administration expense, depending on the nature of the discount or allowance, following a customer specific analysis. Customer discounts and allowances were approximately \$3.9 million at September 30, 2009 (2008 - \$2.2 million).

### Intangible assets

Intangible assets include patents, registered trademarks, computer software, and website development costs and are presented at cost less accumulated amortization. Amortization of patents and registered trademarks are generally computed using the straight-line method based on estimated useful lives ranging from ten to twenty years. Website development costs are amortized using the straight-line method using the estimate life of the website and computer software is amortized on a 50% declining balance basis. The Company amortizes intangible assets on a systematic basis to reflect the pattern in which the economic benefits of the asset are consumed, if that basis can be reliably determined. The expected useful life is the period over which the asset contributes directly or indirectly to future cash flows. Management determines the useful lives of these intangible assets based on a number of factors, which include legal, regulatory or contractual limitations; known technological advances; anticipated demand; and the presence of competition. A significant change in these factors may require a revision of the expected remaining useful life of an intangible asset, which could have a material effect on results of operations.

Research and development costs are charged to expenses as incurred unless a development project meets the Canadian GAAP criteria for deferral and amortization. Deferred research and development costs consist of direct and indirect expenditures related to the Company's research and development programs. The Company assesses whether these costs have met the relevant criteria for deferral and amortization at each reporting date.

The recording of those intangible assets acquired through asset acquisitions or business combinations is at fair value based on an allocation of the purchase price.

### Accrued liabilities

The Company engages a significant number of third party service providers, contract manufacturing and logistics organizations. The basis of accruals is estimated expenses and/or inventory production. Where possible, detective controls, such as confirmations, are used to verify significant accruals. The accruals depend on the issuance and accuracy of estimates in purchase orders and contracts, and the accuracy of estimates on the percentage of completion and costs incurred to the end of the reporting period.

### Contingencies

In the normal course of business, the Company may be subject to loss contingencies, such as claims and assessments arising from litigation and other legal proceedings, contractual commitments and indemnities, product liabilities, and tax matters. The Company is required to accrue for such loss contingencies or expense if it is probable that the outcome will be unfavourable or will take place, and if there is a reasonable estimate of the amount of the loss or expense. Evaluation of the Company's exposure to a loss takes into consideration various factors, including the progress of each contingency, experience with similar contingencies, and consultation with specialists and external legal counsel. The Company re-evaluates contingencies as additional information becomes available. Given the uncertainties inherent in complex litigation, regulatory processes and other contingencies, these evaluations can involve significant judgment about future events.

The ultimate outcome of any litigation or other contingency may be material to the results of operations, financial position and cash flow.

### **Income taxes**

Income taxes have been accounted for using the liability method of tax allocation. Under this method, future tax assets and liabilities are determined based on differences between the accounting and income tax bases of an asset or liability. These are measured using the substantively enacted tax rates, regulations and laws of Canadian, United States, and Swiss tax jurisdictions that are anticipated to be in effect when the differences are expected to reverse. The Company has operations in various countries that have differing tax laws and rates. Income tax reporting is subject to audit by both domestic and foreign tax authorities.

The provision for income taxes involves a number of estimates and assumptions made by management. The amount of income earned in the various operating jurisdictions and the rate of taxes payable in respect of that income has an effect on the Company's consolidated income tax rate. The Company also enters into many transactions and arrangements in the ordinary course of business in which the tax treatment is not entirely certain and may involve different taxation jurisdictions. As a result, management must make estimates and judgments based on knowledge and understanding of domestic and international tax rules in determining the consolidated tax provision. For example, certain countries in which the Company operates could seek to tax a greater share of income than has been provided for by the Company. The outcome of any audits by taxation authorities may differ from the estimates and assumptions used in determining our consolidated income tax provisions and accruals. These assessments could have a material effect on the Company's consolidated income tax provision and results of operations, financial position and cash flow for the period in which the tax authorities make such a determination. The Company may make a valuation allowance on deferred tax assets primarily relating to operating losses and other carry forward items when management does not believe realization is more likely than not. Management must exercise significant judgment to determine the appropriate amount of valuation allowance to record. Changes in the valuation allowance could materially increase or decrease the provision for income taxes in a period and affect the results of operations.

### **Inventory valuation**

Inventories of raw materials and packaging materials, work-in-progress, finished goods and product shipped with right of return are valued at the lower of cost and net realizable value. Work-in-progress costs include direct materials, labour and an allocation of overhead which are determined on a weighted average basis. The Company determines estimated annual production levels and allocates overhead costs on that basis. For product shipped with right of return, displays and packaging materials normally included in the value of the inventory, which the Company does not expect to recover are expensed when the product is initially shipped to the customer. Inventory is reviewed for obsolescence at least on a quarterly basis, and where identified the excess of carrying amount over net realizable value is expensed to cost of goods sold. Management's estimate of inventory not reasonably expected to be realized in cash during the normal operating cycle is classified as non-current inventory. During the fiscal year ended September 30, 2009, inventory provisions of approximately \$1.7 million (2008 - \$2.7 million) were expensed to cost of goods sold. The inventory provisions primarily related to packaging material and excess inventories that would not be useable with planned changes to product branding and the revenue forecasts of the recently updated strategic plan for the Company.

### **Stock-based compensation**

The Company applies the fair value method of accounting for its stock-based compensation. The fair value at grant date of stock options is estimated using the Black-Scholes option pricing model. Stock-based compensation cost is recognized on a straight-line basis over the expected vesting period of the stock-based compensation. Any consideration paid upon exercise of stock options is recorded as an increase in share capital and the recorded fair value of the related stock option is reclassified from contributed surplus to share capital.

On April 1, 2009, the Company implemented a Deferred Share Unit ("DSU") plan. Under the plan, participants are eligible to receive an equivalent cash value of the common shares, at a future date subject to certain conditions. The value of the DSU is equal to the share price at the date of grant. Compensation expense is recognized as stock-based compensation on the date of grant as no vesting periods apply. Changes in the amount of the liability due to share price changes after the initial grant date are recognized as stock-based compensation expense in the period in which the changes occur.

On April 1, 2009, the Company implemented a Restricted Share Unit ("RSU") plan under which participants are eligible to receive an equivalent cash value of the common shares, at a future date subject to certain conditions. The value of the RSU is equal to the share price at the date of grant. In the case of RSUs granted for a prior service period, the compensation cost will be recognized in the period the RSU is granted. In the case of RSUs granted for current or future service periods, the fair value of the grant is based on the intrinsic value of the units and compensation cost is recognized over the expected vesting period of the stock-based compensation. In the event the service period is not defined, treatment will be consistent with RSUs granted for current and future periods. Changes in the amount of the liability due to share price changes after the vesting date are recognized as stock-based compensation expense in the period in which the changes occur.

### **Foreign currency translation of foreign subsidiaries**

The Company considers its wholly owned foreign subsidiaries integrated operations under the definition provided in Section 1651 of the CICA Handbook. These foreign subsidiaries are dependent on the parent company for financial support. Accordingly, the accounts of those affected subsidiaries are translated using the temporal method. This method requires exchange gains or losses resulting from translating the foreign currency denominated financial statements to Canadian dollars to be included in income during the period. A foreign exchange loss of \$0.2 million (2008 - \$0.5 million) was recognized during the year.

## **ADOPTION OF ACCOUNTING CHANGES**

### **Accounting changes**

The Company adopted the following new Canadian Institute of Chartered Accountants ("CICA") Handbook standards.

#### **Inventories**

Effective October 1, 2008, the Company adopted the provisions of the CICA Handbook section 3031, Inventories, retroactively without restatement. This section supersedes the previous inventory section and alters the costing and valuation of inventory due to the expanded guidance on the costs to be included in inventory and additional guidance on the net realizable value of inventory. In addition, the nature of the disclosure of inventories has been expanded to include additional disclosure regarding the accounting policies used in measuring the inventory, the carrying value of the inventory, amounts recognized as an expense during the period, write-downs and the amount of any reversal of write-downs recognized in the period.

In accordance with the new standard, fixed and variable overhead costs associated with the manufacturing of inventory have been added to the inventory value. Upon adoption, the allocation of overhead costs resulted in an increase in opening inventory of \$1.5 million, an increase in future income tax liabilities of \$0.5 million and a decrease in the deficit of \$1.0 million. The impact of adopting the new standard for the year ended September 30, 2009 resulted in an increase in cost of goods sold of \$0.7 million and a decrease in net earnings of \$0.5 million.

### Goodwill and intangible assets

In February 2008, the CICA issued Handbook section 3064, Goodwill and Intangible Assets which supersedes section 3062 Goodwill and Other Intangible Assets, and section 3450 Research and Development Costs. This standard provides additional guidance on when expenditures qualify for recognition as intangible assets and requires that costs be deferred only when relating to an item meeting the asset definition. This new accounting standard is effective for interim and annual financial statements relating to fiscal years beginning on or after October 1, 2008. The Company adopted this standard for the fiscal year commencing October 1, 2008. The adoption of this standard resulted in the reclassification of computer software costs from property and equipment to intangible assets with a cost and net book value of \$0.5 million and \$0.3 million respectively.

### Credit Risk and the Fair Value of Financial Assets and Financial Liabilities

In January 2009, the CICA issued EIC Abstract 173, Credit Risk and the Fair Value of Financial Assets and Financial Liabilities. The EIC requires the Company to take into account the Company's own credit risk and the credit risk of the counterparty in determining the fair value of financial assets and financial liabilities, including derivative instruments. EIC 173 is to be applied retrospectively without restatement of prior periods to all financial assets and liabilities measured at fair value in the interim and annual financial statements for periods ending on or after the date of issuance of the Abstract. The Company has early adopted this Abstract, and has concluded that this standard has no material impact on its consolidated financial statements.

## FUTURE ACCOUNTING PRONOUNCEMENTS

### Convergence with International Financial Reporting Standards

In February 2008, the CICA Accounting Standards Board ("AcSB") confirmed that International Financial Reporting Standards ("IFRS") will replace Canadian GAAP in 2011 for profit-oriented Canadian publicly accountable enterprises. As the Company will be required to report its results in accordance with IFRS commencing in its fiscal year ending September 30, 2012, the Company is assessing the potential impacts of this changeover and developing a conversion plan which will include: a detailed timeline; further training and education requirements; and the impact on accounting policies, information systems, internal controls over financial reporting and business activities.

During the year ended September 30, 2009, the Company engaged a public accounting firm to assist with the completion of a high-level assessment of the significant differences between Canadian GAAP and IFRS specific to the Company. This high-level assessment commenced in the third quarter of 2009 and was completed by the end of the year. The Company also conducted initial IFRS awareness training for staff in the fourth quarter of 2009.

### Consolidated Financial Statements

In January 2009, the CICA issued Handbook section 1601, Consolidated Financial Statements, which replaces the existing standards. This section carries forward existing Canadian guidance for preparing consolidated financial statements other than non-controlling interests. The section is effective for interim and annual financial statements beginning on January 1, 2011 and earlier adoption is permitted. The Company is currently evaluating the impact of adopting this standard on its consolidated financial statements.

### Financial Statement Disclosures

In March 2009, the Canadian Accounting Standards Board announced it has agreed to adopt recent amendments to IFRS 7, Financial Instruments: Disclosures, into Section 3862, Financial Instruments – Disclosures. The amendments to Section 3862 will apply to annual financial statements for years ending after September 30, 2009. The amendments require that an entity disclose the classification, for each class of financial instrument, of fair value measurements within a fair value hierarchy. The hierarchy includes three levels: Level 1 – quoted prices in active markets, Level 2 – measurements

determined using valuation models that employ observable inputs, and Level 3 – measurements determined using valuation models that employ unobservable inputs. The Company is currently evaluating the impact of adopting this standard on its consolidated financial statements.

### NON-GAAP FINANCIAL MEASURES AND RECONCILIATIONS

Normally, a non-generally accepted accounting principles ("non-GAAP") financial measure is a numerical measure of a company's 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.

The Company uses both GAAP and certain non-GAAP measures to assess performance. Management believes these non-GAAP measures provide useful supplemental information to investors in order that they may evaluate the Company's financial performance using the same measures as management. The Company's management believes 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.

#### Working capital

The definition of working capital is current assets less current liabilities. The Company uses working capital as a supplemental financial measure of its liquidity and operational performance.

#### Working capital

(in thousands)

	As at September 30, 2009	As at September 30, 2008
Current assets	\$ 23,866	\$ 27,912
Current liabilities	8,731	14,170
Working capital	\$ 15,135	\$ 13,742

#### EBITDA

EBITDA is defined as earnings before interest, income taxes, depreciation and amortization. The Company uses EBITDA as a supplemental financial measure of its operational performance. Management believes 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 the Company's day-to-day operations and is used by the Company's lenders in computing certain 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 the Company's business. Management evaluates such items through other financial measures such as capital expenditures and cash flow provided by operating activities. The Company believes that 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.

## Management's Discussion and Analysis *(continued)*

### EBITDA

*(in thousands)*

	Three months ended September 30		Fiscal year ended September 30	
	2009	2008	2009	2008
Net earnings	\$ 2,782	\$ 531	\$ 1,301	\$ 4,592
Current income taxes	845	965	1,267	3,151
Future income taxes	(127)	(178)	(324)	(122)
Amortization	355	299	1,311	971
Interest and bank charges	79	283	400	759
Interest revenue	(12)	(88)	(194)	(344)
<b>EBITDA</b>	<b>\$ 3,922</b>	<b>\$ 1,812</b>	<b>\$ 3,761</b>	<b>\$ 9,007</b>

### Cash flow prior to working capital changes

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

The Company uses cash flow prior to working capital changes as a supplemental financial measure in its evaluation of liquidity. Management believes that adjusting principally for the swings in non-cash working capital items due to seasonality assists management in making long-term liquidity assessments. The Company also believes that this measurement is useful as a liquidity and valuation measurement.

### Cash flow prior to working capital changes

*(in thousands)*

	Fiscal year ended September 30	
	2009	2008
Cash (used in) provided by operating activities	\$ (2,676)	\$ 9,103
Change in non-cash operating working capital	6,008	4,288
Change in non-current inventory	(116)	(7,235)
<b>Cash flow prior to working capital changes</b>	<b>\$ 3,216</b>	<b>\$ 6,156</b>

**Consolidated Financial Statements**

For the years ended September 30, 2009 and 2008

Annual Report 2009



Afexa Life Sciences Inc.

The accompanying consolidated financial statements of Afexa Life Sciences Inc. are the responsibility of management and have been approved by the Board of Directors. The financial statements necessarily include some amounts that are based on management's best estimates, which have been made using careful judgment. Management has prepared the consolidated financial statements in accordance with Canadian generally accepted accounting principles. Financing and operating data elsewhere in the annual report are consistent with the information contained in the consolidated financial statements.

In fulfilling its responsibilities, management of Afexa Life Sciences Inc. maintains a system of internal control. Management continuously reviews and revises internal controls to ensure that the control systems design provides reasonable assurance that the design of the control system is appropriate for the business, and to ensure alignment with the Company's strong ethical environment.

The Board of Directors carries out its responsibility with respect to the consolidated financial statements primarily through its Audit Committee. The Audit Committee meets periodically with management and the external auditors to discuss the annual audit, accounting policies and practices, and other financial reporting matters. The most recent financial statements have been audited by Ernst & Young LLP, Chartered Accountants, who have full access to the Audit Committee, with and without the presence of management. Their report follows hereafter.



Jack Moffatt  
Chairman and Chief Executive Officer



Allan Cleiren  
Chief Financial Officer and Senior Vice President Operations

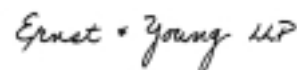
To the Shareholders of Afexa Life Sciences Inc.

We have audited the consolidated balance sheets of Afexa Life Sciences Inc. as at September 30, 2009 and 2008 and the consolidated statements of earnings and comprehensive income and deficit and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at September 30, 2009 and 2008 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Edmonton, Canada  
December 10, 2009



Chartered Accountants

## Consolidated Balance Sheets

29

(in thousands of Canadian dollars)

As at September 30	2009	2008
<b>ASSETS</b>		
Current		
Cash and cash equivalents	\$ 3,495	\$ 4,315
Short-term investment (note 5)	-	5,081
Accounts receivable (note 6)	4,841	5,984
Inventory (note 7)	12,411	9,563
Prepaid expenses and deposits	749	237
Income taxes receivable	2,101	2,459
Future tax asset (note 8)	269	273
	<b>23,866</b>	<b>27,912</b>
Inventory, non-current (note 7)	-	116
Intangible assets (notes 3 and 9)	1,491	1,314
Property and equipment (notes 3 and 10)	12,307	12,392
Future tax asset (note 8)	223	312
	<b>\$ 37,887</b>	<b>\$ 42,046</b>
<b>LIABILITIES</b>		
Current		
Accounts payable and accruals (note 14c)	\$ 7,803	\$ 9,157
Current portion of long-term debt (note 11)	706	700
Customer deposits (note 12)	134	4,255
Future tax liability (note 8)	75	44
Current portion of obligations under capital lease (note 11)	13	14
	<b>8,731</b>	<b>14,170</b>
Long-term debt (note 11)	4,863	5,561
Obligations under capital lease (note 11)	777	746
Deferred revenue (note 13)	180	180
Future tax liability (note 8)	140	107
Other long-term liabilities (note 14d)	136	-
	<b>14,827</b>	<b>20,764</b>
<b>SHAREHOLDERS' EQUITY</b>		
Share capital (note 14)	23,101	23,720
Contributed surplus (note 15)	8,224	8,179
Deficit	(8,265)	(10,617)
	<b>23,060</b>	<b>21,282</b>
	<b>\$ 37,887</b>	<b>\$ 42,046</b>

Commitments and contingencies (note 26)

See accompanying notes to the consolidated financial statements

On behalf of the Board



**J. Douglas Gilpin**  
Director



**David T. Weyant**  
Director

## Consolidated Statements of Earnings and Comprehensive Income and Deficit

30

(in thousands of Canadian dollars except per share amounts)

Years ended September 30	2009	2008
Revenue	\$ 47,592	\$ 49,389
Cost of goods sold	15,440	17,044
	<b>32,152</b>	<b>32,345</b>
Operating expenses		
Selling, general and administration (note 26)	23,899	19,975
Research and development (note 8)	3,401	2,285
Amortization (note 17)	1,311	971
Stock-based compensation (notes 14b, 14c and 14d)	834	641
Interest and bank charges (note 18)	400	759
Loss on foreign exchange (note 20)	182	496
	<b>30,027</b>	<b>25,127</b>
Earnings before other items and income taxes	<b>2,125</b>	<b>7,218</b>
Other items		
Interest income	194	344
Write down of intangible assets (note 9)	(85)	(28)
Other income	10	87
	<b>119</b>	<b>403</b>
Earnings before income taxes	<b>2,244</b>	<b>7,621</b>
Income tax expense (recovery) (note 8)		
Current	1,267	3,151
Future	(324)	(122)
	<b>943</b>	<b>3,029</b>
Net earnings and comprehensive income	<b>1,301</b>	<b>4,592</b>
Deficit, beginning of year	(10,617)	(15,209)
Adjustment (note 3)	1,051	-
Adjusted deficit, beginning of year	(9,566)	(15,209)
Deficit, end of year	\$ (8,265)	\$ (10,617)
Earnings per share (note 16)		
Basic earnings per share	\$ 0.01	\$ 0.04
Diluted earnings per share	0.01	0.04
Weighted average number of shares outstanding		
Basic	106,434,436	106,268,024
Diluted	106,446,476	107,457,887

See accompanying notes to the consolidated financial statements

## Consolidated Statements of Cash Flow

31

(in thousands of Canadian dollars)

Years ended September 30	2009	2008
<b>Operating activities</b>		
Net earnings and comprehensive income	\$ 1,301	\$ 4,592
Items not affecting cash		
Stock-based compensation (notes 14b, 14c and 14d)	782	641
Future income taxes (note 8)	(324)	(122)
Amortization (note 17)	1,311	971
Accreted interest on land under capital lease	50	46
Loss on disposal of property and equipment	11	-
Write down of intangible assets (note 9)	85	28
	<b>3,216</b>	<b>6,156</b>
Change in non-cash operating working capital (note 23)	(6,008)	(4,288)
Change in non-current inventory	116	7,235
<b>Cash (used in) provided by operating activities</b>	<b>(2,676)</b>	<b>9,103</b>
<b>Investing activities</b>		
Purchase of property and equipment	(947)	(4,043)
Purchase of intangible assets	(465)	(473)
Proceeds on disposal of property and equipment	23	-
Purchase of short-term investment (note 5)	-	(9,024)
Redemption of short-term investment (note 5)	5,081	3,943
<b>Cash provided by (used in) investing activities</b>	<b>3,692</b>	<b>(9,597)</b>
<b>Financing activities</b>		
Repayment of obligations under capital lease	(13)	(14)
Issuance of share capital (note 14a)	-	543
Share purchase under normal course issuer bid (note 14a)	(1,115)	-
Issuance of long-term debt (note 11)	-	3,739
Repayment of long-term debt (note 11)	(708)	(123)
Repayment of bank indebtedness (note 11)	-	(2,039)
<b>Cash (used in) provided by financing activities</b>	<b>(1,836)</b>	<b>2,106</b>
(Decrease) increase in cash and cash equivalents	(820)	1,612
Cash and cash equivalents, beginning of year	4,315	2,703
<b>Cash and cash equivalents, end of year</b>	<b>\$ 3,495</b>	<b>\$ 4,315</b>
<b>Supplemental cash flow information:</b>		
Interest paid	\$ 259	\$ 250
Interest received	194	344
Income taxes paid	3,015	2,672
Property and equipment additions		
- financed by obligations under capital lease	-	39
- included in accounts payable and accruals at year end	141	35

See accompanying notes to the consolidated financial statements

## Notes to the Consolidated Financial Statements

Years Ended September 30, 2009 and 2008. All amounts are in thousands of Canadian dollars, except share data

### 1. Nature of operations and basis of presentation

Afexa Life Sciences Inc. (the "Company") is a publicly owned company that develops and sells biopharmaceutical products. It is incorporated under the Business Corporations Act (Alberta). The head office and research centre for the Company is located in Edmonton, Canada.

On April 1, 2009, CV Technologies Inc. announced that it changed its name to Afexa Life Sciences Inc. The change was approved by shareholders at the Company's Annual General and Special Meeting held on March 26, 2009. In conjunction with the change in name, the ticker symbol under which the Company's common shares trade on the Toronto Stock Exchange also changed from CVQ to FXA. The name change is part of a broader branding plan, which will leverage the brand equity associated with COLD-FX®.

The Company has subsidiary companies incorporated and operating in Canada, the United States, and Switzerland. CVT Capital Inc. is incorporated under the Business Corporations Act (Alberta), COLD-fx Pharmaceuticals (USA) Inc. is incorporated in the United States, and fX Life Sciences AG is incorporated under the Swiss Code of Obligations. The Company also has an inactive subsidiary incorporated under the Swiss Code of Obligations (note 28).

### 2. Summary of significant accounting policies

These consolidated financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles ("GAAP"). The significant accounting policies are summarized below.

#### Principles of consolidation

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

#### Use of estimates and measurement uncertainty

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 periods presented. Actual results could differ from these estimates.

Significant estimates made by management include provisions for customer discounts and incentives, allowances for uncollectible accounts, rights of return, the realizable portion of inventory during the Company's normal business cycle, inventory provisions, the realizability of future income taxes, useful lives of long-lived assets, 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, management reviews its estimates to ensure that these values appropriately reflect changes in the Company's business and new information as it becomes available. As at September 30, 2009, management's estimate for customer discounts and incentives totalled approximately \$3,928 (2008 - \$2,207), which are included primarily as a reduction in accounts receivable, or included in accounts payable and accruals and customer deposits.

#### Translation of foreign currencies

The consolidated financial statements of the Company's operations are reported in Canadian dollars. One of the Company's subsidiaries uses the United States dollar as the currency of measurement. This subsidiary is an integrated foreign operation which is translated using the temporal method, whereby monetary assets and liabilities are translated at the exchange rates prevailing at the consolidated balance sheet dates and non-monetary assets and liabilities are translated at the rates in effect when the assets were acquired or liabilities were assumed. Revenues and expenses are translated in a manner that produces substantially the same reporting currency amounts that would have resulted had the underlying transactions been translated on the dates they occurred. This approach is achieved by applying the previous month's closing exchange rate as a proxy for the current month's exchange rate and applying the rate to revenues and expenses that occurred during the month. Amortization and non-monetary items such as inventory, prepaid expenses and deposits, property and equipment, and intangible assets are translated at the exchange rate in effect when the assets were acquired. The resulting exchange gains or losses are included in the determination of earnings.

#### Revenue recognition

Revenue from the sale of goods is recognized when all of the following criteria have been met:

- evidence of a sales arrangement exists;
- title of goods has passed to the customer, which is generally at the time the goods are delivered;
- sales price is fixed and determinable; and
- product returns can be reasonably estimated or the right of return has expired.

## Notes to the Consolidated Financial Statements *(continued)*

*Years Ended September 30, 2009 and 2008. All amounts are in thousands of Canadian dollars, except share data*

Provisions for estimated returns are made when revenue is recognized. When future returns cannot be reasonably estimated, revenue is not recognized until the risk of return has been substantially eliminated. This risk is substantially eliminated when the final customer purchases the product from the retailer or the right of return has expired or been eliminated. The Company relies on third-party information to estimate when the final customer has completed a purchase. Product shipped where the risk of return cannot be estimated is included in inventory as product shipped with right of return.

Customer discounts, rebates and incentive allowances which do not result in a sufficiently separable benefit from the sale are recorded as a reduction in revenue, and if they are separable, they are recorded in either cost of goods sold or in selling, general and administration expense, depending on the nature of the expense. For discounts, rebates and incentive allowances to be sufficiently separable from the sale of the goods, the benefit must be identifiable, available from a party other than a purchaser of the Company's products and the fair value must be reasonably estimable. If discounts, rebates and/or incentive allowances result in negative revenue for a specific customer since inception of the overall relationship, the amount of the cumulative shortfall is classified as an advertising and marketing expense.

Customer discounts, rebates and incentive allowances are recognized at the later of the date on which the Company recognizes the related revenue or the date the Company offers the discount, rebate or incentive. If the related revenue is not recognized and the discount is not recoverable in the event of return, the discount is recognized at the later of the date on which the specific activity occurs or the customer recognizes the discount, rebate or incentive allowance.

### Cash and cash equivalents

Cash and cash equivalents include balances with banks, net of outstanding cheques, and short-term liquid investments with maturities of less than 90 days.

### Inventory

Inventories of raw and packaging materials, work-in-progress, finished goods and product shipped with right of return are valued at the lower of cost and net realizable value. Work-in-progress costs include direct materials, labour and an allocation of overhead which are determined on a weighted average basis. The Company determines estimated annual production levels and allocates overhead costs on that basis (note 3). For product shipped with right of return, displays and packaging materials normally included in the value of the inventory, which the Company does not expect to recover are expensed when the product is initially shipped to the customer. Inventory is reviewed for obsolescence at least on a quarterly basis, and where identified, the excess of carrying amount over net realizable value is expensed to cost of goods sold. Management's estimate of inventory not reasonably expected to be realized in cash during the normal operating cycle is classified as non-current inventory.

### Intangible assets

Intangible assets, including patents, registered trademarks, computer software, and website development costs, are carried at cost less accumulated amortization. Gains or losses arising from the impairment or disposal of individual assets are recognized in earnings in the year of impairment or disposal.

Amortization is provided for using the following methods and rates:

Patents	straight-line over 20 years
Computer software	50%, declining balance
Website development	straight-line over the estimated life
Registered trademarks	straight-line over 10 years

### Property and equipment

Property and equipment, including equipment under capital leases, are carried at cost less accumulated amortization. Gains and losses arising on the disposal of individual assets are recognized in earnings in the year of disposal.

Amortization is not recorded until an asset is available for use. Amortization is provided for using the following methods and rates:

Building	4 - 10%, straight-line
Lab equipment	20%, declining balance
Furniture and equipment	20 - 30%, declining balance
Computer hardware	20%, declining balance
Leasehold improvements	straight-line over term of lease
Equipment under capital lease	20%, declining balance
Automobiles	30%, declining balance

## Notes to the Consolidated Financial Statements *(continued)*

*Years Ended September 30, 2009 and 2008. All amounts are in thousands of Canadian dollars, except share data*

The costs for periodic repairs and maintenance are expensed to the extent the expenditures serve only to restore the assets to their normal operating condition without enhancing the service potential or extending their useful lives.

### Leases

Leases entered into by the Company in which substantially all of the benefits and risks of ownership are transferred to the Company are recorded as capital leases and classified as property and equipment, and obligations under capital lease. Obligations under capital lease reflect the present value of future lease payments, discounted at an appropriate interest rate, and are reduced by lease payments net of imputed interest. Assets under capital leases are amortized based on the estimated useful lives of the assets. All other leases are classified as operating leases and leasing costs are expensed in the period in which they are incurred.

### Research and development costs

Research and development costs are charged to expenses as incurred, net of related tax credits, unless a development project meets the Canadian GAAP criteria for deferral and amortization. Research and development costs include the following direct operating expenses: salaries and benefits, administration, occupancy and insurance, and contracting, consulting and professional fees.

Development costs are capitalized for clearly defined, technically feasible technologies which management intends on producing and promoting to an identified future market with existing or estimated future resources. The Company annually evaluates deferred development costs to consider whether these costs continue to meet criteria for deferral. Amortization of development costs commence at the start of commercial production of the product. Costs are amortized on a straight-line basis over a five year period based on recoverability of unamortized deferred development costs. The Company has not capitalized development costs during the periods presented.

### Investment tax credits

Investment tax credits relating to qualifying scientific research and experimental development expenditures that are recoverable in the current year are accounted for as a reduction in research and development expenditures. Investment tax credits not recoverable in the current year are accrued provided there is reasonable assurance that the credits will be realized.

### Comprehensive income

Comprehensive income is the change in equity (net assets) of the Company, during a period, from transactions and other events and circumstances from non-owner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners. The Company did not have other comprehensive income, a component of comprehensive income not included in net earnings, and accordingly total comprehensive income and net earnings are equal.

### Financial instruments

On acquisition, all financial assets are classified as held-to-maturity, loans and receivables, held-for-trading or available-for-sale. The Company's financial instruments comprise and have been classified as follows: cash and cash equivalents and short-term investment as held-for-trading; accounts receivable is classified as loans and receivables; term mortgages, obligations under financing loans, and accounts payable and accruals have been classified as other liabilities.

For financial instruments that are initially classified on the consolidated balance sheet at fair value and if classified as loans and receivables or held-for-trading, changes in fair value are included in earnings. For those instruments classified as available-for-sale and for derivative financial instruments designated as hedges, changes in fair value are included in other comprehensive income. Other comprehensive income and its components, when presented, are included directly in equity as accumulated other comprehensive income.

Except for revolving debt obligations, financial assets and financial liabilities classified other than as held-for-trading are measured at amortized cost based on the effective interest rate method.

Transaction costs for revolving debt obligations that are directly attributable to the acquisition or issuance of the financial liability are expensed by the Company. Transaction costs for long-term debt obligations are applied against the fair value of the liability when issued and amortized to interest expense using the effective interest rate method.

### Impairment of long-lived assets

The Company evaluates the carrying value of long-lived assets, including property and equipment, intangible assets and other assets subject to amortization, for potential impairment when events and circumstances warrant a review. Factors that the Company considers important which could trigger an impairment review include, but are not limited to, significant under-performance relative to historical or projected future operating results, significant changes in the manner of use of the asset or the overall strategy of the business, significant negative industry or economic trends, a significant decline in the Company's

## Notes to the Consolidated Financial Statements *(continued)*

*Years Ended September 30, 2009 and 2008. All amounts are in thousands of Canadian dollars, except share data*

share price for a sustained period and the Company's market capitalization relative to the net book value of its assets and liabilities. These factors could affect the expected cash flows of the related long-lived asset.

Impairment of non-monetary long-lived assets is recognized when the carrying amount of an asset may not be recoverable. Recoverability is determined by comparing the carrying amount of the asset to the undiscounted future cash flows expected from use and eventual disposition of the asset. When the carrying amount of the asset is greater than the undiscounted future cash flows, the excess of carrying value over its fair value is recorded as a charge to earnings.

### Earnings per share

The computation of basic earnings per share has been calculated by dividing net earnings by the weighted average number of common shares outstanding during the year.

Diluted earnings per share reflect the potential dilution that would occur if stock options were exercised. The computation of diluted earnings per share has been calculated by dividing net earnings available to common shareholders by the sum of the weighted average number of common shares outstanding and all additional common shares that would have been outstanding arising from the exercise of potentially dilutive stock options outstanding during the year. The Company uses the treasury method for outstanding options which assumes that the use of proceeds that could be obtained upon exercise of options in computing diluted earnings per share are used to purchase the Company's common shares at the average market price during the year.

### Income taxes

Income taxes have been accounted for using the liability method of tax allocation. Under this method, future tax assets and liabilities are determined based on differences between the accounting and income tax bases of an asset or liability. These are measured using the substantively enacted tax rates, regulations and laws of Canadian, United States, and Swiss tax jurisdictions that are anticipated to be in effect when the differences are expected to reverse.

### Stock-based compensation plans

The Company applies the fair value method of accounting for its stock-based compensation. The fair value at grant date of stock options is estimated using the Black-Scholes option pricing model. Stock-based compensation cost is recognized on a straight-line basis over the expected vesting period of the stock-based compensation. Any consideration paid upon exercise of stock options is recorded as an increase in share capital and the recorded fair value of the related stock option is reclassified from contributed surplus to share capital.

On April 1, 2009, the Company implemented a Deferred Share Unit ("DSU") plan. Under the plan, participants are eligible to receive an equivalent cash value of the common shares, at a future date subject to certain conditions. The value of the DSU is equal to the share price at the date of grant. Compensation expense is recognized as stock-based compensation on the date of grant as no vesting periods apply. Changes in the amount of the liability due to share price changes after the initial grant date are recognized as stock-based compensation expense in the period in which the changes occur.

On April 1, 2009, the Company implemented a Restricted Share Unit ("RSU") plan under which participants are eligible to receive an equivalent cash value of the common shares, at a future date subject to certain conditions. The value of the RSU is equal to the share price at the date of grant. In the case of RSUs granted for a prior service period, the compensation cost will be recognized in the period the RSU is granted. In the case of RSUs granted for current or future service periods, the fair value of the grant is based on the intrinsic value of the units and compensation cost is recognized over the expected vesting period of the stock-based compensation. In the event the service period is not defined, treatment will be consistent with RSUs granted for current and future periods. Changes in the amount of the liability due to share price changes after the vesting date are recognized as stock-based compensation expense in the period in which the changes occur.

## 3. Changes in significant accounting policies

During the year, the Company adopted the following new Canadian Institute of Chartered Accountants ("CICA") Handbook standards:

### CICA 3031 – Inventories

Effective October 1, 2008, the Company adopted the provisions of the CICA Handbook Section 3031, Inventories, retroactively without restatement. This section supersedes the previous inventory section and alters the costing and valuation of inventory due to the expanded guidance on the costs to be included in inventory and additional guidance on the net realizable value of inventory. In addition, the nature of the disclosure of inventories has been expanded to include additional disclosure regarding the accounting policies used in measuring the inventory, the carrying value of the inventory, amounts recognized as an expense during the period, write-downs and the amount of any reversal of write-downs recognized in the period.

## Notes to the Consolidated Financial Statements *(continued)*

*Years Ended September 30, 2009 and 2008. All amounts are in thousands of Canadian dollars, except share data*

In accordance with the new standard, fixed and variable overhead costs associated with the manufacturing of inventory have been added to the inventory value. Upon adoption, the allocation of overhead costs resulted in an increase in opening inventory of \$1,538, an increase in future income tax liabilities of \$487 and a decrease in the deficit of \$1,051. The impact of adopting the new standard for the year ended September 30, 2009 resulted in an increase in cost of goods sold of \$678 and a decrease in net earnings of \$471.

### **CICA 3064 – Goodwill and intangible assets**

In February 2008, the CICA issued Handbook section 3064, Goodwill and Intangible Assets, which supersedes section 3062, Goodwill and Other Intangible Assets, and section 3450, Research and Development Costs. This standard provides additional guidance on when expenditures qualify for recognition as intangible assets and requires that costs be deferred only when relating to an item meeting the asset definition. This new accounting standard is effective for interim and annual financial statements relating to fiscal years beginning on or after October 1, 2008. The Company adopted this standard for the fiscal year commencing October 1, 2008. The adoption of this standard resulted in the reclassification of computer software costs from property and equipment to intangible assets with a cost and net book value of \$515 and \$286, respectively (notes 9 and 10).

### **CICA Emerging Issues Committee (“EIC”) 173 – Credit Risk and the Fair Value of Financial Assets and Financial Liabilities**

In January 2009, the CICA issued EIC Abstract 173, Credit Risk and the Fair Value of Financial Assets and Financial Liabilities. The EIC requires the Company to take into account the Company's own credit risk and the credit risk of the counterparty in determining the fair value of financial assets and financial liabilities, including derivative instruments. EIC 173 is to be applied retrospectively without restatement of prior periods to all financial assets and liabilities measured at fair value in the interim and annual financial statements for periods ending on or after the date of issuance of the Abstract. The Company has early adopted this Abstract, and has concluded that this standard has no material impact on its consolidated financial statements.

## **4. Future accounting standards**

### **Convergence with International Financial Reporting Standards**

In February 2008, the CICA Accounting Standards Board (“AcSB”) confirmed that International Financial Reporting Standards (“IFRS”) will replace Canadian GAAP in 2011 for profit-oriented Canadian publicly accountable enterprises. As the Company will be required to report its results in accordance with IFRS commencing in its fiscal year ending September 30, 2012, the Company is assessing the potential impacts of this changeover and developing a conversion plan which will include: a detailed timeline; further training and education requirements; and the impact on accounting policies, information systems, internal controls over financial reporting and business activities.

During the year ended September 30, 2009, the Company engaged a public accounting firm to assist with the completion of a high-level assessment of the significant differences between Canadian GAAP and IFRS specific to the Company. This high-level assessment commenced in the third quarter of 2009 and was completed by the end of the year. The Company also conducted an initial IFRS awareness training for staff in the fourth quarter of 2009.

### **CICA 1601 – Consolidated Financial Statements**

In January 2009, the CICA issued Handbook section 1601, Consolidated Financial Statements, which replaces the existing standards. This section carries forward existing Canadian guidance for preparing consolidated financial statements other than non-controlling interests. The section is effective for interim and annual financial statements beginning on January 1, 2011 and earlier adoption is permitted. The Company is currently evaluating the impact of adopting this standard on its consolidated financial statements.

### **CICA 3862 – Financial Statement – Disclosures**

In March 2009, the Canadian Accounting Standards Board announced it has agreed to adopt recent amendments to IFRS 7, Financial Instruments: Disclosures, into section 3862, Financial Instruments – Disclosures. The amendments to section 3862 will apply to annual financial statements for years ending after September 30, 2009. The amendments require that an entity disclose the classification, for each class of financial instrument, of fair value measurements within a fair value hierarchy. The hierarchy includes three levels: Level 1 – quoted prices in active markets, Level 2 – measurements determined using valuation models that employ observable inputs and Level 3 – measurements determined using valuation models that employ unobservable inputs. The Company is currently evaluating the impact of adopting this standard on its consolidated financial statements.

## Notes to the Consolidated Financial Statements *(continued)*

Years Ended September 30, 2009 and 2008. All amounts are in thousands of Canadian dollars, except share data

### 5. Short-term investment

Short-term investment consisted of a cashable guaranteed investment certificate ("GIC") purchased on June 30, 2008. The GIC matured on June 30, 2009, and carried an interest rate of 3.25% with interest being paid at maturity. No short-term investments were held by the Company as at September 30, 2009.

	2009	2008
Guaranteed investment certificate	\$ -	\$ 5,081

### 6. Accounts receivable

	2009	2008
Trade receivables	\$ 6,823	\$ 7,629
Allowance for doubtful accounts	(78)	(58)
	6,745	7,571
Other receivables	415	1,532
Discount and incentive provisions	(3,928)	(2,207)
Return allowances	(296)	(1,019)
Other provisions	(14)	(89)
	2,922	5,788
Reclass net credits in trade receivables	1,919	196
	\$ 4,841	\$ 5,984

Trade receivables are non-interest bearing and are generally on 30-day terms.

The Company identifies impairment of trade receivables through a review of specific accounts and provides an allowance for doubtful accounts based on the excess of their carrying value over their estimated realizable amount. After all efforts of collection have failed, the accounts receivable balance not collected is written off against the allowance for doubtful accounts. At September 30, 2009, trade receivables of \$78 (2008 - \$58) were considered to be impaired and fully provided for. The movement on the provision for impairment of trade receivables for the year is as follows:

	2009	2008
Balance, October 1	\$ 58	\$ 62
Provision for doubtful accounts	80	178
Recovery	(23)	(74)
Amounts written off as uncollectible	(37)	(108)
Balance, September 30	\$ 78	\$ 58

The aging analysis of trade receivables not impaired is as follows:

	Total	< 30 days	30 - 60 days	60 - 90 days	> 90 days
September 30, 2009	\$ 6,745	\$ 4,390	\$ 2,026	\$ 212	\$ 117
September 30, 2008	7,571	4,633	2,739	115	84

Included in the aging analysis are amounts for unapplied credit memos relating to discount and incentive claims, return claims, and other claims which reduce the outstanding trade receivables balance. These amounts are represented in the aging categories as follows <30 days (\$300), 30-60 days (\$84), 60-90 days (nil), >90 days (\$281) (2008 - <30 days (\$117), 30-60 days (\$8), 60-90 days (\$27), >90 days (\$141)).

As at September 30, 2009, three customers (2008 - four) represented 90% (2008 - 73%) of total accounts receivable.

## Notes to the Consolidated Financial Statements *(continued)*

Years Ended September 30, 2009 and 2008. All amounts are in thousands of Canadian dollars, except share data

### 7. Inventory

The Company's inventory is comprised of the following:

	2009	2008
Finished goods	\$ 5,510	\$ 5,222
Work-in-progress	5,975	2,075
Raw and packaging materials	705	1,938
Products shipped with right of return	221	444
	<u>12,411</u>	<u>9,679</u>
Less: non-current portion	-	116
	<u>\$ 12,411</u>	<u>\$ 9,563</u>

The cost of inventory recognized as an expense and included in cost of goods sold, prior to overhead variances, for the year ended September 30, 2009 was \$10,758. Included in cost of goods sold in the year are write-downs of inventory totalling \$1,725. No inventory write-downs recognized in previous periods were reversed.

Included in finished goods and raw and packaging materials inventory is \$235 (2008 - \$31) and \$1 (2008 - \$55), respectively, for promotional products not held for sale.

The Company has pledged inventory as collateral under the terms of the demand operating line of credit and term mortgage.

### 8. Income taxes

Income taxes differ from the amounts that would be computed by applying the federal and provincial income tax rates as follows:

	2009	2008
Income taxes and amounts in lieu of income taxes at statutory rates of 30.4% (2008 - 31.7%)	\$ 683	\$ 2,419
Increase (decrease) resulting from:		
Income tax related to previous periods	(73)	46
Non-deductible amounts	194	91
Tax recovery related to intellectual property transfer	-	(176)
Tax rate differences of foreign subsidiaries	(613)	(247)
Non-deductible stock-based compensation	164	203
Change in valuation allowance	322	325
Portion of prepaid intra-group tax asset charged to expense	-	52
Other	266	316
Income tax expense	<u>\$ 943</u>	<u>\$ 3,029</u>

The tax effects of temporary differences that give rise to significant portions of the future income tax assets and future income tax liabilities are presented below:

	2009	2008
<b>Future income tax assets:</b>		
Non-capital losses carried forward (expiring 2014 to 2027)	\$ 4,468	\$ 3,157
Accounts receivable	105	273
Deferred revenue	210	202
Other tax assets	94	48
	<u>4,877</u>	<u>3,680</u>
<b>Future income tax liabilities:</b>		
Property and equipment	131	83
SRED ITC claim	72	44
Long-term loan	9	14
Other tax liabilities	2	10
	<u>214</u>	<u>151</u>
Net future tax asset	4,663	3,529
Valuation allowance	4,386	3,095
	<u>\$ 277</u>	<u>\$ 434</u>

## Notes to the Consolidated Financial Statements *(continued)*

Years Ended September 30, 2009 and 2008. All amounts are in thousands of Canadian dollars, except share data

Presented in the consolidated financial statements as follows:

	2009	2008
Future tax asset - current	\$ 269	\$ 273
Future tax asset - non-current	223	312
Future tax liability - current	(75)	(44)
Future tax liability - non-current	(140)	(107)
	<b>\$ 277</b>	<b>\$ 434</b>

The Company reviews all available positive and negative evidence to evaluate the recoverability of future tax assets. This includes a review of the Company's cumulative losses in recent years, the carryforward period related to the tax losses, and the tax planning strategies available to the Company. The Company has unused tax loss carryforwards in the United States of approximately U.S. \$3,202 which expire between 2027 and 2029, and are available to reduce taxable income in future years. The Company has unused tax loss carryforwards in Switzerland of approximately \$33,000 which are available to reduce taxable income in future years which expire between 2014 and 2015. The benefit of these losses has not been recorded in these consolidated financial statements. They have been fully offset by a valuation allowance.

During the year, the Company recorded the benefit of investment tax credits of \$542 (2008 - \$573) as a reduction in research and development expenses.

### 9. Intangible assets

<i>Restated (note 3)</i>	Cost	Accumulated amortization	Net book value
September 30, 2009			
Patents	\$ 1,606	\$ 633	\$ 973
Computer software	576	324	252
Website development	213	7	206
Registered trademarks	133	73	60
	<b>\$ 2,528</b>	<b>\$ 1,037</b>	<b>\$ 1,491</b>
September 30, 2008			
Patents	\$ 1,556	\$ 645	\$ 911
Computer software	515	229	286
Registered trademarks	223	106	117
	<b>\$ 2,294</b>	<b>\$ 980</b>	<b>\$ 1,314</b>

During the year ended September 30, 2009, the Company recorded intangible asset amortization expense of \$203 (2008 - \$155) and additions to intangible assets totalled \$465 (2008 - \$473). As at September 30, 2009, the Company conducted an annual review of the carrying value of patents and registered trademarks and determined that there was an impairment of \$85 (2008 - \$28). Impairment is recognized when management believes the carrying value of the asset exceeds its expected future cash flows.

Additions for the year ended September 30, 2009 were \$61 (2008 - \$221) and \$404 (2008 - \$252) for acquired and developed intangible assets, respectively.

### 10. Property and equipment

<i>Restated (note 3)</i>	Cost	Accumulated amortization	Net book value
September 30, 2009			
Building	\$ 11,386	\$ 1,457	\$ 9,929
Lab equipment	1,286	301	985
Land under capital lease	616	-	616
Furniture and equipment	781	311	470
Computer hardware	503	238	265
Leasehold improvements	35	7	28
Equipment under capital lease	38	24	14
	<b>\$ 14,645</b>	<b>\$ 2,338</b>	<b>\$ 12,307</b>

## Notes to the Consolidated Financial Statements (continued)

Years Ended September 30, 2009 and 2008. All amounts are in thousands of Canadian dollars, except share data

Restated (note 3)	Cost	Accumulated amortization	Net book value
September 30, 2008			
Building	\$ 11,307	\$ 614	\$ 10,693
Lab equipment	517	185	332
Land under capital lease	616	-	616
Furniture and equipment	613	212	401
Computer hardware	461	199	262
Leasehold improvements	120	95	25
Equipment under capital lease	94	44	50
Automobiles	45	32	13
	<b>\$ 13,773</b>	<b>\$ 1,381</b>	<b>\$ 12,392</b>

During the year, the Company recorded property and equipment amortization expense of \$1,108 (2008 - \$816), of which \$3 (2008 - \$9) is related to amortization on equipment under capital lease.

## 11. Long-term debt and other credit facilities

### Long-term debt

	2009	2008
On June 16, 2009, the Company renegotiated the term mortgage with interest at the bank's prime lending rate plus 1.25%, an increase of 0.25% over the previous rate, repayable in monthly amounts of \$51 plus interest. Terms of repayment under the renegotiated term mortgage have been extended to July 2012 from July 2011. The unamortized financing costs related to this loan are \$38 (2008 - \$55). Using the effective interest method to determine the carrying value, the effective interest rate is 3.86% (2008 - 6.31%). Repayments were interest only until July 31, 2008.	<b>\$ 5,455</b>	<b>\$ 6,072</b>
Financing loan with interest at 6.99% payable in blended monthly payments of \$8, for 36 months ending in May 2011. The unamortized financing costs related to this loan are nil (2008 - \$2). Using the effective interest rate method to determine the carrying value, the effective interest rate is 7.39% (2008 - 7.24%).	<b>152</b>	<b>244</b>
	<b>5,607</b>	<b>6,316</b>
Less: financing charge	<b>38</b>	<b>55</b>
	<b>5,569</b>	<b>6,261</b>
Less: current portion	<b>706</b>	<b>700</b>
Long-term balance of long-term debt	<b>\$ 4,863</b>	<b>\$ 5,561</b>

### Terms and collateral

#### Term mortgage

The Company may repay the mortgage at any time in whole or in part, subject to a three month interest penalty. The Company's mortgage and demand operating line of credit facilities are subject to certain financial covenants. The facilities agreement contains repayment acceleration clauses that may cause the debt to become due and payable, or the collateral to become immediately enforceable, if certain events of default occur. The acceleration clauses include subjective default events such as any adverse change occurring in the financial condition of the Company, its subsidiaries or its property, equipment or business activities. Management of the Company is not aware of any pending condition that would require accelerated repayment of the bank financing. The Company has pledged as collateral a General Security Agreement constituting a first ranking security interest in all personal property of the Company, a collateral mortgage constituting a first fixed charge on the Company's headquarters and research centre situated on the subleased land.

#### Financing loan

The loan is unsecured and is not subject to any covenants. The loan can be called by the lender if scheduled repayments are not received within 10 days of their due date.

## Notes to the Consolidated Financial Statements *(continued)*

Years Ended September 30, 2009 and 2008. All amounts are in thousands of Canadian dollars, except share data

Absent any demand for partial or full repayment of the obligations, required principal repayments of long-term debt are as follows:

2010	\$	706
2011		681
2012		4,220
Total long-term debt		5,607
Less: amounts representing interest at imputed amounts		38
Carrying value of long-term debt	\$	5,569

At September 30, 2009, the Company has available a \$5,000 (2008 - \$5,000) demand operating line of credit and had drawn nil (2008 - nil). The portion of the line of credit that is available to the Company is based on 75% of accounts receivable aged less than 90 days plus 50% of finished goods inventory for the period from September to February each year or 65% of finished goods inventory for the period from March to August each year to a maximum limit of \$2,500. On June 16, 2009, interest under the available operating line of credit was amended to the bank's prime lending rate plus 0.50% an increase of 0.25% over the previous rate.

Included in the available operating line facility is the ability to issue up to \$1,000 of letters of credit. At September 30, 2009, the Company had one (2008 - two) standby letters of credit in the amount of \$124 (2008 - \$496 and \$124) which will remain in effect until December 1, 2009 (2008 - December 1, 2008 and December 1, 2009, respectively). Standby letters of credit are subject to a charge of 1.75% (2008 - 1.5%) per annum.

### Obligations under capital lease

	2009	2008
Land under capital lease at an imputed interest rate of 6.75%. The Company plans to purchase the land on November 30, 2015 for the stated amount of \$1,155. Imputed interest charges for this lease are \$392 (2008 - \$445).	\$ 1,155	\$ 1,155
Capital leases, collateralized by various pieces of equipment with a net book value of \$17 (2008 - \$58), interest varying from 1.3% to 14.0%, with terms varying up to 56 months.		
Interest expense on obligations under capital lease for the year totaled \$3 (2008 - \$3).	27	55
	1,182	1,210
Less: imputed interest charges	392	450
	790	760
Less: current portion	13	14
Long-term portion of obligations under capital lease	\$ 777	\$ 746

Future minimum lease payments for the obligations under capital lease are as follows:

2010	\$	15
2011		9
2012		2
2013		1
2014		-
Thereafter		1,155
Total obligations under capital lease		1,182
Less: amounts representing interest at imputed amounts		392
Carrying value of obligations under capital lease	\$	790

### 12. Customer deposits

The Company has received customer deposits totalling \$134 (2008 - \$4,255) for product shipped with right of return. As at September 30, 2009, the Company has received inventory returns requiring refund of approximately nil (2008 - \$1,391). The Company has authorized additional inventory returns requiring refund of nil (2008 - \$41) to be delivered subsequent to year end. Inventory returns are not considered payable until the products have passed a quality and verification process.

If the risk of return for the remaining product shipped with the right of return is substantially eliminated, the revenue from the product shipment will be recognized and the liability for the customer deposit eliminated. If the product is returned and cash payment has been made, the customer is entitled to a refund of the deposit. There is no certainty on the amount of deposits that will be recognized as revenue or may require refund.

## Notes to the Consolidated Financial Statements *(continued)*

Years Ended September 30, 2009 and 2008. All amounts are in thousands of Canadian dollars, except share data

During the year ended September 30, 2009, the Company entered into agreements with various U.S. customers to eliminate the right of return on remaining product shipped with right of return. This resulted in the Company recognizing revenue for the year ended September 30, 2009 of \$2,359 and cost of goods sold of \$468.

### 13. Deferred revenue

Deferred revenue relates to long-term deposits as at September 30, 2009 totalling \$180 (2008 - \$180). These deposits require a guaranteed volume of inventory to be available to the customer throughout the duration of the agreement. Revenue may be recognized upon depletion of the inventory.

### 14. 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, September 30, 2007	104,101,006	\$ 22,876
Exercise of options	3,622,492	543
Recognition of fair value of options exercised	-	301
Balance, September 30, 2008	107,723,498	23,720
Repurchase of common shares for cancellation	(2,810,580)	(619)
Balance, September 30, 2009	104,912,918	\$ 23,101

On October 14, 2008, the Company received approval from the Toronto Stock Exchange to purchase common shares under a normal course issuer bid ("NCIB"). The Company is entitled to purchase up to 5,386,175 common shares, representing 5% of its then issued and outstanding common shares. The initial NCIB commenced on October 16, 2008 and will terminate on October 15, 2009. Subsequent to the year ended September 30, 2009, the Company renewed the NCIB which will allow the Company to acquire up to an additional 5,245,645 common shares until the renewed NCIB expires on October 15, 2010.

During the year ended September 30, 2009, 2,810,580 common shares were repurchased pursuant to the Company's NCIB at a total cost of \$1,115 or \$0.40 per common share. All common shares repurchased were cancelled prior to September 30, 2009, resulting in a reduction in share capital of \$619 and a reduction in contributed surplus of \$496 representing the consideration in excess of stated capital during the year ended September 30, 2009.

#### (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 shares reserved for issuance under the stock option plan shall not exceed 22,170,442. At September 30, 2009, 8,660,450 (2008 - 4,110,007) common shares remain reserved for issuance under the stock option plan.

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

	2009		2008	
	Number of options outstanding	Weighted average exercise price	Number of options outstanding	Weighted average exercise price
Outstanding, beginning of year	8,585,443	\$ 1.01	10,952,935	\$ 0.89
Exercised	-	-	(3,622,492)	0.15
Granted	1,285,000	0.40	1,910,000	0.62
Expired, cancelled, and forfeited	(5,835,443)	0.93	(655,000)	2.69
Outstanding, end of year	4,035,000	\$ 0.93	8,585,443	\$ 1.01
Exercisable, end of year	1,193,000	\$ 1.56	5,543,443	\$ 0.93

## Notes to the Consolidated Financial Statements *(continued)*

Years Ended September 30, 2009 and 2008. All amounts are in thousands of Canadian dollars, except share data

The following table summarizes information about stock options outstanding and exercisable at September 30, 2009:

Exercise price	Number outstanding	Weighted average remaining term (in years)	Options vested	Options not vested
\$0.40	1,155,000	5.5	-	1,155,000
\$0.48	600,000	4.9	150,000	450,000
\$0.68	1,205,000	4.3	241,000	964,000
\$1.24	520,000	1.8	388,000	132,000
\$1.25	45,000	3.9	18,000	27,000
\$2.62	250,000	0.8	200,000	50,000
\$2.84	200,000	0.4	160,000	40,000
\$3.42	10,000	1.4	6,000	4,000
\$4.04	30,000	1.9	18,000	12,000
\$4.32	20,000	1.2	12,000	8,000
	4,035,000		1,193,000	2,842,000

During the year ended September 30, 2009, \$541 (2008 - \$641) was recognized as stock-based compensation expense related to options with a corresponding increase to contributed surplus.

On January 21, 2009, the Board of Directors approved amendments to the options of certain optionees to remove performance-based vesting provisions. As originally granted, the options were subject to both performance-based vesting provisions and time-based vesting provisions. The performance-based vesting provisions related to the achievement of certain financial milestones by the Company.

The actual weighted average fair value of the options issued during the year ended September 30, 2009 was \$0.22 (2008 - \$0.45) as determined using the Black-Scholes option pricing model. The following weighted average assumptions were utilized to calculate the fair value of \$0.22 per common share (2008 - \$0.45):

	2009	2008
Total options granted	1,285,000	1,910,000
Weighted average exercise price	\$0.40	\$0.62
Risk-free interest rate	1.50%	3.50%
Expected life	3.7 years	4.7 years
Vesting period	4.0 years	4.7 years
Expected annual volatility	77%	89%
Dividend yield	-	-

### (c) Deferred share units

During the year ended September 30, 2009, the Company issued 242,864 DSUs with fair market value of \$104 and recognized stock-based compensation expense of \$157 (2008 - nil), with a corresponding increase to accounts payable and accruals. Also during the year, 110,016 DSUs were redeemed at an average value of \$0.47 per DSU, resulting in a cash payment of \$52 on redemption. All outstanding DSUs are considered vested at the date of grant. As at September 30, 2009, \$105 (2008 - nil) was recorded in accounts payable and accruals related to the outstanding DSUs.

### (d) Restricted share units

During the year ended September 30, 2009, the Company issued 175,000 RSUs with fair market value of \$65 and recognized stock-based compensation expense of \$136 (2008 - nil), with a corresponding increase to other long-term liabilities. As at September 30, 2009, the Company had 175,000 RSUs outstanding, which vest on November 30, 2011.

## Notes to the Consolidated Financial Statements *(continued)*

Years Ended September 30, 2009 and 2008. All amounts are in thousands of Canadian dollars, except share data

### 15. Contributed surplus

During the year ended September 30, changes in the contributed surplus balance are as follows:

	2009	2008
Balance, beginning of year	\$ 8,179	\$ 7,839
Stock-based compensation recognition of fair value of stock options granted to:		
Employees, officers and directors	525	609
Non-employees	16	32
Recognition of fair value of stock options exercised	-	(301)
Consideration in excess of stated capital from the normal course issuer		
Bid (note 14a)	(496)	-
Balance, end of year	\$ 8,224	\$ 8,179

### 16. Earnings per share

The following table sets forth the computation of basic and diluted earnings per share:

	2009	2008
Net earnings	\$ 1,301	\$ 4,592
Weighted average number of common shares outstanding	106,434,436	106,268,024
Dilutive effect of stock options	12,040	1,189,863
Diluted weighted average number of shares outstanding	106,446,476	107,457,887
Earnings per share		
Basic earnings per share	\$ 0.01	\$ 0.04
Diluted earnings per share	0.01	0.04

### 17. Amortization

	2009	2008
Intangible assets (note 9)	\$ 203	\$ 155
Property and equipment (note 10)	1,108	816
	\$ 1,311	\$ 971

### 18. Interest and bank charges

	2009	2008
Interest on long-term debt	\$ 259	\$ 255
Other interest and bank charges	141	504
	\$ 400	\$ 759

### 19. Related party transactions

Until October 2008, the Company had as part of its management team an individual who was also related to the principal owners of a vendor. During the time the related party relationship existed, the Company expensed \$56 (2008 - \$555) as selling, general and administration costs provided by this vendor for the year ended September 30, 2009.

From July 16, 2007 to July 23, 2008, a shareholder, who was also a director, was provided a fee of 0.5% per month related to a \$5,000 personal guarantee that was given to the Company's lender as part of the security position provided under the Company's credit agreement. During the year ended September 30, 2008, the Company expensed in interest and bank charges \$244 related to the fee on this guarantee. The Company's credit agreement was amended on July 23, 2008, whereby the requirement for this personal guarantee was eliminated. No further expenses were recognized during the year ended September 30, 2009.

All transactions with related parties have occurred in the normal course of operations and are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

## Notes to the Consolidated Financial Statements *(continued)*

Years Ended September 30, 2009 and 2008. All amounts are in thousands of Canadian dollars, except share data

### 20. Loss on foreign exchange

	2009	2008
Realized gain on foreign currency transactions	\$ (93)	\$ (146)
Unrealized loss on foreign currency translation of foreign operations	275	642
	<b>\$ 182</b>	<b>\$ 496</b>

The foreign currency translation gains and losses primarily represent net gains or losses on the translation of the net assets and liabilities of the Company's integrated foreign operations.

### 21. Capital disclosures

The Company's objective to manage 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 financing facilities. 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 year.

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 lending agreement. The current ratio is calculated as current assets (as shown on the balance sheet) over current liabilities (as shown on the balance sheet) and is to be maintained above 1.25:1. At September 30, 2009, this ratio has increased to 2.73:1 from the September 30, 2008 ratio of 1.97:1. The increase in this ratio from September 30, 2008 is largely due to a significant decrease in customer deposits and the strategic build up of inventory levels which is offset by a decrease in cash and cash equivalents and short-term investments.

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. This ratio is to be maintained below 2.00:1. At September 30, 2009, this ratio was 0.69:1 (2008 - 1.04:1). The decrease in this ratio is primarily due to the decrease in customer deposits and the adoption of the new inventory standard (note 3) resulting in a decrease to the opening deficit and net earnings for the year ended September 30, 2009.

### 22. Financial instruments

#### Fair value of financial instruments

The fair value of financial instruments represents the amounts that would have been received from or paid to counterparties, calculated at the reporting date, to settle these instruments. Cash and cash equivalents, short-term investment, accounts receivable, and accounts payable and accruals are financial assets and liabilities that have short periods to maturity and the carrying values contained in the consolidated balance sheets approximate their estimated fair value. The fair values of other financial instruments reflect the Company's best estimate based upon estimated interest rates at which the Company believes it could enter into similar instruments at the consolidated balance sheet dates. These estimates approximate the carrying values of the underlying liabilities.

#### Management of risks arising from financial instruments

The Company does not use derivative financial instruments. There has been no change with respect to the Company's overall risk exposure during the year ended September 30, 2009.

#### Market risk

##### (a) Interest rate risk

Bank indebtedness and term mortgage are 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's 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, \$58 for the year ended September 30, 2009 (2008 - \$51). The Company entered into Bankers Acceptance agreements during the year to manage interest rate risk. As at September 30, 2009, no such agreements were in place. 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 a term not to exceed July 31, 2012.

## Notes to the Consolidated Financial Statements *(continued)*

Years Ended September 30, 2009 and 2008. All amounts are in thousands of Canadian dollars, except share data

### (b) Foreign exchange risk

The Company has assets and liabilities that are denominated in foreign currencies and thus are 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 to a 10% increase in the United States dollar, with all other variables held constant, would result in a decrease in the Company's earnings before income taxes of approximately \$3 for the year ended September 30, 2009 (2008 - \$400). The Company does not use derivative financial instruments to reduce its exposure to foreign exchange risk.

### Credit risk

The maximum exposure to credit risk of the Company as at September 30, 2009 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 September 30, 2009, three customers (2008 - four) represented 90% of total accounts receivable (2008 - 73%). Included in accounts receivable is an allowance for doubtful accounts of \$78 (2008 - \$58). At September 30, 2009, two customers made up \$67 or 86% (2008 - two customers made up \$41 or 71%) of the allowance for doubtful accounts.

### 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 controls liquidity risk by management of working capital, cash flows and the availability of borrowing facilities.

## 23. Change in non-cash operating working capital

	2009	2008
Accounts receivable	\$ 1,143	\$ 654
Inventory	(1,310)	(671)
Prepaid expenses and deposits	(512)	154
Accounts payable and accruals	(1,566)	997
Income taxes receivable	358	698
Customer deposits	(4,121)	(6,120)
	<b>\$ (6,008)</b>	<b>\$ (4,288)</b>

## 24. 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's operations are carried on in the following geographic locations:

	2009	2008
Revenue		
Canada	\$ 45,233	\$ 47,291
United States	2,359	2,098
	<b>\$ 47,592</b>	<b>\$ 49,389</b>

Geographic information about the Company's revenue is based on the location of the contracting organization.

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

The Company derives significant revenue from certain customers. During the year ended September 30, 2009, four Canadian customers (2008 - four) accounted for \$35,992 or 76% (2008 - \$34,498 or 70%) of the Company's consolidated revenue.

## Notes to the Consolidated Financial Statements *(continued)*

Years Ended September 30, 2009 and 2008. All amounts are in thousands of Canadian dollars, except share data

### 25. Employee savings plan

The Company and its subsidiaries match voluntary contributions made by employees to their Registered Retirement Savings Plans to a maximum of 3% of earnings for each employee. Contributions made by the Company during the year ended September 30, 2009 were \$227 (2008 - \$179).

### 26. Commitments and Contingencies

#### Commitments

At September 30, 2009, the Company's contractual obligations for the next five years and thereafter are as follows:

	2010	2011	2012	2013	2014	Thereafter	Total
Long-term debt	\$ 706	\$ 681	\$ 4,220	\$ -	\$ -	\$ -	\$ 5,607
Obligations under capital lease	15	9	2	1	-	1,155	1,182
Leased premises	126	181	162	162	162	895	1,688
Other operating lease payments, sponsorships and other	2,406	746	281	-	-	-	3,433
	\$ 3,253	\$ 1,617	\$ 4,665	\$ 163	\$ 162	\$ 2,050	\$ 11,910

The Company has entered into agreements to lease premises in Toronto and Montreal, Canada. These leases expire at various dates up to February 29, 2020. The Company has various operating leases, sponsorship agreements and other commitments made in the normal course of business, including the Company's commitment with the Vancouver Organizing Committee for the 2010 Olympic and Paralympic Winter Games ("VANOC"), for a four-year Official Supplier partnership with VANOC.

#### 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 Alberta. The lawsuits, brought on behalf of shareholders who purchased the Company's common shares between December 11, 2006 and March 23, 2007, allege 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 claim damages of \$110,000. A national law firm, Stikeman Elliott LLP, has been 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. These claims remain unproven and the actions have not received court approval. The agreement in principle provides for the settlement, release and dismissal of all claims asserted against the Company, its former auditor and the individual proposed defendants. The Company's anticipated contribution to the settlement amount is to be funded through its insurance coverage. The agreement in principle remains subject to final settlement documents and receipt of court approval. The settlement does not constitute any admission of liability by the Company or its officers, directors and employees.

On August 6, 2009, the Company announced that it had reached a settlement with the Alberta Securities Commission ("ASC") in respect of an investigation of the Company and certain of its present and former directors and officers. Pursuant to the terms of the settlement agreement, the Company has paid a total of \$740, inclusive of investigation costs, to the ASC in final settlement of the matter for the Company and the directors and officers. This amount has been recorded in selling, general and administration expenses for the year.

At September 30, 2009, the Company was involved in various other legal claims in the normal course of operations. Management has reviewed the claims and believes that it has adequately provided for provisions where required related to these legal claims.

### 27. Cyclical nature of business

Revenue from the Company's lead products is greater in the first, second and fourth quarters of the fiscal year.

## Notes to the Consolidated Financial Statements *(continued)*

48

*Years Ended September 30, 2009 and 2008. All amounts are in thousands of Canadian dollars, except share data*

### **28. Corporate restructuring**

In November 2007, the Board of Directors approved management's proposal to modify the Company's international structure. In 2008, management simplified the corporate structure with the formation of a new foreign company, fx Life Sciences AG, that will result in dissolving fx Life Sciences International GmbH. As a result of the Company's international restructuring, \$1,930 was held in a foreign bank account and was not available for use. These funds became available for use on October 9, 2008. fx Life Sciences International GmbH is inactive as a result of restructuring and will likely be dissolved in the next fiscal year.

### **29. Comparative figures**

The comparative consolidated financial statements have been reclassified from statements previously presented to conform to the presentation of the current year consolidated financial statements.

### **30. Subsequent event**

On October 14, 2009, the Company renewed its normal course issuer bid ("NCIB") with the Toronto Stock Exchange ("TSX"). Under the NCIB, in the next twelve months, the Company may acquire up to 5,245,645 common shares, which is 5% of the total issued and outstanding common shares. All purchases of common shares will be made through the facilities of the TSX at the market price of the shares at the time of acquisition. Daily repurchases by the Company will be limited to a maximum of 19,453 common shares, other than block purchase exceptions, based on an average daily trading volume for the last six calendar months of 77,812 common shares. Any shares acquired by the Company will be cancelled. The NCIB commenced on October 16, 2009 and will terminate on October 15, 2010 or such earlier time as the bid is completed or terminated at the option of the Company.

## Corporate Information

### DIRECTORS

**Jack Moffatt, MBA**  
Chairman and Chief Executive Officer  
Edmonton, Alberta

**J. Douglas Gilpin, CA** <sup>(1)(3)</sup>  
Lead Director  
Edmonton, Alberta

**Maurice "Ted" Bilyea, MA, BA** <sup>(3)</sup>  
Corporate Director  
Toronto, Ontario

**Robert B. Church, PhD, BSc, MSc** <sup>(2)</sup>  
Professor Emeritus,  
Faculty of Medicine,  
University of Calgary  
Calgary, Alberta

**John A. Rogers, FCA** <sup>(1)(2)</sup>  
Corporate Director  
Toronto, Ontario

**David T. Weyant, QC** <sup>(3)</sup>  
Vice President/General Counsel  
Calgary Health Region  
Calgary, Alberta

**William B. White, B.Sc.** <sup>(1)(2)</sup>  
Partner, CBW Associates  
Etobicoke, Ontario

(1) Audit Committee

(2) Governance & Nominating Committee

(3) Human Resources & Compensation Committee

### OFFICERS

**Jack Moffatt, MBA**  
Chairman and Chief Executive Officer

**Jacqueline J. Shan, PhD, DSc**  
Chief Scientific Officer

**Allan Cleiren, CA**  
Chief Financial Officer & Sr. VP Operations

**Lei Ling, PhD**  
Vice President, Product Development

**G. Warren Michaels**  
Vice President, Communications

**Frederick Pittman**  
Vice President, Sales

**Sharla K. Sutherland, PhD**  
Vice President, Regulatory &  
Scientific Affairs

**Steve Wallace**  
Vice President, Marketing

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### BANKERS

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Edmonton, Alberta

### LEGAL COUNSEL

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Edmonton, Alberta

### SHAREHOLDER COMMUNICATIONS/ REGISTRAR AND TRANSFER AGENT

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### STOCK EXCHANGE LISTING

The Toronto Stock Exchange (TSX)  
Trading symbol: FXA

### INVESTOR RELATIONS INFORMATION:

Requests for information should be directed to:  
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& Corporate Secretary  
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E-Mail: [IR@afexa.com](mailto:IR@afexa.com)

### ANNUAL GENERAL AND SPECIAL MEETING OF SHAREHOLDERS

March 18, 2010, 9:30 a.m. MT  
Alberta Research Council  
250 Karl Clarke Road  
Edmonton, Alberta T6N 1E4

Afexa Life Sciences Inc. has established corporate governance policies and procedures which are available for review on the Company's website at [www.afexa.com](http://www.afexa.com) under the heading "Corporate".



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