

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.

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 ¹	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 ¹	3,216	6,156
	As at	As at
	September 30, 2009	September 30, 2008
Working capital ¹	\$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.

¹ 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 ¹	\$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 ¹	15,135	13,742
Long-term debt and obligations under capital lease (including current portion)	6,359	7,021

¹ 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 ¹	\$ 706	\$ 681	\$ 4,220	\$ -	\$ -	\$ -	\$ 5,607
Obligations under capital lease	15	9	2	1	-	1,155	1,182
Leased premises ²	126	181	162	162	162	895	1,688
Other lease payments and sponsorships ³	2,406	746	281	-	-	-	3,433
Total contractual obligations	\$ 3,253	\$ 1,617	\$ 4,665	\$ 163	\$ 162	\$ 2,050	\$ 11,910

¹ 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.

² 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.

³ 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[®] and MEMORY-FX[®] 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, condroitin 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)
EBITDA	\$ 3,922	\$ 1,812	\$ 3,761	\$ 9,007

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)
Cash flow prior to working capital changes	\$ 3,216	\$ 6,156