

Consolidated Financial Statements of  
(Unaudited)

## **AKELA PHARMA INC.**

Periods ended September 30, 2008 and 2007

### **NOTICE TO READER**

The accompanying unaudited interim financial statements of Akela Pharma Inc. for the periods ended September 30, 2008 and 2007 have been prepared by the management and have not been reviewed by the Company's auditor.

# **AKELA PHARMA INC.**

Consolidated Financial Statements  
(Unaudited)

Periods ended September 30, 2008 and 2007  
(in thousands of US dollars)

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## **Financial Statements**

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# AKELA PHARMA INC.

Consolidated Balance Sheets  
(Unaudited)

September 30, 2008 and December 31, 2007  
(in thousands of US dollars)

	September 30, 2008	December 31, 2007
<b>Assets</b>		
Current assets:		
Cash	\$ 4,665	\$ 6,688
Accounts receivable	5,420	4,806
Prepaid expenses	310	462
	<u>10,395</u>	<u>11,956</u>
Restricted cash (note 6)	1,858	600
Property and equipment	5,081	5,220
Intangible assets	12,304	14,170
Goodwill (note 4)	6,457	6,457
Other assets	3,053	738
	<u>\$ 39,148</u>	<u>\$ 39,141</u>

## Liabilities and Shareholders' Equity

Current liabilities:

Accounts payable and accrued liabilities	\$ 7,194	\$ 8,873
Deferred revenue	3,690	2,598
Current portion of long-term debt (note 7)	601	499
	<u>11,485</u>	<u>11,970</u>

Deferred revenue	14,006	10,145
Long-term debt (note 7)	5,637	5,824
Future income taxes	986	1,154

Shareholders' equity:

Common shares (unlimited authorized, 21,615,577 and 11,768,294 common shares issued and outstanding with no par value at September 30, 2008 and December 31, 2007) (note 8)	66,346	54,227
Preference shares (issuable in series, unlimited authorized, zero issued and outstanding) (note 8)	-	-
Warrants (note 10)	2,814	364
Additional paid-in capital	8,012	11,702
Accumulated other comprehensive income	3,110	3,110
Deficit	<u>(73,248)</u>	<u>(59,355)</u>
	<u>(70,138)</u>	<u>(56,245)</u>
Total shareholders' equity	7,034	10,048

Commitments, contingencies and guarantees (note 12)

	<u>\$ 39,148</u>	<u>\$ 39,141</u>
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See accompanying notes to unaudited consolidated financial statements.

# AKELA PHARMA INC.

## Consolidated Statements of Operations and Comprehensive Loss (Unaudited)

Periods ended September 30, 2008 and 2007  
(in thousands of US dollars, except share and per share data)

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2008	2007	2008	2007
Revenues	\$ 4,155	\$ 3,144	\$ 11,247	\$ 7,927
Expenses:				
Direct costs	2,160	1,293	5,598	3,534
Selling, general and administrative	1,679	3,953	5,485	10,491
Research and development	3,175	5,723	8,629	15,361
Stock-based compensation <i>(note 11)</i>	103	331	384	828
Depreciation of property and equipment	497	327	1,405	736
Amortization of intangible assets	736	750	2,160	1,984
Interest on long-term debt	41	43	112	140
Foreign exchange	(352)	(662)	(2)	(1,376)
	8,039	11,758	23,771	31,698
Net loss before income taxes	(3,884)	(8,614)	(12,524)	(23,771)
Recovery of (provision for) income taxes:				
Current	-	(26)	-	(164)
Future	46	42	139	122
	46	16	139	(42)
Net loss and comprehensive loss	\$ (3,838)	\$ (8,598)	\$ (12,385)	\$ (23,813)
Basic and diluted net loss per share	\$ (0.18)	\$ (0.73)	\$ (0.67)	\$ (2.03)
Basic and diluted weighted average number of shares outstanding	21,615,577	11,764,723	18,497,399	11,704,578

See accompanying notes to unaudited consolidated financial statements.

# AKELA PHARMA INC.

## Consolidated Statement of Shareholders' Equity (Unaudited)

Nine-Month period ended September 30, 2008  
(in thousands of US dollars)

	Common Shares		Warrants	Additional Paid-in Capital	Accumulated other comprehensive		Total
	Number	Dollars			income	Deficit	
Balance, December 31, 2007	11,768,294	\$ 54,227	\$ 364	\$ 11,702	\$ 3,110	\$ (59,355)	\$ 10,048
Issuance of units <i>(note 8)</i>	8,625,000	8,045	2,450	-	-	(1,508)	8,987
PharmaForm acquisition - Phase II Share Payment <i>(note 4)</i>	1,222,283	4,074	-	(4,074)	-	-	-
Stock-based compensation <i>(note 11)</i>	-	-	-	384	-	-	384
Net loss	-	-	-	-	-	(12,385)	(12,385)
Balance, September 30, 2008	21,615,577	\$ 66,346	\$ 2,814	\$ 8,012	\$ 3,110	\$ (73,248)	\$ 7,034

See accompanying notes to unaudited consolidated financial statements.

# AKELA PHARMA INC.

## Consolidated Statements of Cash Flows (Unaudited)

Periods ended September 30, 2008 and 2007  
(in thousands of US dollars)

	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
Cash flows from operating activities:				
Net loss	\$ (3,838)	\$ (8,598)	\$ (12,385)	\$ (23,813)
Adjustments for:				
Depreciation of property and equipment	497	327	1,405	736
Amortization of intangible assets	736	750	2,160	1,984
Stock-based compensation <i>(note 11)</i>	103	331	384	828
Unrealized foreign exchange (gain) loss	(162)	-	102	-
Services rendered for shares	-	38	-	90
Future income taxes	(46)	(42)	(139)	(122)
Net changes in operating assets and liabilities <i>(note 13(a))</i>	2,621	12,421	2,711	11,153
	(89)	5,227	(5,762)	(9,144)
Cash flows from financing activities:				
Restricted cash	(1,258)	-	(1,258)	(600)
Repayments of long-term debt	(137)	(67)	(463)	(727)
Proceeds from issuance of units <i>(note 8)</i>	-	-	10,200	-
Unit issue costs <i>(note 8)</i>	-	-	(1,213)	-
	(1,395)	(67)	7,266	(1,327)
Cash flows from investing activities:				
Acquisition of PharmaForm, net of cash <i>(note 4)</i>	-	(16)	-	(8,196)
Acquisition of property and equipment	(1,042)	(1,012)	(3,026)	(1,881)
Addition to intangible assets	(151)	-	(340)	-
	(1,193)	(1,028)	(3,366)	(10,077)
Net increase (decrease) in cash	(2,677)	4,132	(1,862)	(20,548)
Cash, beginning of period	7,569	12,120	6,688	35,304
Effect of exchange rate changes	(227)	(1,193)	(161)	303
Cash, end of period	\$ 4,665	\$ 15,059	\$ 4,665	\$ 15,059

See accompanying notes to unaudited consolidated financial statements.

# AKELA PHARMA INC.

Notes to Consolidated Financial Statements  
(Unaudited)

Periods ended September 30, 2008 and 2007

(in thousands of US dollars, except share and per share data unless otherwise noted)

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## 1. Nature of operations:

The consolidated financial statements of Akela Pharma, Inc., formerly LAB International Inc., (the "Company") have been prepared under Canadian generally accepted accounting principles. These financial statements reflect all adjustments which are, in the opinion of management, necessary to fairly state the results of the interim periods presented. The Company's revenues and expenses are subject to fluctuation. Consequently, the results for any quarter are not necessarily indicative of the results for the full year. The interim consolidated financial statements follow the same accounting policies as described in the Company's latest annual report, except as described in note 2 below. The interim consolidated financial statements do not include all disclosures required for annual financial statements and should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company's latest annual report.

The Company's Board of Directors, as authorized by the shareholders, declared effective October 10, 2007 a 1-for-7 reverse stock split, resulting in every seven shares of common stock being combined into one share of common stock. The reverse stock split affects all of the Company's outstanding stock, stock options and warrants outstanding on the record date. The consolidated financial statements have been retroactively adjusted to reflect the reverse stock split for all periods presented.

The Company is subject to a number of risks, including the successful development and marketing of its technologies. The success of our strategic plan will require additional capital which the Company is actively pursuing. Management believes that if additional financing is not secured in the short term, the Company may have to delay or significantly reduce the scope of its product development programs. PharmaForm, the Company's subsidiary located in Austin, Texas is a profitable provider of contract formulation and drug development services and is financially self sufficient.

## 2. Significant accounting policies and basis of presentation:

### (a) New accounting policies:

Effective with the commencement of its 2008 fiscal year, the Company adopted the Canadian Institute of Chartered Accountants ("CICA") Handbook Section 1535, *Capital Disclosures*, CICA Handbook Section 3862, *Financial Instruments – Disclosure*, and CICA Handbook Section 3863, *Financial Statements - Presentation*. Handbook section 1535 establishes standards for disclosing information about an entity's capital and how it is managed. Sections 3862 and 3863, which replace existing Section 3861, *Financial Instruments – Disclosure and Presentation*, are enhanced and expanded to complement the changes in accounting policy adopted in the prior year in accordance with Section 3855, *Financial Instruments – Recognitions and Measurement*. These new standards, which are effective January 1, 2008 for the Company, relate to disclosure and presentation only and do not impact our financial results.

### (b) Future accounting pronouncements:

In 2007, the CICA issued Section 3064, *Intangibles*, which will replace Section 3062, *Goodwill and Other Intangible Assets*. The standard provides guidance on the recognition of intangible assets in accordance with the definition of an asset and the criteria for asset recognition as well as clarifying the application of the concept of matching revenues and expenses, whether these assets are separately acquired or internally developed. This

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standard applies to interim and annual financial statements relating to fiscal years beginning on or after October 1, 2008. The Company is currently evaluating the effects of adopting this standard.

In 2005 the Accounting Standards Board of Canada (AcSB) announced that accounting standards in Canada are to converge with IFRS. In May 2007, the CICA published an updated version of its "Implementation Plan for Incorporating International Financial Reporting Standards into Canadian GAAP." This plan includes an outline of the key decisions that the CICA will need to make as it implements the Strategic Plan for publicly accountability enterprises that will converge Canadian generally accepted accounting standards with IFRS. While IFRS uses a conceptual framework similar to Canadian GAAP, there are significant differences in accounting policy which must be addressed. The CICA has confirmed the changeover date from current Canadian GAAP to IFRS to be January 1, 2011.

### 3. Development and license agreements:

In June 2007, the Company signed a licensing and development agreement with Janssen Pharmaceutica N.V. ("Janssen"), a Belgium subsidiary of Johnson & Johnson, for its lead product candidate Fentanyl TAIFUN®.

The licensing agreement covers the European Union, Eastern Europe, Russia, the Middle East and Africa. The Company and Janssen will collaborate to develop the product for the initial indication of break-through cancer pain. The Company will manufacture and Janssen will market and distribute the product. Under the terms of the agreement, the Company received a signing fee of \$10,700 (€8,000) which has been deferred and is being recognized rateably over the estimated development period. The Company can receive up to an additional \$77,400 (€55,000) for meeting development, regulatory and commercial sales milestones. The Company could also receive royalty revenues and revenues from the sales of the product to Janssen. In December 2007, the Company extended the territory coverage of the initial license and development agreement to include Canada for a consideration of \$1,100. In May 2008, the original agreement was amended in support of the development effort and to secure timely advancement of the Phase III clinical trials. Under the amended agreement, advanced milestone payments of \$3,500 (€2,500) are payable on the first local regulatory approval of the Phase III protocol and \$2,800 (€2,000) on the first clinical site readiness. An additional milestone of \$3,500 (€2,500) will be due as of the inclusion of the 7th patient in the study. The Company triggered the first two in this series of three milestones in August and September 2008, and management expects the final milestone event to occur before the end of the year.

The Company has entered into licensing and development agreements with SK Chemicals Co. Ltd. in Korea in 2004 and Teikoku Seiyaku Co. Ltd. in Japan in 2005 for the development and registration of Fentanyl TAIFUN® in the South Korean/Chinese (excluding Taiwan and Hong Kong) and Japanese markets, respectively. Under these agreements, the Company received a signing fee and is entitled to development milestone payments and reimbursements for development activities. In addition, the licensees will pay the Company royalties on sales and manufacturing revenues, if any, for supplying the finished product.

### 4. Business acquisition:

On January 25, 2007, the Company completed the acquisition of all of the outstanding membership interests of Formulation Technologies, L.L.C. (doing business as "PharmaForm") a privately held company headquartered in Austin, Texas. The acquisition of PharmaForm added FDA and DEA approved specialized drug formulation and

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manufacturing capabilities and unique patents pending related to abuse deterrent and transmucosal drug delivery systems. The results of PharmaForm are consolidated from the date of acquisition.

The share purchase agreement requires additional share consideration to be issued to the previous owners of PharmaForm if its gross revenues are greater than \$10,000 for the 2007 calendar year. As of December 31, 2007, this milestone had been achieved and additional shares having a value of \$4,074 were issued on March 31, 2008.

In total, the aggregate purchase price including the payment at closing and the Phase II distribution is as follows:

	Cash plus Transaction Costs	Value of Common Shares	Number of Common Shares	Total Value of Consideration
Payment at Closing	\$ 8,620	\$ 4,379	862,791	\$ 12,999
Phase II Distribution	-	4,074	1,222,283	4,074
	\$ 8,620	\$ 8,453	2,085,074	\$ 17,073

Future contingent payments under the purchase agreement include:

- (a) A payment (the Phase I Share Payment) is required to be made on when an IND application dossier is filed with the FDA for the first proprietary non-inhalation product developed by PharmaForm.
- (b) A final payment (the Phase III Share Payment) is required to be made on either (i) the date any proprietary non-inhalation product developed by PharmaForm completes the first Phase III clinical study or for which PharmaForm enters into a binding contractual arrangement with a third party, or (ii) the date of issuance to PharmaForm by the U.S. PTO of a notice that would allow PharmaForm to develop, produce and market an EDACS product candidate.

As of September 30, 2008, the maximum remaining contingent consideration payable by the Company is approximately \$9,000, most of which is payable in common shares of the Company. Any further purchase price consideration paid by the Company will be accounted for as additional goodwill. All obligations to make contingent payments will terminate on January 25, 2012. Each of the Phase I and III contingent payments will be made in common shares in an amount of \$4,400 plus \$100 per Phase, payable either in cash or in common shares at the option of the selling shareholders.

As part of the purchase agreement, the selling shareholders have the right to sell back to the Company the common shares issued in connection with this transaction as well as any common shares issued as part of the contingent consideration in the future, should the Company fail to either have its common shares listed on the Toronto Stock Exchange (TSX), or the NASDAQ Global Market ("NASDAQ") or another US exchange within a reasonable period of time after the closing date of the purchase transaction.

If Phase I or III contingent payments are made, and the Company fails to maintain its listing requirements and the put option is exercised by the holder, the contingent shares would be sold back at a price equal to the average closing price of the common shares on the primary market for the common shares for the ten trading day period ending on the last trading day immediately preceding the triggering event but subject to a minimum price equal to 70% of the closing value at date of acquisition and a maximum of 130% of the closing value at date of acquisition for the Phase I share Payment and 30% and 170% for the Phase III Share Payment.

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The following table summarizes the estimated fair value of the assets acquired and liabilities assumed at the date of acquisition. The purchase price allocation is based upon management's best estimate of the relative fair values of the identifiable assets acquired and liabilities assumed.

Net assets acquired:	
Current assets, including cash of \$424	\$ 2,002
Property and equipment	2,618
Intellectual property rights acquired	3,600
Non-competition agreement	1,400
FDA/DEA certifications	1,000
Customer contracts and relationships	2,000
Goodwill	6,457
Current liabilities	(1,673)
Long-term liabilities	(331)
	<hr/>
	\$ 17,073
Consideration:	
Cash	\$ 7,500
862,791 common shares	4,379
1,222,283 common shares, phase II distribution	4,074
Transaction costs, of which \$828 were incurred prior to December 31, 2006	1,120
	<hr/>
	\$ 17,073

## 5. Restructuring:

In order to streamline its operations, the Company adopted a plan in December 2006 to transfer certain activities from Finland to Austin, Texas by October 31, 2007. In connection with this plan, the Company terminated approximately 35 employees, and recorded a restructuring charge of \$3,858 which included a \$3,523 impairment loss on property and equipment and \$335 for employee severance. At September 30, 2008 and December 31, 2007, nil and \$128, respectively of accrued severance costs remain unpaid and are included in "Accrued liabilities" on the consolidated balance sheet.

On March 5, 2007, the Finnish subsidiary and its landlord agreed to an early termination of their lease agreement. The agreement requires a lump-sum payment of \$2,780 (€1,130) which includes \$1,896 (€1,452) covering the base rent for the period from April 1, 2007 to September 30, 2008, \$306 (€236) for maintenance costs for the period from February 1, 2007 to September 30, 2008 and the repayment of the unsecured long-term debt of \$577 (€442), including related accrued interest of \$50 (€38). The lump-sum payment for rent and maintenance costs less \$557 (€416) representing monthly rent charges for the period from April 1, 2007 to October 31, 2007, the cease-use date, was charged to research and development expense in March 2007.

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## 6. Restricted Cash:

Restricted cash of \$1,858 as of September 30, 2008 consists of a \$600 certificate of deposit pledged as collateral on a \$1,200 term loan repayable in May 2012 (see note 7) and a \$1,258 cash deposit required as security for a 15 year office lease commencing on November 1, 2008 for the Company's new lab facility in Austin, Texas.

## 7. Long-term debt:

	September 30, 2008	December 31, 2007
Capital loans in Euros (2008 - €2,539 ; 2007 - €2,539) from Finnish governmental agency, bearing interest at the basic rate of interest of the Bank of Finland less 1%, with a minimum interest rate of 3%. The term of the loans are eight years with no capital repayments in the first four years; repayments are conditional on specified equity requirements in the Company's Finnish subsidiary, unsecured	3,574	3,702
Capital loans in Euros (2008 - €188; 2007 - €188) bearing interest at 5%; repayments are conditional on specified equity requirements in the Company's Finnish subsidiary, unsecured	265	275
Note payable in Euros (2008 - €494; 2007 - €494) from Finnish governmental agency, bearing interest at the basic rate of interest of the Bank of Finland less 3%, with a minimum interest rate of 1%. The term of the loans are eight years with no capital repayments in the first five years, unsecured	695	721
Note payable, bearing 8.75% interest, repayable in 60 months, secured by a 1 <sup>st</sup> lien on accounts receivable and property and equipment and by \$600 of restricted cash	929	1,084
Capital lease obligations, bearing interest from 6% to 10.11%, secured by related laboratory equipment	751	541
Auto loan, bearing 8.5% interest, secured by the related automobile	24	-
	6,238	6,323
Current portion of long-term debt	601	499
	\$ 5,637	\$ 5,824

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## 8. Capital stock:

(a) Capital stock consists of an unlimited number of preference and common shares with the following forms:

(i) Preference shares

The preference shares may be issued in one or more series, each series to consist of such number of shares as may, before the issue thereof, be fixed by resolution of our board of directors. The directors shall determine before the issue thereof the designations, rights, privileges, restrictions and conditions attaching to the preference shares of each series including the rate or amount of dividends or the method of calculating dividends, the dates of payment thereof, the redemption and/or purchase prices and terms and conditions of redemption and/or purchase, any voting rights, any conversion rights and any sinking fund or other provisions.

The preference shares of each series will, with respect to payment of dividends and the distribution of assets in the event of our liquidation, dissolution or winding up, rank on a parity with the preference shares of every other series and be entitled to preference over our Common Shares and over any other shares ranking junior to the preference shares. The preference shares of any series may also be given such other preferences over our Common Shares and over any other shares ranking junior to the preference shares as may be fixed by our directors.

(ii) Common shares

The holders of Common Shares are entitled: (a) to vote at all meetings of shareholders except meetings at which only holders of a specified class of shares are entitled to vote; (b) to receive dividends as and when declared by our board of directors out of moneys properly applicable thereto subject to the rights of the holders of the preference shares; and (c) to receive our remaining property upon our dissolution, subject to the rights of the holders of the preference shares.

(b) Issuance of capital stock:

On March 27, 2008, the Company concluded a public offering of 8,625,000 units, each unit consisting of one common share and one-half of one common share purchase warrant, for aggregate proceeds of \$10,200 (Cdn \$10,350). Each whole warrant is exercisable to purchase one common share at a price of Cdn \$1.50 per share and expires three years from the closing date subject to the Company's right to accelerate the expiry date of the warrants in certain events. Expenses in connection with the offering were approximately \$1,213 (Cdn \$1,285). As compensation for the offering, the Company also granted the underwriters common share purchase warrants (Compensation Options) bearing a fair value of \$295 (Cdn \$299). Each Compensation Option is exercisable to purchase 603,750 common shares at a price of Cdn \$1.20 per share that expires two years from the closing date. In total, the fair value of the common shares and common share purchase warrants, including the Compensation Options, was \$8,045 (Cdn \$8,164) and \$2,450 (Cdn \$2,486), respectively, using the Black-Scholes pricing model on the date of grant. (See note 10).

On March 31, 2008, the Company issued 1,222,283 shares of common stock to the former owners of PharmaForm as consideration for meeting a gross revenue milestone as of December 31, 2007. This

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\$4,074 Phase II distribution of common shares was recorded as an increase to goodwill. (See note 4 for further discussion).

## 9. Stock option plan:

The Company's stock option plans (the "Plans") are designed to attract, retain and motivate directors, officers, employees and consultants of the Company and to advance the interests of the Company by providing such persons with the opportunity to participate in the long-term growth of the Company. The Plans are administered by the Company's board of directors and, subject to the provisions of the Plan, the number of shares subject to each option, the option price, the expiration date of each option, the extent to which options are exercisable from time to time and the terms and conditions relating to each such option shall be determined by the board of directors. The exercise price of the stock options granted must not be less than the most recent quoted closing market price per share. Options are granted for a term not exceeding ten years. In general, options vest over periods of up to three years.

Under the Company's 2002 Stock Incentive Plan, the aggregate number of common shares available for issuance is 10% of the common shares outstanding. The number of common shares, which may be issued to any one person shall not exceed 5% of the Company's common shares on a non-diluted basis. Effective June 2007, no further options can be granted under the 2002 Stock Option Plan.

In June 2007, the shareholders approved the 2007 Stock Incentive Plan. Under the 2007 Stock Incentive Plan, the aggregate number of common shares available for issuance is 262,357. The maximum number of common shares that may be awarded to any one grantee during any calendar year cannot exceed 71,428. In addition, the number of common shares issuable to insiders, at any time or in any given year, under all security based compensation arrangements, cannot exceed 10% of the issued and outstanding common shares.

The Company may also issue restricted and unrestricted stock awards at a price that may be less than fair market value, subject to restrictions and conditions, if applicable, as the administrator may determine at the time of the grant. No stock awards have been issued by the Company.

Changes in outstanding options issued under the Company's stock option plan for the periods ended September 30, 2008 and December 31, 2007 were as follows:

	Number	Weighted Average Exercise Price (CDN \$'s)
Balance, December 31, 2006	942,809	\$ 7.84
Granted	279,633	6.95
Cancelled	(96,049)	8.66
Balance, December 31, 2007	1,126,393	7.43
Granted	438,000	1.24
Balance, September 30, 2008	1,564,393	\$ 5.69
Options exercisable, September 30, 2008	997,467	\$ 7.47

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The weighted average exercise price and remaining life of outstanding and exercisable options issued under the Company's stock option plan for the period ended September 30, 2008 was as follows:

Range of exercise prices (CDN)	Options outstanding	Weighted average exercise price (CDN)	Options exercisable	Weighted average exercise price (CDN)	Weighted average remaining contractual life (years)
\$10.85 - 10.85	67,137	\$ 10.85	67,137	\$ 10.85	3.90
\$6.86 - 8.47	84,761	\$ 7.67	84,761	\$ 7.67	5.04
\$7.00 - 8.75	264,075	\$ 7.54	262,290	\$ 7.54	5.65
\$6.58 - 7.42	175,096	\$ 6.73	167,000	\$ 6.73	6.75
\$5.81 - 10.99	255,691	\$ 7.33	205,692	\$ 7.31	7.60
\$6.12 - 7.49	279,633	\$ 6.95	200,706	\$ 6.96	8.48
\$1.12 - 1.38	438,000	\$ 1.24	-	\$ -	9.47
\$1.12 - 10.99	1,564,393	\$ 5.69	987,586	\$ 7.47	6.64

## 10. Warrants and broker units:

As of September 30, 2008, the following warrants were outstanding:

Warrants	Fair value at issuance (USD)	Common share equivalents	Exercise price (CDN)	Expiration Date
Number				
1	\$ 364	252,898	\$ 7.83	April 22, 2010
4,312,500	2,155	4,312,500	\$ 1.50	March 28, 2011
603,750	295	603,750	\$ 1.20	March 28, 2010
4,916,251	\$ 2,814	5,169,148		

On March 27, 2008, the Company issued 4,312,500 purchase warrants and 8,625,000 common shares as part of a public offering for aggregate proceeds of \$10,200 (Cdn \$10,350). (See note 8). Each of the 4,312,500 warrants issued as part of the offering is exercisable to purchase one common share at a price of Cdn \$1.50 per share and expires on March 28, 2011 subject to the Company's right to accelerate the expiry date in certain events. As compensation for the offering, the Company also granted the underwriters common share purchase warrants (Compensation Options) bearing a fair value of \$295 (Cdn \$299). Each Compensation Option is exercisable to purchase 603,750 common shares at a price of Cdn \$1.20 per share that expires on March 28, 2010. In total, the fair value of the common shares and common share purchase warrants, including the Compensation Options, was \$8,045 (Cdn \$8,164) and \$2,450 (Cdn \$2,486), respectively, using the Black-Scholes pricing model with the following assumptions on the date of grant.

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	Warrants	Compensation Options
Risk-free interest rate	2.64%	2.57%
Expected volatility	71.03%	73.76%
Expected life in years	3	2
Expected dividend yield	-	-

## 11. Stock-based compensation:

For the nine month period ended September 30, 2008, the Company granted 438,000 (2007 – 272,133) options. The Company recognized total stock-based compensation of \$103 (2007 – \$331).

The weighed average fair value of each option granted is estimated on the date of grant using the Black-Scholes pricing model with the following weighted average assumptions:

	2008	2007
Risk-free interest rate	3.05%	4.15%
Expected volatility	77.11%	65.00%
Expected life in years	6.00	6.00
Expected dividend yield	-	-

The following table summarizes the weighted average grant-date fair value per share for options granted during the periods ended September 30, 2008 and 2007:

	Number of options	Weighted average grant-date fair value (CDN \$'s)
Exercise price per share equal to market price per share at date of grant:		
2008	438,000	0.84
2007	272,133	6.96

Dividend yield was excluded from the calculation since it is the present policy of the Company to retain all earnings to finance operations.

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## 12. Commitments, contingencies and guarantees:

### (a) Commitments:

The aggregate maturities of the contractual obligations are as follows:

	2008	2009	2010	2011	2012+	Total
Operating leases	\$ 679	1,467	989	1,015	12,989	\$ 17,139
Capital leases *	448	852	238	40	-	1,578
Service contracts	1,047	984	843	560	47	3,481
Clinical studies	1,406	23	-	200	-	1,629
Long-term debt *	321	463	322	1,073	3,783	5,962
	<b>\$ 3,901</b>	<b>3,789</b>	<b>2,392</b>	<b>2,888</b>	<b>16,819</b>	<b>\$ 29,789</b>

\* Long-term debt and capital leases include principal and related interest.

The Company is party to license agreements with Auxilium Pharmaceutical, Inc. (“Auxilium”) granting Auxilium an exclusive, worldwide royalty-bearing license to develop, make and sell products that contain oral transmucosal film technology for which there is an issued patent in the United States. The terms of these license agreements are for the life of the licensed patents.

To increase the speed of the development of products using the licensed technology, Auxilium entered into a research and development agreement with PharmaForm, on a fee-for-service basis. Auxilium will be the sole owner of any intellectual property rights developed in connection with this agreement.

The intellectual rights associated with this agreement are based on sublicense agreements with the University of Mississippi and the University of Texas. In the event that the University of Mississippi or the University of Texas license agreements are terminated during the term of the Auxilium agreement, PharmaForm shall pay to Auxilium one-half of all direct expenses and costs Auxilium has incurred relating to the research and development of the compounds, technology, or products pursued under the Agreement which exceed the cumulative gross profit earned by Auxilium on such products, as of the date of the termination of such agreement. With respect to each of the University of Mississippi sublicense agreement, the right to terminate for convenience may only be exercised by all inventors as a group. One of the Company’s board members is an inventor. The University of Texas license agreement may only be terminated for convenience by mutual agreement of the parties thereto. As of September 30, 2008, the minimum amount of this contingency is \$2.1 million, representing one-half of amounts received by the Company from Auxilium, and is subject to upward adjustment for any additional amounts incurred by Auxilium on this project. The Company has not recorded a liability with respect to this guarantee as the Company does not expect to make any payments for this item and the standby liability is nominal.

The Company is party to a royalty bearing license for a drug delivery system in which it is required to pay 75% of any sublicense fees received by the Company to the licensors. The Company’s sublicense to Auxilium is subject to these agreements.

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*(b) Contingencies:*

The Company's Finnish subsidiary received certain low interest loans and grants from a Finnish governmental agency. In the summer of 2007, following the Company's decision to down-size its Finnish operations, it was notified that this agency was reviewing loans previously made totalling €3,150 and €56, respectively. The agency has concluded that the loans would not be collected prematurely at this time but has made a demand for repayment of the grants, together with interest. The loans received from the Finnish governmental agency continue to be reflected as long-term debt in the financial statements in accordance with the original agreements.

In February 2007, the Company initiated an Opposition proceeding before the European Patent Office to challenge a European patent granted to an unrelated third party. The Company initiated the Opposition proceeding in order to challenge this granted patent in view of certain prior art references not previously considered by the European Patent Office during the procurement process. An Opposition is an administrative inter partes proceeding, the outcome of which is appealable. Based on the advice and analysis of the Company's European Patent Attorney, management reasonably believes that the outcome of this Opposition proceeding will be favorable to the Company and the granted European patent may be withdrawn in its entirety.

The Company is the defendant in an action filed in the District Court of Travis County, Texas by a former executive. The action claims actual and compensatory damages in an unspecified amount, costs and other relief in connection with the termination of employment in October 2007. The Company does not expect the resolution of this matter will have a material effect on the Company's consolidated financial statements.

*(c) Guarantees:*

The Company has entered into a number of standard indemnification agreements in the ordinary course of its business. Pursuant to these agreements, the Company indemnifies, holds harmless, and agrees to reimburse the indemnified party for losses suffered or incurred by the indemnified party, who are generally the Company's business partners or customers. The Company agrees to indemnify for claims, demands or judgments that arise out of negligence or misconduct of the Company, or act of alleged infringement of intellectual property by any third-party with respect to the Company's activities under the agreement. At September 30, 2008 and December 31, 2007, the Company has not recorded a liability with respect to these guarantees as the Company is not aware of any such claim and does not expect to make any payments for the aforementioned items and the standby liability is nominal.

**13. Supplemental cash flow disclosure and other information:**

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(a) Net changes in operating assets and liabilities:

	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
Accounts receivable	\$ (3,811)	\$ 10,921	\$ (626)	\$ 71
Prepaid expenses and other assets	(38)	(1,441)	137	(3,616)
Accounts payable and accrued liabilities	382	4,547	(1,809)	4,565
Deferred revenue	6,032	(1,606)	4,953	10,133
	2,565	12,421	2,655	11,153

(b) Cash paid for:

	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
Income taxes	\$ -	\$ -	\$ -	\$ 411
Interest	48	196	123	497

(c) Non-cash transactions:

	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
Issuance of additional common shares in connection with the acquisition of PharmaForm	\$ -	\$ -	\$ -	\$ 4,379
Services rendered in exchange for shares	-	38	-	90
Property and equipment financed through capital leases	299	364	544	364
Issuance of warrants to underwriters as compensation for March 27, 2008 public offering (note 7(b))	-	-	295	-

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## 14. Financial instruments:

### (a) Classification:

The classification of financial instruments under the new accounting standards as of September 30, 2008 and December 31, 2007 and their respective carrying values and fair values are as follows:

<b>September 30, 2008</b>	<b>Available- for-sale</b>	<b>Loans and receivables</b>	<b>Other financial liabilities</b>	<b>Carrying value</b>	<b>Fair value</b>
Cash	\$ 4,665			\$ 4,665	\$ 4,665
Accounts receivable		5,432		5,432	5,432
Restricted cash		1,858		1,858	1,858
Accounts payable and accrued liabilities			7,194	7,194	7,194
Long-term debt			6,238	6,238	6,238

<b>December 31, 2007</b>	<b>Available- for-sale</b>	<b>Loans and receivables</b>	<b>Other financial liabilities</b>	<b>Carrying value</b>	<b>Fair value</b>
Cash	\$ 6,688			\$ 6,688	\$ 6,688
Accounts receivable		4,806		4,806	4,806
Restricted cash		600		600	600
Accounts payable and accrued liabilities			8,873	8,873	8,873
Long-term debt			6,323	6,323	6,323

### (b) Fair value:

Fair value is the amount of consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act. In the absence of quoted prices in active markets, considerable judgment is required in estimating fair value. Estimates are not necessarily indicative of the amounts the Company could realize in a current market transaction. The following methods and assumptions were used to estimate fair values:

#### (i) Available-for-sale

Cash – Cash is classified as “available-for-sale” due to its short-term nature and the fact that it must be readily available to finance the Company's operations. The carrying value is therefore considered a reasonable approximation fair value.

#### (ii) Loans and receivables

Accounts receivable and restricted cash – Due to their short-term nature, the carrying values of accounts receivable and restricted cash is considered a reasonable approximation of fair value.

#### (iii) Other financial liabilities

Accounts payable, accrued liabilities and long-term debt – Accounts payable and accrued liabilities are measured at amortized cost which approximates fair value due to their short-term nature. Long-

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term debt is also measured at amortized cost with interest recognized in net income using the effective interest method. Based on rates currently available to the Company for debt with similar terms and remaining maturities, the carrying value of long-term debt is currently considered a reasonable approximation of fair value.

As of September 30, 2008 and December 31, 2007, the carrying amount of financial assets that the Company has pledged as collateral for long-term debt facilities was approximately \$8 million and \$8.8 million, respectively.

## 15. Financial risk management:

The following is a discussion of the Company's exposure to and management of risks arising from financial instruments, including credit risk, foreign currency risk, interest rate risk, and liquidity risk.

### (a) Credit risk:

Credit risk results from the possibility that a loss may occur from the failure of another party to perform according to the terms of the contract. Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of cash, restricted cash and accounts receivable. Cash and restricted cash are maintained with a high credit quality financial institution. For accounts receivable, the Company performs periodic credit evaluations and typically does not require collateral. Provisions are recognized, if necessary, in order to reflect risks related to bad debts. During the reporting period and for the three months ended September 30, 2008, a \$0.1 million provision was recorded as a result of this evaluation. The carrying amount of cash, restricted cash and trade accounts receivable represents the Company's maximum credit exposure.

For the three and nine months ended September 30, 2008, the Company's three largest customers accounted for approximately 28% and 25% of revenues, respectively. One of these customers accounts for approximately 52% of accounts receivable at September 30, 2008.

The following table sets forth details of the age of receivables:

<b>Consolidated</b>	
	As of September 30, 2008
Total accounts receivable	\$ 5,432
Of which:	
Not overdue	4,726
Past due for more than one day but for not more than three months	592
Past due more for than three months but for not more than six months	114
<b>Total accounts receivable, net</b>	<b>\$ 5,432</b>

### (b) Foreign currency risk:

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The functional currency of the Company and its subsidiaries is the US dollar. Foreign currency risk is limited to the portion of the Company's business transactions denominated in currencies other than US dollars and by the translation of assets and liabilities denominated in currencies other than the US dollar at each balance sheet date. Revenues are primarily received in US dollars and other currencies while a portion of expenses are paid in other currencies, primarily the Canadian dollar and the Euro. The Company's consolidated profitability could therefore be affected by the Canadian and Euro/US dollar exchange rate and other exchange rates relative to the US dollar, which exchange rates may fluctuate over time and cannot be accurately predicted. From time to time, the Company engages in the use of derivative financial instruments to manage its currency exposure. At September 30, 2008 and December 31, 2007, the Company had not entered into any derivative financial instruments.

The following is a breakdown of financial instruments by foreign currency as of September 30, 2008:

(in thousands of US dollars)	September 30, 2008				
	\$Cdn	Euro	\$Bds	INR	Total
Cash	\$ 430	\$ 3,640	\$ 29	\$ 149	4,248
Accounts receivable	81	2,975	2	-	3,058
Accounts payable and accrued liabilities	426	983	118	17	1,544
Long-term debt	-	5,072	-	24	5,096
	\$ 937	\$ 12,670	\$ 149	\$ 190	\$ 13,946

The following exchange rates applied during the reporting period and for the three and nine months ended September 30, 2008:

Currency	Exchange	Average		Closing
		Three months ended September 30, 2008	Nine months ended September 30, 2008	Nine months ended September 30, 2008
Canadian dollar	US/Cdn	0.9603	0.9821	0.9397
Euro	US/Euro	1.5004	1.5209	1.4076
Barbadian	US/Bds	0.5076	0.5076	0.4952
Indian Rupee	US/INR	0.0229	0.0240	0.0214

(c) *Interest rate risk:*

The Company's exposure to interest rate risk primarily arises from a loan in Euros from the Finnish governmental body, which bears interest at floating rates. As of September 30, 2008, \$0.7 million of the Company's total debt portfolio was subject to movement in floating interest rates. A +/-1% change in interest rates would, everything else being equal, have an effect on the loss from continuing operations before income taxes for the three and nine months ended September 30, 2008 of approximately +/- \$2 and +/- \$5, respectively.

(d) *Liquidity risk:*

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Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due. The Company manages its liquidity risk by continuously monitoring forecasts and actual cash flows and through regular distribution of this information to the Board of Directors and the Audit Committee.

The following are the contractual maturities of financial liabilities as of September 30, 2008:

	Carrying Amount	Less than 1 year	1 to 3 years
Accounts Payable and accrued liabilities	\$ 7,194	7,194	-
Operating leases	17,139	679	2,456
Capital leases *	1,578	448	1,130
Service contracts	3,481	1,047	2,387
Clinical studies	1,629	1,406	23
Long-term debt *	5,962	321	1,858
	<b>\$ 36,983</b>	<b>11,095</b>	<b>7,854</b>

\* Long-term debt and capital leases include principal and related interest.

## 16. Capital Management

The Company's objectives when managing capital are:

- To preserve our primary goal of becoming an integrated product development company with a diversified product portfolio,
- To maintain a flexible capital structure which optimizes the cost of capital at acceptable risk,
- To sustain our ability to continue as a going concern in order to provide returns for shareholders.

In the management of capital, the Company includes cash, long-term debt and shareholders' equity (excluding comprehensive income) in the definition of capital.

In order to ensure the availability of sufficient capital to support clinical trials and product development, the Company's original licensing and development agreement with Janssen Pharmaceutica NV for Fentanyl TAIFUN® was amended in May 2008 to secure advanced milestones of \$3,500 (€2,500) on the first local regulatory approval of the Phase III protocol and \$2,800 (€2,000) on clinical site readiness. Under the licensing agreement an additional milestone of \$3,500 (€2,500) will be due as of the inclusion of the 7th patient in the study. The Company triggered the first two in this series of three milestones in August and September 2008, and management expects the final milestone event to occur before the end of the year. (See note 3 for further discussion). To ensure the availability of current capital resources in the coming twelve months, the Company may also attempt to issue new equity securities, issue new debt or pursue various other funding alternatives. Management believes that if additional financing is not secured in the short term, the Company may have to delay or significantly reduce the scope of its product development programs. PharmaForm, the Company's subsidiary located in Austin, Texas is a profitable provider of contract formulation and drug development services and is financially self sufficient.

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As of December 31, 2008, the Company must be in compliance with the following externally imposed capital requirements associated with a \$1,200 term loan repayable in May 2012. These ratios will be measured in 2009 based on the December 31, 2008 financial statements of the Company's PharmaForm operations.

- Current Ratio for the U.S. subsidiaries as of the end of each fiscal year not less than 2 to 1.0, with "Current Ratio" defined as current assets divided by Current Liabilities.
- Debt Coverage Ratio for the U.S. subsidiaries as of the end of each year not less than 1.25 to 1.0, with "Debt Coverage Ratio" defined as the ratio of Cash Flow to the sum of Current Maturities of Long Debt plus interest expense.

The Company monitors these requirements on a monthly basis.

## 17. Related party transactions:

The Company incurred legal and consulting fees totalling \$46 and \$61 during the three months ended September 30, 2008 and 2007 and fees of \$146 and \$344 during the nine months ended September 30, 2008 and 2007 for professional services provided by two firms associated with the Board of Directors.

During the three months ended September 30, 2008 and 2007, the Company also incurred nil and \$54 in expenses for IT consulting services provided by a firm owned by the Company's former Chief Executive Officer (CEO). During the nine months ended September 30, 2008 and 2007, the Company incurred total fees of \$71 and \$166 in expenses for these services.

The Company incurred additional expense of \$66 and \$106 during the three months ended September 30, 2008 and 2007 and fees of \$254 and \$312 during the nine months ended September 30, 2008 and 2007 for management services provided by PRI International Consulting Inc., a company directly controlled by the Company's former CEO.

During the three and nine months ended September 30, 2007, the Company incurred interest expense of \$20 and \$64 on long-term debt payable to non-controlling shareholders. In March 2007 the Company repaid \$500 of this debt. As a tenant under a facilities lease held by one of these non-controlling shareholders, the Company also incurred rent expense of \$242 and \$1,845 during the three and nine months ended September 30, 2007.

During the three and nine months ended September 30, 2008 and 2007, the Company incurred expenses totalling \$155 and \$479 and \$190 and \$539 for consulting services paid to three current shareholders and the former principal owners of PharmaForm. One of these shareholders is also a member of the Board of Directors.

These transactions are measured at the exchange amount of consideration established and agreed to by the related parties.

## 18. Comparative figures:

Certain of the comparative figures have been reclassified to conform to the presentation adopted in the current year.