

Consolidated Financial Statements of
(Unaudited)

AKELA PHARMA INC.

Periods ended March 31, 2010 and 2009

NOTICE TO READER

The accompanying unaudited interim financial statements of Akela Pharma Inc. for the three month periods ended March 31, 2010 and 2009 have been prepared by the management and have not been reviewed by the Company's auditor.

AKELA PHARMA INC.

Consolidated Financial Statements
(Unaudited)

Three month periods ended March 31, 2010 and 2009
(in thousands of US dollars)

Financial Statements

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AKELA PHARMA INC.

Consolidated Balance Sheets
(Unaudited)

March 31, 2010 and December 31, 2009
(in thousands of US dollars)

Going Concern Uncertainty (note 1)

	March 31, 2010	December 31, 2009
Assets		
Current assets:		
Cash (note 1)	\$ 160	\$ 107
Restricted cash (note 6)	705	938
Accounts receivable	1,104	1,679
Prepaid expenses and other current assets	393	417
	<u>2,362</u>	<u>3,141</u>
Property and equipment	3,860	4,217
Other assets	618	598
	<u>\$ 6,840</u>	<u>\$ 7,956</u>
Liabilities and Shareholders' Deficiency		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 7,509	\$ 7,801
Deferred revenue	2,954	2,795
Current portion of long-term debt (note 7)	1,801	1,015
	<u>12,264</u>	<u>11,611</u>
Deferred revenue	13,994	14,630
Long-term debt (note 7)	5,886	6,615
Income taxes	827	799
Shareholders' deficiency:		
Common shares (unlimited authorized, 30,890,338 common shares issued and outstanding with no par value at March 31, 2010 and December 31, 2009)	67,544	67,544
Warrants (note 9)	2,651	2,954
Additional paid-in capital	8,821	8,511
Accumulated other comprehensive income	3,110	3,110
Deficit	(108,257)	(107,818)
	<u>(26,131)</u>	<u>(25,699)</u>
Commitments, contingencies and guarantees (note 11)		
	<u>\$ 6,840</u>	<u>\$ 7,956</u>

See accompanying notes to unaudited consolidated financial statements.

AKELA PHARMA INC.

Consolidated Statements of Operations and Comprehensive Loss
(Unaudited)

Three month periods ended March 31, 2010 and 2009
(in thousands of US dollars, except share and per share data)

Going Concern Uncertainty (note1)

	Three months ended	
	March 31,	
	2010	2009
Revenues	\$ 2,601	\$ 3,770
Expenses:		
Direct costs	1,444	2,068
Selling, general and administrative	1,403	1,434
Research and development	129	1,389
Restructuring costs (note 5)	-	676
Stock-based compensation (note 10)	7	77
Depreciation of property and equipment	357	372
Amortization of intangible assets	-	423
Interest on long-term debt	63	37
Unrealized loss on securities held for trading (note 3)	29	87
Foreign exchange gain	(392)	(40)
	3,040	6,523
Loss before under noted items	(439)	(2,753)
Other income (expense):		
Settlement with LRI (note 3)	-	1,664
Provision for repayment of government grants (note 4)	-	(1,544)
	-	120
Net loss and comprehensive loss	\$ (439)	\$ (2,633)
Basic and diluted net loss per share	\$ (0.01)	\$ (0.12)
Basic and diluted weighted average number of shares outstanding	30,890,338	21,615,577

See accompanying notes to unaudited consolidated financial statements.

AKELA PHARMA INC.

Consolidated Statement of Shareholders' Deficiency (Unaudited)

Three month period ended March 31, 2010
(in thousands of US dollars)

Going Concern Uncertainty (note 1)

	Common Shares		Warrants	Additional Paid-in Capital	Accumulated other comprehensive		Total
	Number	Dollars			income	Deficit	
Balance, December 31, 2009	30,890,338	\$ 67,544	\$ 2,954	\$ 8,511	\$ 3,110	\$ (107,818)	(25,699)
Stock-based compensation (note 10)	-	-	-	7	-	-	7
Expiration of warrants (note 9)	-	-	(303)	303	-	-	-
Net loss	-	-	-	-	-	(439)	(439)
Balance, March 31, 2010	30,890,338	\$ 67,544	\$ 2,651	\$ 8,821	\$ 3,110	\$ (108,257)	(26,131)

See accompanying notes to unaudited consolidated financial statements.

AKELA PHARMA INC.

Consolidated Statements of Cash Flows (Unaudited)

Three months ended March 31, 2010 and 2009
(in thousands of US dollars)

Going Concern Uncertainty (note 1)

	Three months ended March 31,	
	2010	2009
Cash flows from operating activities:		
Net loss	\$ (439)	\$ (2,633)
Adjustments for:		
Depreciation of property and equipment	357	372
Amortization of intangible assets	-	423
Provision for repayment of government grants (note 4)	-	1,544
Resstructuring charges (note 5)	-	571
Stock-based compensation (note 10)	7	77
Unrealized foreign exchange gain	(392)	(43)
Unrealized loss on securities held for trading (note 3)	30	87
Net changes in operating assets and liabilities (note 12 (a))	(129)	1,300
	(566)	1,698
Cash flows from financing activities:		
Repayments of long-term debt	(94)	(162)
Proceeds from issuance of long-term debt	500	-
	406	(162)
Cash flows from investing activities:		
Acquisition of property and equipment	(20)	(792)
Restricted cash (note 6)	233	-
	213	(792)
Net increase in cash	53	744
Cash, beginning of period	107	2,345
Cash, end of period (note 1)	\$ 160	\$ 3,089

See accompanying notes to unaudited consolidated financial statements.

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Notes to Consolidated Financial Statements
(Unaudited)

Periods ended March 31, 2010 and 2009

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

1. Nature of operations

Akela Pharma, Inc. (“Akela” or “the Company”) is an integrated drug development company focused on developing therapies for the growing multi-billion dollar inhalation and pain markets. In addition to our own product portfolio, we provide research and development services including specialty drug manufacturing, product development, quality control testing, analytical method development and patent litigation support.

Akela’s unaudited interim consolidated financial statements have been prepared by the Company in accordance with Canadian generally accepted accounting principles (“GAAP”) and follow the same accounting policies and methods of their application as the most recent annual consolidated financial statements except as described in note 2. In the opinion of Management, all adjustments necessary for a fair presentation are reflected in the interim financial statements. Such adjustments are of a normal and recurring nature. The results of operations for the interim periods are not necessarily indicative of the operating results for the full year. The interim financial statements do not include all of the disclosures required by GAAP applicable to annual financial statements and should be read in conjunction with the annual consolidated financial statements and notes thereto included in the Company’s annual report for the year ended December 31, 2009.

The accompanying financial statements have been prepared on a going concern basis which contemplates that Akela will continue in operation for the foreseeable future and will be able to realize its assets and discharge its liabilities in the normal course of business. The Company has and continues to incur significant net losses. The Company has funded such losses with external debt, share issuances, exclusive licensing and development agreements, government grants and working capital. As of March 31, 2010, the Company has a cash balance of \$160, net current liabilities of \$9,901 and a shareholders’ deficit of \$26,131.

An acute shortage of investor capital available for pharmaceutical development has adversely impacted the ability of the Company to obtain financing as well as the financial stability of its customer base, the credit quality of its receivables and the certainty of its revenue projections. Moreover, Akela will continue to encounter difficulty in raising additional financing from either new or existing investors until the Company significantly reduces its outstanding debt. The Company could and may also receive claims from creditors, as a number of Akela’s liability obligations are in default as at date of this report (see notes 7 and 11). As such, the realization of assets and discharge of liabilities in the ordinary course of business are subject to significant uncertainty.

These financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts, the amount and classification of liabilities and the reported revenue and expenses that would be necessary should the Company be unable to continue as a going concern.

Akela’s ability to continue as a going concern is dependent upon, amongst other things, the successful development and marketing of its technologies, securing financing for its drug development program, the continued support and cooperation of shareholders, lenders, suppliers and the achievement of profitable operations. These endeavours are dependent on a number of circumstances outside the Company’s control, especially as it relates to financing for small biotech and specialty pharmaceutical companies. Management’s actions and plans with respect to addressing the going concern uncertainty include the following:

- a) The Company, in 2010, began negotiating the sale of its contract service operations, PharmaForm. Proceeds from this disposition will be dedicated to the reduction of the Company’s outstanding liabilities. Savings resulting from the

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- reduction of overhead associated with the sale, combined with cost restructuring initiatives undertaken during 2009, will be dedicated to the continuance of operations. Any remaining funds will be utilized in the further advancement of Fentanyl TAIFUN®.
- b) During January, May and June of 2010, in order to facilitate the continuance of operations until additional sources of cash are realized, certain shareholders agreed to extend a \$2,750 fully secured line of credit, bearing interest at 15%
 - c) The Company has and is continuing to implement plans to reduce operational costs. In order to ensure the availability of current capital resources, the Company will attempt to issue new equity securities, issue new debt or pursue various other funding alternatives (see note 15).

Management believes that the above actions, together with the continued support and cooperation of shareholders, lenders and suppliers, the securing of additional milestone payments and other financing, and the successful sale of PharmaForm, will enable Akela to continue as a going concern. There can, however, be no assurance that the actions taken to date will result in sufficient funds being generated to enable the Company to continue as a going concern for the next twelve months. The financing environment within which the Company operates remains very challenging. Until such time as Akela's research and development efforts are commercialized or fully funded by third parties, for which no assurance can be given, the Company will continue to incur significant operating losses. Should the Company be unsuccessful in raising additional financing, it may have no choice but to seek protection from its creditors.

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2. Significant accounting policies and basis of presentation

a) New accounting policies:

- i) *International Financial Reporting Standards*: The Accounting Standards Board of Canada (“AcSB”) will converge Canadian GAAP for publicly accountable enterprises with International Financial Reporting Standards (“IFRS”) over a transition period that will end effective January 1, 2011 for publicly accountable profit oriented enterprises. The changeover date is for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. IFRS uses a conceptual framework similar to Canadian generally accepted accounting principles, but there are significant differences in recognition, measurement and disclosure requirements. The Company will implement this standard in its first quarter of fiscal year ending December 31, 2011. The Company has not yet developed an IFRS transition plan in preparation for the changeover to IFRS.
- ii) Section 1582, *Business Combinations*: This new Section will be applicable to business combinations for which the acquisition date is on or after the Company’s interim and fiscal year beginning January 1, 2011. Early adoption is permitted. The section improves the relevance, reliability and comparability of the information that a reporting entity provides in its financial statements about a business combination and its effects. The Company has not yet determined the impact of the adoption of this new Section on its consolidated financial statements.
- iii) Section 1601, *Consolidated Financial Statements*: This new Section will be applicable to financial statements related to the Company’s interim and fiscal year beginning on or after January 1, 2011. Early adoption is permitted. This section establishes standards for the preparation of the consolidated financial statements. The Company has not yet determined the impact of the adoption of this new Section on its consolidated financial statements.
- iv) Section 1602, *Non-controlling interest*: This new Section will be applicable to financial statements related to the Company’s interim and fiscal year beginning on or after January 1, 2011. Early adoption is permitted. This section establishes standards for accounting for a non-controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. The Company has not yet determined the impact of the adoption of this new Section on its consolidated financial statements.
- v) In December 2009, the EIC of the Accounting Standards Board issued EIC-175, *Multiple Deliverable Revenue Arrangements*, which addresses certain aspects of accounting by a vendor for arrangements under which it will perform multiple revenue-generating activities, amending the previous guidance under EIC-142, *Revenue Arrangements with Multiple Deliverables*. The amendments require a vendor to allocate arrangement consideration at the inception of an arrangement to all deliverables using the relative selling price method, thus prohibiting the use of the residual method. EIC-175 also changes the level of evidence of the standalone selling price required to separate deliverables when more objective evidence of the selling price is not available. EIC-175 may be applied prospectively and must be applied to revenue arrangements with multiple deliverables entered into or materially modified in the first annual fiscal period beginning on or after January 1, 2011. Early adoption is permitted. The Company is currently evaluating the impact and effective date of EIC-175.

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3. Settlement with LRI

On March 10, 2009, the Company agreed to accept a payment of \$2,000 Cdn (\$1,563 US) and 500,000 common share purchase warrants with an exercise price of \$0.50 Cdn (\$0.39 US) from LAB Research Inc. (LRI) as full and final settlement of its lawsuit relating to a failed Fentanyl TAIFUN® toxicology study. The fair value of the warrants together with the cash proceeds received as part of this settlement resulted in a gain of \$1,664.

The fair value of the warrants as of March 10, 2009, \$130 Cdn (\$101 US), was determined using the Black-Scholes pricing model and the following assumptions:

	Warrants
Risk-free interest rate	0.98%
Expected volatility	103.85%
Expected life in years	1.8
Expected dividend yield	-

A decline in the fair value of the warrants subsequent to the settlement resulted in an unrealized losses of \$29 and \$87 on securities held for trading for the three months ended March 31, 2010 and 2009, respectively.

The fair value of the warrants as of March 31, 2010, \$49, has been included in prepaid and other current assets and was determined using the following Black-Scholes pricing model assumptions:

	Warrants
Risk-free interest rate	0.96%
Expected volatility	75.25%
Expected life in years	0.75
Expected dividend yield	-

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4. Provision for repayment of government grants

In 2004 and 2005, the Company's Finnish subsidiary entered into certain funding arrangements with Tekes, the Finnish Funding Agency for Technology and Innovation. These arrangements provided for funding grants and loans, payable to the Company in instalments, with respect to inhalation technology development. Following the Company's decision to down-size its Finnish operations in the summer of 2007, the Company was notified that this agency was reviewing loans and subsidies previously granted totaling €3,150 and €56, respectively. The agency concluded that the loans would not be collected prematurely but made a demand for repayment of the grants, together with interest. In April 2009 the Company's appeal against this decision was rejected by the Administrative Court of Turku, which concluded that Tekes had the right, by virtue of its lawful discretion, to order repayment of financing received through the grants. As a result, a charge of \$1,544, the US dollar equivalent of the grants received \$1,269 (€56), together with interest from July 2007 through March 31, 2009. On June 30, 2009 Akela announced that it had reached an agreement with Tekes to settle their demand for immediate repayment of the grants. According to the terms of the agreement, Akela will pay back the grants received plus interest, in equal quarterly instalments, during a period of four years, starting in September 2010 with the last payment to occur in September 2014. As a result of this settlement, the Company's \$1,544 provision associated with Tekes' claim has been classified as long-term debt (see note 7). Upon the advice of legal counsel, the Company's estimated obligation, \$1,728 (€1,278), has been calculated as the principle amount of the original grants, €56, together with interest payable at rate of 11.5% from July 1, 2007 through December 31, 2008 and at a rate of 9.5% from January 1, 2009 thereafter. The Company continues to accrue interest on the Tekes' claim at a provisional rate of 9.5% until a formal amortization schedule is received.

5. Restructuring costs

In February 2009, the Company undertook measures to cut costs in order to preserve cash for its continued operations. In connection with the cost reduction plan, the Company terminated approximately 40 employees and recorded a restructuring charge of \$676, which included a \$136 impairment loss on property and equipment, \$105 for employee severance, \$356 in costs associated with the development of commercial TAIFUN® injection moulds and \$79 in charges resulting from the termination of the Company's license agreement to CGRP, a former non-pain product candidate. At March 31, 2010 and December 31, 2009, \$249 of accrued restructuring charges remained unpaid and is included in "Accounts payable and accrued liabilities" on the consolidated balance sheets.

6. Restricted cash:

Restricted cash as of March 31, 2010 consists of a \$705 cash deposit required as security for a 15 year office lease commencing on November 1, 2008 for a site which had been planned for a new laboratory facility in Austin, Texas. On April 2, 2010 Akela surrendered this cash to the landlord, HEP Davis Spring, L.P. (HEP Davis Spring), as part of an agreement to terminate this lease. During 2010, \$233 of the amounts on deposit as security for the HEP Davis Spring lease was drawn to satisfy current lease payments.

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7. Long-term debt

	March 31, 2010	December 31, 2009
Repayment of grants by the Company's Finnish subsidiary in Euros (€1,190) bearing a current estimated provisional interest of 9.5%. According to the terms of the Company's settlement agreement with the lender, Akela will pay back the grants received plus interest, in equal quarterly installments during a period of four years, starting in September 2010 with the last payment to occur in September 2014. (See note 4).	\$ 1,728	\$ 1,786
Capital loans of the Company's Finnish subsidiary in Euros (2009 - €2,539 ; 2008 - €2,539) 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 to February 2013 with no capital repayments in the first five years; interest or other remuneration are conditional on specified equity requirements in the Company's Finnish subsidiary. For the three months ended March 31, 2010 and 2009 no interest was payable on this unsecured debt.	3,433	3,632
Capital loans of the Company's Finnish subsidiary in Euros (2009 - €188; 2008 - €188) bearing interest at 5%; interest or other remuneration are conditional on specified equity requirements in the Company's Finnish subsidiary. For the three months ended March 31, 2010 and 2009 no interest was payable on this unsecured debt.	255	270
Note payable of the Company's Finnish subsidiary in Euros (2009 - €464; 2008 - €494) 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 loan is eight years to December 2013. The Company agreed to repay \$210 (€147) of the loan balance during the third quarter of 2009 with capital repayments beginning in 2011. During the fourth quarter of 2009, the Company failed to fulfill its commitment to repay the \$210 (€147) loan balance of this note. At March 31, 2010, the effective interest rate on this unsecured debt was 1.75%.	628	664
Balance carried forward	6,044	6,352

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	2009	2009
Balance brought forward	6,044	6,352
Line of credit, bearing 15% interest, repayable in July 2010, secured by a 1 st lien on accounts receivable of Akela's subsidiary, PharmaForm.	500	-
Present value of \$1,200 payable in monthly installments of \$10 through March 2020 pursuant to lease termination agreement.	620	620
Capital lease obligations of Akela's subsidiary, PharmaForm, bearing interest from 6% to 10.11%, secured by related laboratory equipment.	514	649
Auto loan of the Company's Indian subsidiary bearing 8.5% interest	9	9
	7,687	7,630
Current portion of long-term debt	1,801	1,015
	\$ 5,886	\$ 6,615

As of the date of this report a number of the Company's payment obligations are in default. See also notes 1 and 11.

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Notes to Consolidated Financial Statements
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(in thousands of US dollars, except share and per share data unless otherwise noted)

8. Stock option plan

During the three months ended March 31, 2010, no awards or cancellations occurred under the Company's 2007 Stock Incentive Plan.

	Number	Weighted Average Exercise Price (CDN \$'s)	
Balance, December 31, 2009	558,055	\$	3.49
Balance, March 31, 2010	558,055	\$	3.49
Options exercisable, March 31, 2010	414,389	\$	4.22

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 March 31, 2010 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)
\$22.26 - 73.24	6,212	\$ 73.24	6,212	\$ 73.24	0.14
\$12.01 - 22.25	8,875	\$ 22.25	8,875	\$ 22.25	0.14
\$6.51 - 12.00	5,000	\$ 6.86	5,000	\$ 6.86	7.08
\$3.76 - 6.50	17,750	\$ 3.94	17,750	\$ 3.94	0.14
\$3.01 - 3.75	243,776	\$ 3.24	243,776	\$ 3.24	0.51
\$2.26 - 3.00	79,342	\$ 2.39	55,676	\$ 2.39	0.31
\$1.51 - 2.25	7,100	\$ 2.25	7,100	\$ 2.25	0.14
\$1.01 - 1.50	120,000	\$ 1.38	30,000	\$ 1.38	8.04
\$0.61 - 1.00	40,000	\$ 0.61	10,000	\$ 0.61	8.60
\$0.15 - 0.60	30,000	\$ 0.15	30,000	\$ 0.15	3
\$0.15 - 73.24	558,055	\$ 3.49	414,389	\$ 4.22	1.44

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9. Warrants and broker units

As of March 31, 2010, the following warrants were outstanding:

Warrants		Common share equivalents	Exercise price (CDN)	Expiration Date
Number	Fair value at issuance (USD)			
1	364	252,898	\$ 8.96	April 22, 2010
111,410	4	111,410	\$ 14.08	November 1, 2010
4,312,500	2,155	4,312,500	\$ 1.50	March 28, 2011
941,725	49	941,725	\$ 7.04	January 4, 2012
974,533	79	974,533	\$ 7.04	January 24, 2012
6,340,169	\$ 2,651	6,593,066		

10. Stock-based compensation

For the period ended March 31, 2010, the Company granted nil (2009 – 713,565) options and recognized total stock-based compensation of \$7 (2009 – \$77).

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:

	2009
Risk-free interest rate	0.97%
Expected volatility	188.45%
Expected life in years	1.81
Expected dividend yield	-

The following table summarizes the weighted average grant-date fair value per share for options granted during the period ended March 31, 2009:

	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:		
2009	713,565	0.05

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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11. Commitments, contingencies and guarantees

(a) Commitments:

The annualized aggregate maturities of the Company's contractual obligations are as follows:

	2010	2011	2012	2013	2014	2015+	Total
Operating leases	567	623	-	-	-		\$ 1,190
Capital leases *	537	146	-	-	-	-	683
Service contracts	420	560	47	-	-	-	1,027
Long-term debt *	1,006	880	799	721	394	4,318	8,118
	2,530	2,209	846	721	394	4,318	\$ 11,018

* 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 March 31, 2010, the minimum amount of this contingency is \$2.3 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.

In May 2008, Akela's original license and development agreement with Janssen for Fentanyl TAIFUN® was amended to secure advanced milestones of €2.5 million on the first local regulatory approval of the Phase III protocol and €2.0 million on clinical site readiness. As part of this agreement, Akela agreed to use the funds to prepare and conduct the Phase III clinical and long-term toxicology studies and finance other project critical

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expenses. Failure to comply with these conditions would result in an obligation to refund all of the funds to Janssen. The Company triggered the advance milestones in August and September 2008 and the resulting proceeds were dedicated to the Fentanyl program under the supervision of the Joint Development Team (JDT) which is comprised of six members; three representatives of Akela and three representatives of Janssen. As the advanced milestones were invested to sustain the clinical program and timely progress toward the development of Fentanyl TAIFUN® from the date of the amendment (May 23, 2008) through March 31, 2010, the Company believes it has complied with the terms of the advance milestones.

In June 2009, Akela's license and co-development agreement with Teikoku Seiyaku Co. Ltd for Fentanyl TAIFUN® was amended to secure advanced milestones of up to \$2,000 to support the continued development of the Fentanyl TAIFUN® inhaler (the "Product"). As part of this agreement, Akela agreed to use the funds to prepare and conduct the Phase III clinical and long-term toxicology studies, set up commercial manufacturing operations for the Product including investments in manufacturing equipment, conduct necessary pharmaceutical development activities, including the development of the inhaler and stability studies, and finance other project critical expenses, exclusively for the Product. Akela received \$200 upon signing of the amendment and will receive \$1,800 subject to meeting a near term development milestones related to the development of the Product. On February 11, 2010, this milestone was achieved. Although the Company achieved the milestone during the first quarter of 2010, it remains uncertain as to the timing or ability of the Company to collect the funds related to the \$1,800 development milestone. In the future should the Company receive the milestone payment, all funds will be committed to the ongoing development of Fentanyl TAIFUN®. As use of the \$200 received to date has been dedicated to the development of the Product in accordance with the terms of the amended agreement, the Company has not recorded a liability with respect to this guarantee.

(b) Contingencies:

In February 2010, Akela and its wholly owned subsidiary, PharmaForm, announced the outcomes of two legal cases involving former employees, Michael Crowley and Stephen Lerner. In Michael Crowley vs. Formulation Technologies, LLC doing business as ("d/b/a/") PharmaForm, the arbitrator found in favor of Mr. Crowley. As a result, Mr. Crowley has been awarded \$325 for payment under Mr. Crowley's employment agreement, commissions and vacation accruals earned over his employment period, partial payment of Mr. Crowley's legal fees and Mr. Crowley's out-of-pocket expenses. In the separate matter of Lerner vs. Akela Pharma Inc. and Formulation Technologies, LLC d/b/a/ PharmaForm, a jury sided with Mr. Lerner and awarded him \$189 in severance pay and approximately \$47 in vacation pay earned during the period which he was employed by the company in addition to out of pocket legal expenses. The judgment was solely against Akela Pharma. After reviewing the evidence and hearing the arguments of counsel, the District Court of Travis County, Texas denied the jury's award of severance in the Lerner suit, and on May 11, 2010, the court issued a final verdict awarding Mr. Lerner unused vacation pay and out of pocket legal expenses. Akela's provisions for losses on these legal actions, totaling \$485, have been recorded in accounts payable and accrued liabilities as of March 31, 2010.

The Company and certain board members have also been named as defendants in actions filed in the District Court of Travis County, Texas by two former employees; Andrew Reiter and Robert Clayborough. The actions claim actual and compensatory damages in an unspecified amount, costs and other relief in connection with the termination of employment. While the results of litigation cannot be predicted with certainty, the Company does

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not expect the ultimate conclusion of these matters will have a material adverse effect on the Company's consolidated financial statements. Provisions have been recorded for the amounts the Company may be required to pay to settle these litigation matters.

In addition to executive employment termination litigation resulting from recent organizational changes at Akela, the Company also faces claims from creditors for unpaid services and supplies, as a number of Akela's liability obligations are in default as at the audit report date (see notes 1 and 7). While the outcome of these claims cannot be predicted with certainty the Company does not anticipate that these pending legal matters will have a material adverse effect on the Company's financial condition. The amounts payable under such claims have been recorded in accounts payable and accrued liabilities as of March 31, 2010.

(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 March 31, 2010 and December 31, 2009, 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.

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12. Supplemental cash flow disclosure and other information

(a) Net changes in operating assets and liabilities:

	Three months ended March 31,	
	2010	2009
Accounts receivable	\$ 575	\$ 3,259
Prepaid expenses and other assets	(6)	(342)
Accounts payable and accrued liabilities	(221)	(928)
Deferred revenue	(477)	(689)
	<u>(129)</u>	<u>1,300</u>

(b) Cash paid for:

	Three months ended March 31,	
	2010	2009
Interest	\$ 15	\$ 36

(c) Non-cash transactions:

	Three months ended March 31,	
	2010	2009
Receipt of warrants as full and final settlement of lawsuit with LRI on March 10, 2009 regarding a failed toxicology study <i>(note 3)</i>	\$ -	\$ 101

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13. Financial instruments

(a) Classification:

The classification of financial instruments as of March 31, 2010 and December 31, 2009 and their respective carrying values and fair values are as follows:

	Held-for-trading	Loans and receivables	Held-to-maturity	Other financial liabilities	Carrying value	Fair value
March 31, 2010						
Cash	\$ 160				\$ 160	\$ 160
Accounts receivable		1,153			1,153	1,153
Restricted cash and deposits			705		705	705
Accounts payable and accrued liabilities				7,509	7,509	7,509
Long-term debt				7,687	7,687	3,696
December 31, 2009						
Cash	\$ 107				\$ 107	\$ 107
Accounts receivable		1,679			1,679	1,679
Restricted cash and deposits			938		938	938
Accounts payable and accrued liabilities				7,801	7,801	7,801
Long-term debt				7,630	7,630	3,358

(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 “held for trading” 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. The fair value of long-term debt is estimated based on discounted cash flows using period-end market

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yields or the market value of similar instruments with the same maturity, or quoted market prices when available. Due to the judgment used in applying a wide range of acceptable techniques and estimates in calculating fair value amounts, fair values are not necessarily comparable among financial institutions or other market participants and may not be realized in an actual sale or the immediate settlement of the instrument.

As of March 31, 2010 and December 31, 2009, the carrying amount of assets that the Company has pledged as collateral for long-term debt facilities was approximately \$1.0 million and \$8.1 million, respectively.

14. 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 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 three months ended March 31, 2010 and 2009, no 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 ended March 31, 2010, the Company's three largest customers accounted for approximately 45% of revenues. One customer accounted for approximately 12% of accounts receivable at March 31, 2010.

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

	As of March 31, 2010
Total accounts receivable	\$ 1,104
Of which:	
Not overdue	1,094
Past due for more than one day but for not more than three months	82
Past due more for than three months but for not more than six months	548
Total accounts receivable, gross	\$ 1,724
Allowance for doubtful accounts	(620)
Total accounts receivable, net	\$ 1,104

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(b) *Foreign currency risk:*

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 loss 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 March 31, 2010 and December 31, 2009, the Company had not entered into any derivative financial instruments.

The following is a breakdown of financial instruments by foreign currency as of March 31, 2010:

(in thousands of US dollars)	March 31,			
	2010			
	\$Cdn	Euro	\$Bds	INR
Cash	\$ 4	\$ 1	\$ 46	\$ -
Accounts receivable	75	7	-	-
Accounts payable and accrued liabilities	1,575	1,025	142	146
Long-term debt	-	6,044	-	-

The following exchange rates applied during the reporting period and for the three months ended March 31, 2010:

Currency	Exchange	Average	Closing
Canadian dollar	US/Cdn	0.9609	0.9844
Euro	US/Euro	1.3838	1.3523
Barbadian	US/Bds	0.5076	0.4924
Indian Rupee	US/INR	0.0218	0.0196

(c) *Interest rate risk:*

The Company's exposure to interest rate risk primarily arises from a loan in Euros from a Finnish governmental body, which bears interest at floating rates. As of March 31, 2010, \$0.6 million of the Company's total debt portfolio was subject to movement in floating interest rates. A 1% change in interest rates would have an effect on the loss from continuing operations before income taxes for the three months ended March 31, 2010 of approximately \$2. The Company currently does not have any outstanding credit facilities, other than those described in note 6.

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(d) *Liquidity risk:*

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 March 31, 2010:

	Amounts Payable	Less than 1 year	1 to 3 years	3 to 5 years	Thereafter
Accounts Payable and accrued liabilities	\$ 7,509	\$ 7,509	\$ -	\$ -	\$ -
Capital leases *	683	537	146	-	-
Long-term debt *	8,118	1,006	1,679	1,115	4,318
	\$ 16,310	9,052	1,825	1,115	4,318

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

15. Capital Management

The Company's objectives when managing capital are:

- To sustain the continuance of the Fentanyl TAIFUN® program,
- 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' deficiency (excluding comprehensive income) in the definition of capital.

Our ability to raise funding from the capital markets is challenging and is expected to remain so for the foreseeable future. The Company's strategy therefore is sustain the continuance of the Fentanyl TAIFUN® program through the sale of PharmaForm and other non-strategic assets and seek funding for our proprietary compounds from our current and new commercial partners. Until we succeed in raising additional capital through partner funding, equity or debt financing we are not recruiting any further patients into clinical studies.

At March 31, 2010, the Company was subject to the following externally imposed capital requirements associated with a line of credit secured by a 1st lien on accounts receivable of Akela's subsidiary, PharmaForm, repayable in July 2010 (see also note 7):

- The lender may request that the entire unpaid principle balance and any accrued interest be paid in full if the value of the 60 day or less accounts receivables falls below \$750.

The Company is not subject to any other externally imposed capital requirements.

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16. Related party transactions

During the three-months ended March 31, 2010 and 2009, the Company incurred expenses totalling \$140 and \$147, for consulting services paid to three current shareholders and the former principal owners and founders of PharmaForm. One of these shareholders is Robert O. Williams III, Ph.D., a member of the Board of Directors. As of March 31, 2010, accounts payable includes a \$233 outstanding liability to these shareholders for previously rendered consulting services.

During the three-months ended March 31, 2009, the Company incurred legal and tax consulting fees totalling \$35 for services provided by Knorr Rechtsanwälte, a firm associated with Dr. Günter Knorr, the Company's former Chairman of the Board. This related party relationship was terminated in 2009.

During the three-months ended March 31, 2009, the Company also incurred \$62 in expenses for IT consulting services provided by Guardus Corporation, a firm owned by Dr. Halvor Jaeger, the Company's former Chief Executive Officer (CEO). This related party relationship was terminated in 2009.

In addition, during the three-months ended March 31, 2009, the Company incurred expenses of \$55 for management services provided by PRI International Consulting Inc., a company directly controlled by Dr. Jaeger. This related party relationship was terminated in 2009.

In addition, during the three-months ended March 31, 2009 the Company incurred \$25 in expenses for financial consulting services performed by Charlestown Capital Advisors, LLC, a private investment company founded and managed by Raj Maheshwari, a former board member of the Company. This related party relationship was terminated in 2009.

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

17. Comparative figures

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