

Consolidated Financial Statements of

AKELA PHARMA INC.
(formerly LAB International Inc.)

Years ended December 31, 2007 and 2006



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AUDITORS' REPORT TO THE SHAREHOLDERS

We have audited the consolidated balance sheets of Akela Pharma Inc. (formerly LAB International Inc.) as of December 31, 2007 and 2006 and the consolidated statements of operations and comprehensive loss, shareholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2007 and 2006 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

KPMG LLP

Chartered Accountants

Montréal, Canada

March 28, 2008

AKELA PHARMA INC.

(formerly LAB International Inc.)

Consolidated Financial Statements

Years ended December 31, 2007 and 2006

(in thousands of US dollars)

Financial Statements

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AKELA PHARMA INC.

(formerly LAB International Inc.)

Consolidated Balance Sheets

Years ended December 31, 2007 and 2006
(in thousands of US dollars)

| | 2007 | 2006 |
|---|------------------|------------------|
| Assets | | |
| Current assets: | | |
| Cash | \$ 6,688 | \$ 35,304 |
| Accounts receivable (note 10) | 4,806 | 1,347 |
| Prepaid expenses | 462 | 712 |
| | <u>11,956</u> | <u>37,363</u> |
| Restricted cash (note 14) | 600 | - |
| Property and equipment (note 11) | 5,220 | 397 |
| Intangible assets (note 12) | 14,170 | 8,015 |
| Goodwill (note 7) | 6,457 | - |
| Other assets (note 13) | 738 | 828 |
| | <u>\$ 39,141</u> | <u>\$ 46,603</u> |
| Liabilities and Shareholders' Equity | | |
| Current liabilities: | | |
| Accounts payable and accrued liabilities | \$ 8,873 | \$ 4,886 |
| Deferred revenue | 2,598 | 1,606 |
| Current portion of long-term debt (note 14) | 499 | 1,456 |
| | <u>11,970</u> | <u>7,948</u> |
| Deferred revenue | 10,145 | - |
| Long-term debt (note 14) | 5,824 | 4,248 |
| Future income taxes (note 16) | 1,154 | 1,204 |
| Shareholders' equity: | | |
| Common shares (unlimited authorized, 11,768,294 and 10,891,218 common shares issued and outstanding with no par value at December 31, 2007 and 2006) (note 17) | 54,227 | 49,758 |
| Preference shares (issuable in series, unlimited authorized, zero issued and outstanding) (note 17) | - | - |
| Warrants (note 19) | 364 | 366 |
| Additional paid-in capital | 11,702 | 6,629 |
| Accumulated other comprehensive income | 3,110 | 3,110 |
| Deficit | <u>(59,355)</u> | <u>(26,660)</u> |
| | <u>(56,245)</u> | <u>(23,550)</u> |
| Total shareholders' equity | 10,048 | 33,203 |
| Commitments, contingencies and guarantees (note 22) | | |
| Subsequent events (note 28) | | |
| | <u>\$ 39,141</u> | <u>\$ 46,603</u> |

See accompanying notes to audited consolidated financial statements.

Approved on behalf of the Board of Directors:
(Signed) Yves Glaude, Director

(Signed) Maurice St-Jacques, Director

AKELA PHARMA INC.

(formerly LAB International Inc.)

Consolidated Statements of Operations and Comprehensive Loss

Years ended December 31, 2007 and 2006

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

| | 2007 | 2006 |
|--|--------------------|-------------------|
| Revenues | \$ 12,632 | \$ 25,966 |
| Expenses: | | |
| Direct costs | 5,897 | 14,088 |
| Selling, general and administrative | 14,016 | 13,303 |
| Research and development | 17,744 | 11,521 |
| Stock-based compensation <i>(note 20)</i> | 997 | 886 |
| Amortization of property and equipment | 1,122 | 2,071 |
| Amortization of intangible assets | 2,722 | 1,281 |
| Interest on long-term debt and loss on settlement of convertible debentures | 194 | 1,436 |
| Foreign exchange | (1,249) | 996 |
| | <u>41,443</u> | <u>45,582</u> |
| Net loss before under noted items | (28,811) | (19,616) |
| Other (expense) income: | | |
| Gain on disposal of interest in LAB Research Inc. | - | 30,111 |
| Share in net income of a company subject to significant influence | - | 265 |
| US listing charges <i>(note 8)</i> | (3,988) | - |
| Restructuring <i>(note 9)</i> | - | (3,859) |
| | <u>(3,988)</u> | <u>26,517</u> |
| Net (loss) earnings before income taxes | (32,799) | 6,901 |
| Recovery of (provision for) income taxes <i>(note 16)</i> : | | |
| Current | (62) | (2,519) |
| Future | 166 | (4,581) |
| | <u>104</u> | <u>(7,100)</u> |
| Net loss and comprehensive loss | <u>\$ (32,695)</u> | <u>\$ (199)</u> |
| Basic and diluted net loss per share <i>(note 21)</i> | <u>\$ (2.79)</u> | <u>\$ (0.02)</u> |
| Basic and diluted weighted average number of shares outstanding | <u>11,720,507</u> | <u>10,388,586</u> |

See accompanying notes to audited consolidated financial statements.

AKELA PHARMA INC.

(formerly LAB International Inc.)

Consolidated Statements of Shareholders' Equity

Years ended December 31, 2007 and 2006
(in thousands of US dollars)

| | Common Shares | | Warrants | Holder conversion options | Additional Paid-in Capital | Accumulated other comprehensive | | Total |
|---|---------------|-----------|----------|---------------------------------|-------------------------------|------------------------------------|-------------|-----------|
| | Number | Dollars | | | | income | Deficit | |
| Balance, December 31, 2005 | 9,997,476 | \$ 42,121 | \$ 563 | \$ 969 | \$ 5,627 | \$ 3,110 | \$ (25,024) | \$ 27,366 |
| Settlement of debentures | 659,778 | 6,194 | - | (935) | - | - | (1,476) | 3,783 |
| Services rendered <i>(note 17(b))</i> | 195,474 | 1,056 | - | - | - | - | - | 1,056 |
| Share issue costs | - | - | - | - | - | - | 39 | 39 |
| Expiration of conversion options | - | - | - | (34) | 34 | - | - | - |
| Expiration of warrants | - | - | (174) | - | 174 | - | - | - |
| Exercise of warrants | 15,714 | 146 | (23) | - | - | - | - | 123 |
| Exercise of options | 22,776 | 241 | - | - | (92) | - | - | 149 |
| Stock-based compensation <i>(note 20)</i> | - | - | - | - | 886 | - | - | 886 |
| Net loss | - | - | - | - | - | - | (199) | (199) |
| Balance, December 31, 2006 | 10,891,218 | \$ 49,758 | \$ 366 | \$ - | \$ 6,629 | \$ 3,110 | \$ (26,660) | \$ 33,203 |
| Purchase of PharmaForm <i>(note 7)</i> | 862,791 | 4,379 | - | - | 4,074 | - | - | 8,453 |
| Services rendered <i>(note 17(b))</i> | 14,285 | 90 | - | - | - | - | - | 90 |
| Expiration of warrants | - | - | (2) | - | 2 | - | - | - |
| Stock-based compensation <i>(note 20)</i> | - | - | - | - | 997 | - | - | 997 |
| Net loss | - | - | - | - | - | - | (32,695) | (32,695) |
| Balance, December 31, 2007 | 11,768,294 | \$ 54,227 | \$ 364 | \$ - | \$ 11,702 | \$ 3,110 | \$ (59,355) | \$ 10,048 |

See accompanying notes to audited consolidated financial statements.

AKELA PHARMA INC.

(formerly LAB International Inc.)

Consolidated Statements of Cash Flows

Years ended December 31, 2007 and 2006
(in thousands of US dollars)

| | 2007 | 2006 |
|---|-------------|-----------|
| Cash flows from operating activities: | | |
| Net loss | \$ (32,695) | \$ (199) |
| Adjustments for: | | |
| Amortization and write-off | | |
| of property and equipment | 1,122 | 2,071 |
| Amortization of intangible assets | 2,722 | 1,281 |
| Stock-based compensation | 997 | 886 |
| Loss on settlement of convertible debenture | - | 658 |
| Accretion expense on convertible debenture | - | 157 |
| Unrealized foreign exchange (gain) loss | (1,268) | 988 |
| Services rendered for shares | 90 | 24 |
| Future income taxes | (166) | 4,575 |
| Gain on disposal of interest in LAB Research | - | (30,111) |
| Share in net income of a company subject to significant influence | - | (265) |
| Restructuring | | 3,523 |
| Gain on disposal of long-term investment | - | (129) |
| Net changes in operating assets and liabilities (note 23(a)) | 14,268 | 174 |
| | (14,930) | (16,367) |
| Cash flows from financing activities: | | |
| Restricted cash | (600) | - |
| Proceeds from issuance of shares | - | 331 |
| Repayments of long-term debt | (1,816) | (528) |
| | (2,416) | (197) |
| Cash flows from investing activities: | | |
| Acquisition of PharmaForm, net of cash (note 7) | (8,196) | - |
| Acquisition of property and equipment | (2,815) | (1,830) |
| Addition to intangible assets | (734) | (399) |
| Cash balance transferred to LAB Research | - | (847) |
| Proceeds on disposal of LAB Research | - | 50,164 |
| Transaction costs | - | (8,505) |
| Other advances and investments | - | (150) |
| | (11,745) | 38,433 |
| Net (decrease) increase in cash | (29,091) | 21,869 |
| Cash, beginning of year | 35,304 | 13,989 |
| Effect of exchange rate changes | 475 | (554) |
| Cash, end of year | \$ 6,688 | \$ 35,304 |

See accompanying notes to audited consolidated financial statements.

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(formerly LAB International Inc.)
Notes to Consolidated Financial Statements

December 31, 2007 and 2006
(in thousands of US dollars, except share and per share data)

1. Nature of operations:

Akela Pharma, Inc. ("Akela" or "the Company"), formerly Lab International Inc., is an integrated product development company primarily focused on therapeutics for pain utilizing its proprietary drug delivery technologies. The Company's lead product candidate is Fentanyl TAIFUN®, a fentanyl formulation specifically designed to be delivered with our TAIFUN® Multi-Dose Inhaler. The Company is developing Fentanyl TAIFUN® as a rapid-acting inhaled opioid analgesic for treatment of break-through cancer pain.

Until August 2006 the Company operated in two distinct business units. The Pharma business unit ("Pharma") continues the development of novel therapeutics and platforms with a focus on inhalation delivery. Pharma's drug development activities were supported by the scientific expertise, infrastructure and cash flows derived from the Company's second business unit, LAB Research Inc. ("LRI"), a pre-clinical contract research services organization with operations in North America and Europe. In August 2006, the Company sold a majority interest in LRI as part of a public offering for this segment. In September and November 2006, the Company sold its remaining interests in LRI. In total, the Company realized aggregate proceeds of \$50,164 (C\$56,891) from the disposal of its entire interest in LRI.

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 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. In order to achieve its business plan, the Company anticipates the need to raise additional capital and/or achieve sales and other revenue generating activities. The Company is actively pursuing additional financing alternatives to pursue its development activities and on March 27, 2008 concluded a public offering for aggregate proceeds of Cdn \$10.4 million. (See note 28b for further discussion). Management believes that funds from operations as well as existing financing will be sufficient to meet the Company's requirements at least until January 1, 2009. However, if the Company is unable to raise additional capital, it may be required to reduce the scope of planned development efforts which would impact the ability to bring products to market under current timelines.

2. Change in functional and reporting currency:

The Company adopted the US dollar as its functional and reporting currency effective January 1, 2007, as a significant portion of its revenues, expenses, assets and liabilities are now denominated in U.S. dollars. Prior to that date, the Company's operations were measured in Canadian dollars and the consolidated financial statements were expressed in Canadian dollars. All opening assets and liabilities were translated into US dollars using the exchange rate in effect on January 1, 2007. For comparative purposes, historical financial statements and notes thereto up to and including December 31, 2006 have been restated into US dollars as if the Company had adopted the US dollar as its reporting currency for those periods. Assets and liabilities at December 31, 2006 were translated at the closing rate on this date and revenues and

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2. Change in functional and reporting currency (continued):

expenses were translated at the average rates in effect for the period and equity transactions were translated at historical rates.

The change in the functional currency for the prior periods resulted in a currency translation adjustment of \$3,110 as of December 31, 2006, which is reflected in other comprehensive income, a separate component of shareholders' equity.

3. Significant accounting policies:

(a) Principles of consolidation:

The consolidated financial statements include the consolidated accounts of the Company and its wholly-owned subsidiaries. As described in note 5, the Company disposed of a majority interest in LRI on August 3, 2006. The results of operations of LRI are consolidated with those of the Company up until the date of loss of control. From August 3 up until November 9, 2006, the date of sale of the remaining interest in LRI, the Company accounted for its interest in LRI using the equity method. Under the equity method, the carrying value of the investment is adjusted for the Company's share of earnings or losses less dividends.

All significant intercompany balances and transactions have been eliminated on consolidation.

(b) Cash and cash equivalents:

All highly liquid investments with an original maturity of three months or less are accounted for as cash equivalents. At December 31, 2007 and 2006, the Company had no cash equivalents.

(c) Property and equipment:

Property and equipment are recorded at cost. Assets under capital leases are recorded at the present value of minimum lease payments. Amortization is computed using the straight-line method over the following periods:

| | |
|---------------------------------|---------------|
| Laboratory equipment | 5 to 10 years |
| Manufacturing equipment | 5 to 10 years |
| Computer equipment and software | 3 to 5 years |
| Furniture and office equipment | 3 to 7 years |
| Leasehold improvements | 7 years |
| Automotive equipment | 5 to 7 years |

(d) Intangible assets:

The capitalized amount with respect to patents relates to direct costs incurred in connection with securing the patents. Patents are stated at cost and amortized using the straight-line method over periods ranging from ten to twenty years. Licenses, trademarks and intellectual property rights acquired are stated at cost and are amortized over their estimated useful lives of ten years using the

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3. Significant accounting policies (continued):

straight-line method. Other intangible assets are amortized using the straight-line method over the following periods:

| | |
|--------------------------------------|---------|
| Customer contracts and relationships | 3 years |
| Non competition agreement | 3 years |
| FDA/DEA Certification | 5 years |

(e) *Impairment of long-lived assets and goodwill:*

Long-lived assets, consisting of property and equipment and intangible assets with finite useful lives, are tested for recoverability whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognized for long-lived assets, when the carrying amount of an asset to be held and used exceeds the sum of the undiscounted cash flows expected from its use and disposal; the impairment recognized is measured as the amount by which the carrying amount of the net asset exceeds its fair value. Fair value is the estimated value at which the asset would be bought or sold in a transaction between willing parties. The fair value against which the asset is measured may be established based on comparable information or transactions, or any other acceptable method of assessment.

Goodwill represents the excess of the cost of an acquired enterprise over the fair value of the assets acquired and liabilities assumed less any subsequent writedowns for impairment. Goodwill is subject to an annual impairment test. Goodwill impairment is evaluated between annual tests upon the occurrence of certain events or circumstances. Goodwill impairment is assessed based on a comparison of the fair value of a reporting unit to the underlying carrying value of the reporting unit's net assets, including goodwill. When the carrying amount of the reporting unit exceeds its fair value, the fair value of the reporting unit's goodwill is compared with its carrying amount to measure the amount of impairment, if any.

(f) *Income taxes:*

The Company applies the asset and liability method to account for income taxes. Under this method, future income tax assets and liabilities are determined based on the differences between the financial reporting and the tax basis of assets and liabilities and are measured using substantively enacted tax rates and laws that are expected to be in effect in the periods in which the future tax assets or liabilities are expected to be realized or settled. The Company establishes a valuation allowance against future income tax assets if, based on available information, it is more likely than not that some or all of the future income tax assets will not be realized.

(g) *Revenue recognition:*

Pharma's revenues consist of pharmaceutical testing services performed on behalf of third parties. Revenues are recognized at the time research activities are performed under the agreement. Upfront

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3. Significant accounting policies (continued):

and milestone payments which require the Company's ongoing involvement are deferred and amortized into income over the estimated period of service. Upfront payments are nonrefundable. When a milestone is achieved, a portion of the milestone revenue equal to the amount of progress towards completion of the total contract is recognized. The remaining portion of the milestone is amortized into future periods as additional progress towards completion is achieved. To measure performance, the Company compares the direct labor costs incurred to estimated total direct labor contract costs through completion. The Company believes direct labor cost reliably tracks the progress toward completion and is the best indicator of the performance under the contract obligations because our service is people intensive. Therefore, such costs directly correspond to the level of effort necessary to perform the service. The estimated total direct labor costs to complete a project are reviewed and revised periodically throughout the lives of the contracts, with adjustments to revenue resulting from such revisions being recorded on a cumulative basis in the period in which the revisions are first identified. Fees for development funding, sales and royalties are recognized when the service is rendered or the product delivered, the amount is determinable and collectibility is reasonably assured. Deferred revenues represent deferred license fees and payments received in advance of services being performed, milestones being reached or from final deliverables being provided.

PharmaForm's revenues are included from the date of acquisition, January 25, 2007. PharmaForm revenue for contract services is recognized as work is performed, and amounts are earned. The timing of cash received from contract services agreements can differ from when revenue is recognized. The Company considers amounts to be earned once evidence of an arrangement has been obtained, services are delivered, fees are fixed or determinable, and collectability is reasonably assured. For contracts with fees based on time and materials, revenue is recognized over the period of performance.

For fixed price contracts, depending on the specific contractual provisions and the nature of the deliverables, revenue may be recognized as milestones are achieved or when final deliverables have been provided. At times, arrangements with customers involve multiple elements. The deliverables in each arrangement are evaluated at contract inception to determine whether they represent separate units of accounting. The total fee for the arrangement is allocated to each unit of accounting based on its relative fair value, taking into consideration any performance, cancellation or termination provisions. Fair value for each element is generally established based on the sales price charged when the same or similar services are sold separately to customers. Revenue is recognized when revenue recognition criteria for each unit of accounting is met.

LRI's revenues are included up until August 3, 2006, consisting of services rendered to customers, and are recognized as the services are performed or delivered by the Company. Revenue is recorded by determining the status of work performed per contract in relation to the total services to be provided. Work in progress represents amounts receivable for services rendered, but which only become billable in accordance with contractual payment terms.

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3. Significant accounting policies (continued):

Revenues that include multiple elements are considered to be revenue arrangements with multiple deliverables. Under these arrangements, the identification of separate units of accounting is required and revenue is allocated among the separate units based on their relative fair values or using the residual method. Revenues for each unit of accounting are then recorded as described above.

Sales taxes collected from customers are presented on a net basis.

(h) Research and development expenses:

Research and development costs are expensed as incurred and include salaries, benefits and other operating costs such as outside services, supplies and allocated overhead costs. The Company performs research and development for its proprietary products and technology development and for others pursuant to collaboration agreements. For proprietary products and internal technology development programs, the Company invests its own funds without reimbursement from a third party. Costs associated with the treatment phase of clinical trials are accrued based on the total estimated cost of the clinical trials and are expensed ratably based on patient enrolment in the trials. Costs associated with the start-up and reporting phases of the clinical trials are expensed as incurred.

Collaboration agreements typically include the development and licensing of the Company's technology. Under these agreements, the Company may be reimbursed for development costs, entitled to milestone payments when and if certain development or regulatory milestones are achieved, compensated for the manufacture and supply of clinical and commercial product and entitled to royalties on sales of commercial product. All of the Company's collaboration agreements are generally cancellable by the partner without significant financial penalty.

(i) Government assistance:

Amounts received resulting from government assistance programs, including grants and investment tax credits for research and development, are reflected as a reduction of the cost of the asset or expense to which they relate at the time the eligible expenditures are incurred. Tax credits are recorded in the accounts when reasonable assurance exists that they will be realized.

(j) Foreign currency transactions:

Transactions denominated in currencies other than the functional currency are measured and recorded in the functional currency using the exchange rate in effect at the date of the transaction or the average rate for the period in the case of recurring revenue and expense transactions. Monetary assets and liabilities are revalued into the functional currency at each balance sheet date using the exchange rate in effect at that date, with any resulting exchange gains or losses being credited or charged to the consolidated statements of operations. Non-monetary assets and liabilities are measured and recorded in the functional currency using the exchange rate in effect at the date of the transaction and are not revalued for subsequent changes in exchange rates.

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3. Significant accounting policies (continued):

(k) *Stock-based compensation:*

Employee stock options are accounted for using the fair value based method. Under this method, compensation cost is measured at fair value at the date of grant and is expensed over the award's vesting period.

(l) *Earnings per share:*

Basic earnings per share are computed by dividing net earnings by the weighted average number of common shares outstanding during the year. Diluted earnings per share are computed in a manner consistent with basic earnings per share except that the weighted average number of shares outstanding is increased to include additional shares from the assumed exercise of options and warrants, if dilutive. The number of additional shares is calculated by assuming that outstanding options and warrants were exercised and that the proceeds from such exercises are used to repurchase common shares at the average share price for the reporting period.

The dilutive effect of convertible debentures is reflected in diluted earnings per share by application of the "if-converted" method, if dilutive. Under the if-converted method, convertible notes are assumed to have been converted at the beginning of the year (or at time of issuance, if later) and the resulting common shares are included in the denominator for purposes of calculating diluted earnings per share.

(m) *Use of estimates:*

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and revenue and expenses for the period reported.

Significant areas requiring the use of management estimates include estimating the advancement of work on certain contracts for revenue recognition purposes, estimating the useful lives of long-lived assets, including property and equipment and intangible assets, estimating the fair value of the financial liability and equity components of a compound financial instrument, estimating the fair value of assets and liabilities in connection with business combinations as well as estimating stock-based compensation and the recoverability of research tax credits receivable and future tax assets. The reported amounts and note disclosures are determined to reflect the most probable set of economic conditions and planned courses of action. Actual results could differ from those estimates.

4. Changes in accounting policies:

(a) *New accounting policies:*

Effective with the commencement of its 2007 fiscal year, the Company adopted the Canadian Institute of Chartered Accountants ("CICA") Handbook Section 1530, *Comprehensive Income*, CICA Handbook Section 3251, *Equity*, CICA Handbook Section 3855, *Financial Instruments – Recognition and*

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4. Changes in accounting policies (continued):

Measurement, CICA Handbook Section 3861, *Financial Instruments – Disclosure and Presentation*, and CICA Handbook Section 3865, *Hedges*. Sections 3855, 3861 and 3865 provide comprehensive requirements for the recognition and measurement of financial instruments, as well as standards on when and how hedge accounting may be applied. Handbook section 3251 establishes standards for the presentation of equity and changes in equity during the reporting period and requires the Company to present separately equity components and changes in equity arising from (i) net earnings; (ii) other comprehensive income; (iii) other changes in retained earnings; (iv) changes in contributed surplus and (v) changes in capital. A new consolidated statement of changes in shareholders' equity is presented in these consolidated financial statements.

Handbook Section 1530 also establishes standards for reporting and displaying comprehensive income. Comprehensive income is defined as the change in equity from transactions and other events from non-owner sources. Other comprehensive income refers to items recognized in comprehensive income but that are excluded from net income calculated in accordance with generally accepted accounting principles. A new financial statement has been presented in relation to the new standards.

Under these new standards, all financial instruments are classified into one of the following five categories: held for trading, held-to-maturity investments, loans and receivables, available-for-sale financial assets or other financial liabilities. All financial instruments, including derivatives, are included on the consolidated balance sheet and are measured either at fair market value with the exception of loans and receivables, investments held-to-maturity and other financial liabilities, which are measured at amortized cost. Subsequent measurement and recognition of changes in fair value of financial instruments depend on their initial classification. Held for trading financial investments are measured at fair value and all gains and losses are included in net income in the period in which they arise. Available-for-sale financial instruments are measured at fair value with revaluation gains and losses included in other comprehensive income until the assets are removed from the balance sheet.

The standards also require derivative instruments to be recorded as either assets or liabilities measured at their fair value unless exempted from derivative treatment as a normal purchase and sale. Certain derivatives embedded in other contracts must also be measured at fair value. All changes in the fair value of derivatives are recognized in earnings unless specific hedge criteria are met, which requires that a company must formally document, designate and assess the effectiveness of transactions that receive hedge accounting. The Company chose to review all contracts in place on January 1, 2007 that were entered into after January 1, 2003, for any embedded derivatives required to be accounted for at fair value from the base contract.

As a result of these standards, the Company has classified cash equivalents and restricted cash as available for sale. The Company has classified accounts receivable as loans and receivables and accounts payable and accrued liabilities and long-term debt as other financial liabilities. The adoption of these standards has no impact on the consolidated statement of operations and comprehensive loss for the fiscal year ended December 31, 2007.

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4. Changes in accounting policies (continued):

(b) *Future accounting pronouncements:*

In December 2006, the CICA issued Section 1535, *Capital Disclosures*. This Section established standards for disclosing information about an entity's capital and how it is managed. For the Company, this Section is effective for fiscal periods beginning on or after January 1, 2008. The new standard relates to disclosure only and will not impact the Company's financial results.

In December 2006, the CICA issued Section 3862, *Financial Instruments – Disclosure*, and Section 3863, *Financial Statements - Presentation*. These Sections are effective for fiscal periods beginning on or after October 1, 2007. For the Company, these sections replace existing Section 3861, *Financial Instruments – Disclosure and Presentation*. Disclosure standards are enhanced and expanded to complement the changes in accounting policy adopted 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 will not impact our financial results.

In January 2008, 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 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.

5. Corporate reorganization and disposal of LAB Research Inc.:

Until August 2006, the Company was a fully integrated drug development company operating in two distinct business units. The Pharma business unit ("Pharma") focuses on the development of novel therapeutics and platforms with an emphasis on inhalation based pain therapeutics. Pharma's drug development activities were supported by the scientific expertise, infrastructure and cash flows derived from the Company's second business unit, LAB Research Inc. ("LRI"), a pre-clinical contract research services organization with operations in North America and Europe.

5. Corporate reorganization and disposal of LAB Research Inc. (continued):

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As part of an initial public offering of LRI completed on August 3, 2006, the Company completed the following corporate reorganization:

- (i) On May 24, 2006, the Company incorporated a new entity, LRI, to acquire the pre-clinical contract research services business of the Company. These services were conducted by the LAB Research Segment and consisted of LAB Pre-clinical International Research Inc. ("LAB Canada"), Scantox, Biologisk Laboratorium A/S ("LAB Denmark"), LAB International Research Center Hungary Limited Liability Company ("LAB Hungary") and LAB Research International, Inc. ("LAB US").
- (ii) LAB Canada transferred all of the assets and undertakings comprising its contract research business as well as the shares of LAB US that it held directly to LRI in consideration for a \$23,245 (C\$26,181) note and 101,915 common shares;
- (iii) The Company transferred all of the shares of LAB Denmark that it held to LRI in consideration for a \$12,430 (C\$14,000) note and 2,015,713 common shares;
- (iv) The Company transferred all of the shares of LAB Hungary that it held to LRI in consideration for a \$6,962 (C\$7,841) note and one common share;
- (v) LAB Canada transferred all the shares of LAB Hungary that it held to LRI in consideration for a \$70 (C\$79) note and one common share;
- (vi) The Company sold all of the notes referred to above to 4349695 Canada Inc, a wholly-owned subsidiary of the Company, in exchange for common shares; and
- (vii) 4349695 Canada Inc. subscribed for 12,025,226 common shares of LRI for a total of \$42,707 (C\$48,101) payable by the cancellation of the notes referred to above.

Upon completion of these transactions, LRI owned all of the contract research assets of LAB Canada and all of the outstanding shares of LAB Hungary, LAB Denmark and LAB US.

As part of this reorganization, the Company and LRI entered into a number of agreements including a Preferred Supplier Agreement which requires that the Company use the pre-clinical inhalation toxicology services of LRI on an exclusive basis for a period of 60 months at reasonable terms and conditions. Both parties also entered into a 60 month non-competition agreement covering Canada, the U.S. and Europe with the exception of Russia, Ukraine, Romania and Belarus.

Disposal of interest in LRI:

On August 3, 2006, the Company sold 6,250,000 common shares that it held in LRI for gross proceeds of \$22,072 (C\$25,000) with an over allotment option granted to the Underwriters for an additional 1,500,000 common shares at \$3.55 (C\$4) per share. Concurrently, LRI issued 3,750,000 common shares for aggregate proceeds of \$13,318 (C\$15,000). The Company retained approximately 44% of LRI subsequent to these transactions. Net proceeds amounted to \$20,865 (C\$23,500) after Underwriters' commissions of \$1,332 (C\$1,500).

5. Corporate reorganization and disposal of LAB Research Inc. (continued):

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On September 12, 2006, the Underwriters exercised their over allotment option and the Company sold an additional 1,500,000 common shares for gross proceeds of \$5,297 (C\$6,000). The transaction reduced the Company's interest in LRI to 35.4% and generated net proceeds of \$5,042 (C\$5,640) after Underwriters' commissions of \$322 (C\$360).

On November 9, 2006 the Company sold its remaining interest in LRI for gross proceeds of \$22,929 (C\$25,891) and net proceeds of \$21,427 (C\$24,195) after Underwriters' commissions of \$1,502 (C\$1,696).

The total gain on dilution and disposal of LRI recorded in the third and fourth quarter of 2006 included \$50,164 (C\$56,891) in gross proceeds less the carrying value of the assets sold and \$7,654 (C\$8,680) of related Underwriter's commissions, professional fees and senior management bonuses related to the transactions.

6. 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 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 free of \$10.7 million (€ 8.0 million) which has been deferred and is being recognized ratably over the estimated development period. The Company can receive up to an additional \$74.4 million (€ 55.0 million) 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 \$1.1 million. All other commercial and contractual obligations remain in effect.

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.

7. 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

7. Business acquisition (continued):

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headquartered in Austin, Texas. The acquisition of PharmaForm added FDA and DEA approved specialized drug formulation and 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 aggregate purchase price amounted to \$17,073 including \$7,500 of cash and 862,791 common shares valued at approximately \$4,379, and contingently issuable shares having a value of \$4,074. Under the agreement, additional consideration is payable by the Company upon completion of certain milestones relating to PharmaForm's drug development programs. In total, the maximum remaining contingent consideration payable by the Company is approximately \$9 million, most of which is payable in common shares. All obligations to make contingent payments will terminate on January 25, 2012. As explained below, one of the contingent milestones was met at December 31, 2007 and the Company will issue additional consideration for this event in the first half of 2008.

The aggregate purchase price was 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 | 1,222,284 | 4,074 |
| | \$ 8,620 | \$ 8,453 | 2,085,075 | \$ 17,073 |

The phase II distribution is required to be made if PharmaForm's gross revenue (as defined in the PharmaForm acquisition agreement) within 12 months of January 1, 2007 equals or exceeds \$10 million, within 18 months equals or exceeds \$15 million or within 24 months equals or exceeds \$20 million. At December 31, 2007, this milestone was reached and the associated payment in common stock will take place in the first half of 2008. At December 31, 2007, the Phase II distribution has been accounted for as an increase to goodwill and additional paid in capital. The Company will reclassify the additional paid in capital to common stock when the capital stock is issued.

Additional consideration is payable by the Company upon completion of certain milestones relating to PharmaForm's drug development programs. All obligations to make contingent payments will terminate on January 25, 2012 (60 months following the closing date). Contingent payments made in the future will be accounted for as goodwill. The contingent payments required to be made to the PharmaForm sellers are as follows:

- (a) A payment (the Phase I Share Payment) is required to be made on the date which is the later of six months following the closing date and the date when an IND application dossier is filed with the FDA for the first proprietary non-inhalation product developed by PharmaForm.

7. Business acquisition (continued):

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- (b) A final payment (the Phase III Share Payment) is required to be made on the date which is the later of 18 months following the closing date and 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.

Each of the Phase I and III contingent payments will be made in common shares in an amount of \$4.0 million, plus \$0.1 million 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. Since the Company is already listed on the TSX, the Company believes that the probability of the selling shareholders obtaining this right is remote.

If Phase I or II 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, 60% and 140% for the Phase II Share Payment and 30% and 170% for the Phase III Share Payment.

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.

7. Business acquisition (continued):

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| | |
|---|-----------|
| 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 |
| | <hr/> |
| Consideration: | |
| Cash | \$ 7,500 |
| 862,791 common shares | 4,379 |
| 1,222,284 issuable contingent shares | 4,074 |
| Transaction costs, of which \$828 were incurred prior to December 31, 2006 | 1,120 |
| | <hr/> |
| | \$ 17,073 |
| | <hr/> |

8. US listing charges:

In October 2007, the Company filed a Registration Statement with the U.S. Securities and Exchange Commission (SEC) with the intention of effecting an initial public offering of Common Shares in the United States. On January 17, 2008, due to unfavorable market conditions, the Company withdrew its Registration Statement from the SEC, and \$3,988 of deferred corporate transaction costs associated with this proposed share offering were expensed.

9. 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. For the years ended December 31, 2007 and 2006, the Company recorded a charge of \$265 and \$336, respectively, associated with these terminations. In addition, the Company recorded an impairment loss on its property and equipment located in Finland in the amount of \$3,523. At December 31, 2007 and 2006, \$128 and \$3,859, respectively of accrued for severance costs remain unpaid and are included in "Accrued liabilities" on the consolidated balance sheet.

9. Restructuring (continued):

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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 (€2,130) 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 2007.

10. Accounts receivable:

| | 2007 | 2006 |
|---------------------------------|----------|----------|
| Trade | \$ 4,417 | \$ 892 |
| Grant receivable ⁽¹⁾ | - | 105 |
| Sales taxes | 248 | 198 |
| Interest | - | 120 |
| Other | 141 | 32 |
| | \$ 4,806 | \$ 1,347 |

(1) In 2004, the Company entered into a funding agreement with Tekes, a Finnish governmental agency, which provided government assistance for the research and development of the Company's inhalation products. The Company was eligible to receive funding of up to 50% of eligible project costs to a maximum of \$5,218 (€4,500), of which 30% or \$1,565 (€1,350) represented a grant and 70% or \$3,653 (€3,150) was in the form of a loan. During 2006, the Company submitted claims under the agreement with Tekes of \$1,767, of which \$105 were receivable as of December 31, 2006. Of the total claim, \$372 was recorded as a reduction of research and development expenses and \$1,357 was recorded as a liability in capital loans during the year ended December 31, 2006. No amounts were submitted in 2007. Refer to Commitments and Contingencies (note 22) for further discussion.

11. Property and equipment:

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| | 2007 | | |
|---------------------------------|------------------|-----------------------------|------------------------|
| | Cost | Accumulated amortization | Net carrying amount |
| Laboratory equipment | \$ 2,940 | \$ 353 | \$ 2,587 |
| Manufacturing equipment | 3,808 | 3,808 | - |
| Computer equipment and software | 764 | 402 | 362 |
| Furniture and office equipment | 455 | 62 | 393 |
| Leasehold improvements | 2,300 | 498 | 1,802 |
| Automotive equipment | 123 | 47 | 76 |
| | <u>\$ 10,390</u> | <u>\$ 5,170</u> | <u>\$ 5,220</u> |

| | 2006 | | |
|---------------------------------|-----------------|-----------------------------|------------------------|
| | Cost | Accumulated amortization | Net carrying amount |
| Laboratory equipment | \$ 799 | \$ 799 | \$ - |
| Manufacturing equipment | 3,262 | 3,262 | - |
| Computer equipment and software | 676 | 402 | 274 |
| Furniture and office equipment | 136 | 107 | 29 |
| Leasehold improvements | 41 | 2 | 39 |
| Automotive equipment | 73 | 18 | 55 |
| | <u>\$ 4,987</u> | <u>\$ 4,590</u> | <u>\$ 397</u> |

Depreciation expense related to assets under capital leases was \$20 (2006-\$150).

In December 2006, an impairment charge of \$3,523 was recorded against property and equipment located in Finland. Refer to Restructuring (note 9) for further discussion.

12. Intangible assets:

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| | 2007 | | |
|---------------------------------------|-----------|-----------------------------|------------------------|
| | Cost | Accumulated amortization | Net carrying amount |
| Intellectual property rights acquired | \$ 9,529 | \$ 2,423 | 7,106 |
| Licenses | 3,587 | 1,134 | 2,453 |
| Customer contracts and relationships | 2,000 | 611 | 1,389 |
| Patents | 1,664 | 236 | 1,428 |
| Non-competition agreement | 1,400 | 428 | 972 |
| FDA/DEA certifications | 1,000 | 183 | 817 |
| Trademarks | 17 | 12 | 5 |
| | \$ 19,197 | \$ 5,027 | \$ 14,170 |

| | 2006 | | |
|---------------------------------------|-----------|-----------------------------|------------------------|
| | Cost | Accumulated amortization | Net carrying amount |
| Intellectual property rights acquired | \$ 5,858 | \$ 1,380 | \$ 4,478 |
| Licenses | 3,541 | 668 | 2,873 |
| Patents | 829 | 173 | 656 |
| Trademarks | 17 | 9 | 8 |
| | \$ 10,245 | \$ 2,230 | \$ 8,015 |

13. Other assets:

| | 2007 | | 2006 | |
|--|------|-----|------|-----|
| Deposits for leases and laboratory equipment | \$ | 738 | \$ | - |
| Deferred corporate transaction costs | | - | | 828 |
| | \$ | 738 | \$ | 828 |

Deferred corporate transaction costs at December 31, 2006 related to direct and incremental costs incurred in connection with the acquisition of PharmaForm LLC, which was acquired on January 25, 2007.

14. Long-term debt:

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| | 2007 | 2006 |
|--|----------|----------|
| Long-term debt in Euros (2006- €404) bearing 8% interest, repaid in March 2007 | \$ - | \$ 533 |
| Long-term debt in Euros (2006 - €700) bearing 8% interest, repaid in October 2007 | - | 923 |
| Capital loan in Euros (2007 - €3,033 ; 2006 - €3,033) from Finnish governmental agency, bearing interest at the basic rate of interest of the European Central Bank less 1%, with a minimum interest rate of 3%. The term of the loan is eight years with no capital repayments in the first four years; repayments are conditional on specified equity requirements in the Company's Finnish subsidiary | 4,423 | 3,999 |
| Capital loans in Euros (2007 - €188; 2006 - €188) bearing interest at 5%; repayments are conditional on specified equity requirements in the Company's Finnish subsidiary, unsecured | 275 | 249 |
| Note payable, bearing 8.75% interest, repayable in 60 months, secured by a 1 st lien on accounts receivable and property and equipment and by a \$600 certificate of deposit. | 1,084 | - |
| Capital lease obligation, bearing 7.5% interest, secured by the related laboratory equipment | 130 | - |
| Capital lease obligation, bearing 8.75% interest, secured by the related laboratory equipment | 335 | - |
| Capital lease obligation, bearing 10.77% interest, secured by the related laboratory equipment | 76 | - |
| | 6,323 | 5,704 |
| Current portion of long-term debt | 499 | 1,456 |
| | \$ 5,824 | \$ 4,248 |

Long-term debt repayments for the next five years are as follows:

| | |
|------------|----------|
| 2008 | \$ 499 |
| 2009 | 400 |
| 2010 | 333 |
| 2011 | 274 |
| 2012 | 119 |
| Thereafter | 4,698 |
| | \$ 6,323 |

Minimum lease payments included above under obligations for capital leases are as follows: 2008, \$289; 2009, \$170; 2010, \$82.

15. Convertible debentures:

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On April 22, 2005, the Company entered into a securities purchase agreement providing for the issuance of a Secured Convertible Term Note (the "Note") in the aggregate principal amount of US \$5,000 (CDN \$6,243).

The Note bore interest at the Wall Street Journal U.S. prime rate plus 2% (subject to reduction in certain events), had a term of three years, is secured by the pledge of the shares of certain subsidiaries and is convertible into common shares at a price of US \$0.85 per share. The Note was repayable over 32 months in equal monthly capital repayments of US \$156 beginning in September 2005. In connection with this transaction, LAB has also issued to the holder a warrant exercisable to purchase up to 252,898 common shares of LAB for five years at a price of \$8.96 (US \$7.70) per share.

During 2006, the Company issued 659,777 common shares as settlement for the outstanding Note. The consideration paid by the Company as settlement was allocated to the liability and the equity elements of the convertible debenture based on the relative fair values at the date of the transaction. The amount of the loss on settlement related to the liability element was charged to the statement of operations and the difference between the carrying amount and the amount considered to be settled relating to the holder conversion option was charged to the statement of deficit.

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16. Income taxes:

The income tax provision (recovery) differs from the amount computed by applying the combined Canadian federal and Quebec tax rates to earnings before income taxes. The reasons for the difference and the related tax effects are as follows:

| | 2007 | 2006 |
|---|-------------|----------|
| (Loss) earnings before income taxes | \$ (32,799) | \$ 6,901 |
| Combined Canadian federal and Quebec provincial income taxes at 32% (2005 - 31%) | (10,497) | 2,210 |
| Adjustments for: | | |
| Non-taxable portion of capital gains | - | (5,402) |
| Difference with foreign tax rates | 3,090 | 1,431 |
| Benefit of losses not recorded | 6,968 | 7,844 |
| Stock-based compensation | 347 | 291 |
| Tax credits not taxable | - | (46) |
| Permanent differences and others | (12) | 772 |
| Income tax (recovery) provision | \$ (104) | \$ 7,100 |

The (recovery of) provision for income taxes is composed of the following:

| | 2007 | 2006 |
|----------------------|----------|----------|
| Current income taxes | \$ 62 | \$ 2,519 |
| Future income taxes | (166) | 4,581 |
| | \$ (104) | \$ 7,100 |

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16. Income taxes (continued):

The future income tax balances are summarized as follows:

| | 2007 | 2006 |
|---|------------|------------|
| Future income tax assets: | | |
| Non-capital losses | \$ 19,307 | \$ 13,783 |
| Share issue costs and deferred financing fees | 746 | 761 |
| Research and development expenses | 4,549 | 4,638 |
| Intangible assets | 319 | - |
| Other | 3,324 | 343 |
| | 28,245 | 19,525 |
| Less valuation allowance | (28,245) | (19,525) |
| | - | - |
| Future income tax liabilities: | | |
| Intangible assets | (1,154) | (1,204) |
| | (1,154) | (1,204) |
| Net future income tax liabilities | \$ (1,154) | \$ (1,204) |
| Presented as: | | |
| Long-term liabilities | \$ (1,154) | \$ (1,204) |
| | \$ (1,154) | \$ (1,204) |

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16. Income taxes (continued):

The Company has accumulated scientific research and experimental expenditures and non-capital losses which are available to reduce future years' taxable income. Details of the available deductions, before valuation allowance, are as follows:

| | Federal | Provincial | Foreign |
|--|-----------|------------|---------|
| Scientific research and experimental expenditures: | | | |
| Available indefinitely | \$ 20,566 | \$ - | \$ - |
| Non-capital losses expiring: | | | |
| 2011 | - | - | 5,873 |
| 2012 | - | - | 5,002 |
| 2013 | - | - | 6,912 |
| 2014 | - | - | 5,145 |
| 2015 | 2,446 | 2,427 | 9,085 |
| 2016 | - | - | 16,517 |
| 2017 | 9,256 | 9,256 | 16,353 |

17. 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.

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17. Capital stock (continued):

(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 October 16, 2006, the Company issued 192,617 common shares in connection with research and development milestones attained relating to calcitonin gene-related peptide which was acquired as part of the Company's acquisition of Seyvika Holding Inc. in 2003. The common shares had an aggregate market value of \$1,032 (C\$1,173) at the date of issuance.

During the years ended December 31, 2007 and 2006, the Company issued 14,285 and 2,857 shares of common stock, respectively, to an outside consultant for services rendered. The share issuance cost for services rendered was \$90 and \$24, respectively.

18. 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.

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. 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.

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 714,285. 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,

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18. Stock option plan (continued):

under all security based compensation arrangements, cannot exceed 10% of the issued and outstanding common shares. Under the 2002 Plan, the number of common shares available for issuance is equal to 10% of the common shares outstanding. Effective June 2007, no further options can be granted under the 2002 Stock Option Plan. 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 years ended December 31, 2007 and 2006, were as follows:

| | Number | Weighted Average Exercise Price (CDN \$'s) |
|--|-----------|---|
| Balance, December 31, 2005 | 753,818 | \$ 7.84 |
| Granted | 269,393 | 7.70 |
| Cancelled | (57,626) | 7.49 |
| Exercised | (22,776) | 7.28 |
| 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 |
| Options exercisable, December 31, 2007 | 806,104 | \$ 7.55 |

| Exercise Price (CDN \$'s) | Options outstanding | Options exercisable | Weighted average remaining contractual life (years) |
|---------------------------------|------------------------|------------------------|---|
| \$5.81 - 6.50 | 71,784 | 42,856 | 9.11 |
| \$6.51 - 6.80 | 159,620 | 133,906 | 7.75 |
| \$6.81 - 7.00 | 473,834 | 267,590 | 7.97 |
| \$7.01 - 8.50 | 258,307 | 213,189 | 7.75 |
| \$8.51 - 10.85 | 162,848 | 148,563 | 6.05 |
| | 1,126,393 | 806,104 | 7.68 |

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18. Stock option plan (continued):

In March 2008, the Company granted 240,000 options with an exercise price of \$1.12 per share to senior executives.

The following table summarizes information about stock options outstanding and exercisable at December 31, 2007:

| Exercise Price (CDN \$'s) | Options outstanding | Options exercisable | Weighted average remaining contractual life (years) |
|------------------------------|------------------------|------------------------|---|
| \$10.85 | 67,137 | 67,137 | 4.72 |
| \$6.86 | 41,904 | 41,904 | 5.79 |
| \$8.47 | 42,857 | 42,857 | 5.96 |
| \$7.00 | 134,081 | 134,081 | 6.26 |
| \$8.75 | 74,283 | 74,283 | 6.56 |
| \$7.70 | 5,712 | 5,712 | 6.88 |
| \$7.00 | 35,714 | 35,714 | 6.94 |
| \$7.07 | 7,142 | 7,142 | 6.99 |
| \$8.19 | 7,142 | 5,358 | 7.02 |
| \$7.42 | 21,904 | 21,428 | 7.18 |
| \$6.58 | 35,715 | 23,810 | 7.46 |
| \$6.65 | 117,477 | 106,881 | 7.73 |
| \$7.28 | 167,896 | 125,038 | 8.33 |
| \$8.33 | 2,083 | 2,083 | 8.31 |
| \$10.99 | 21,428 | 7,143 | 8.46 |
| \$5.81 | 14,285 | 14,285 | 8.88 |
| \$6.30 | 49,999 | 28,571 | 9.05 |
| \$7.00 | 202,139 | - | 9.29 |
| \$6.86 | 59,996 | 55,891 | 9.47 |
| \$7.49 | 3,571 | 3,571 | 9.51 |
| \$6.72 | 6,428 | 3,215 | 9.64 |
| \$6.12 | 7,500 | - | 9.94 |
| | 1,126,393 | 806,104 | 7.68 |

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19. Warrants and broker units:

As of December 31, 2007, the following warrants were outstanding:

| Number | Exercise price | Expiration Date |
|---------|----------------|-----------------|
| 252,898 | \$ 7.70 | April 22, 2010 |

20. Stock-based compensation:

For the year ended December 31, 2007, the Company granted 279,633 (2006 – 269,393) options. The Company recognized total stock-based compensation of \$997 (2006 – \$886).

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:

| | 2007 | 2006 |
|-------------------------|--------|--------|
| Risk-free interest rate | 4.18% | 4.01% |
| Expected volatility | 63.95% | 65.00% |
| Expected life in years | 6.00 | 5.00 |
| Expected dividend yield | - | - |

The following table summarizes the weighted average grant-date fair value per share for options granted during the years ended December 31, 2007 and 2006:

| | Number of options | Weighted average grant-date fair value (CDN \$'s) |
|---|-------------------|---|
| Exercise price per share equal to market price per share: | | |
| 2007 | 279,633 | 4.31 |
| 2006 | 269,393 | 4.20 |

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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21. Earnings per share:

Because the Company incurred losses in 2007 and 2006, the earnings per share impact of the following stock options, warrants and convertible debentures is considered anti-dilutive and have therefore been excluded from the calculations above:

| | Stock Options | Warrants | Broker Units | Convertible Debentures |
|---------------------------|------------------|----------|-----------------|---------------------------|
| Balance—December 31, 2006 | 942,809 | 57,143 | 1,000 | 334,992 |
| Balance—December 31, 2007 | 1,126,393 | 1 | - | - |

22. Commitments, contingencies and guarantees:

(a) Commitments:

The aggregate maturities of the contractual obligations are as follows:

| | 2008 | 2009 | 2010 | 2011 | 2012+ | Total |
|-------------------|-----------------|--------------|--------------|--------------|--------------|------------------|
| Operating leases | \$ 723 | 602 | 44 | - | - | \$ 1,369 |
| Capital leases * | 190 | 186 | 85 | - | - | 461 |
| Service contracts | 1,043 | 1,004 | 856 | 560 | 47 | 3,510 |
| Clinical studies | 830 | - | - | - | - | 830 |
| Long-term debt * | 575 | 445 | 445 | 445 | 4,969 | 6,879 |
| | \$ 3,361 | 2,237 | 1,430 | 1,005 | 5,016 | \$ 13,049 |

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

The Company is party to an exclusive world-wide master license agreement whereby it was granted licenses to further develop and exploit commercial applications to be derived from a specific invention bearing a United States patent serial number. Under the license agreement, the Company undertakes to pay a royalty of 1.5% to 5% of specified sales, with a minimum annual amount of \$9. This license agreement will expire when the last of the patent rights expire. To date, only the minimum annual payment has been made.

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.

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22. Commitments, contingencies and guarantees (continued):

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 Akela'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 December 31, 2007, the minimum amount of this contingency is \$1.6 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

(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 the Finnish operations, it was notified that this agency was reviewing loans and grants previously made totalling 3,150,000 euros and 955,664 euros, respectively. The agency has not at this time attempted to call the loans but has made a demand for repayment of the grants, together with interest. Discussions with the agency are ongoing and the Company cannot determine if such review will lead to repayment of all or a portion of the grants received. However, 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. This granted European patent contains claims directed to an inhalation device that could be asserted against the Company's TAIFUN® inhalation device. 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; either the granted European patent will likely be

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22. Commitments, contingencies and guarantees (continued):

withdrawn in its entirety or the claims that survive the Opposition likely will not correspond to the Company's TAIFUN® inhalation device. However, an unfavorable outcome may adversely affect the Company's ability to commercialize products utilizing our TAIFUN® inhalation device in Europe. The Company is also aware of a counterpart patent that has issued in the United States. However, the Company reasonably believes that the claims of this U.S. patent, which are not the same as those in the European patent, do not cover the Company's TAIFUN® inhalation device and that the device should not be found to infringe the claims of this U.S. patent.

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 December 31, 2007 and 2006, the Company has not recorded a liability with respect to these guarantees as the Company is not aware of any such claim does not expect to make any payments for the aforementioned items and the standby liability is nominal.

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23. Supplemental cash flow disclosure and other information:

(a) Net changes in operating assets and liabilities:

| | 2007 | 2006 |
|---|------------|------------|
| Accounts receivable | \$ (2,001) | \$ (1,448) |
| Work in progress | - | 168 |
| Research tax credits receivable | - | 698 |
| Prepaid expenses | (511) | (5,096) |
| Accounts payable and accrued liabilities | 5,995 | 2,962 |
| Deferred revenue | 10,785 | 2,623 |
| Amortization of deferred financing fees | - | 433 |
| Amortization of deferred gain of property | - | (56) |
| Deferred rent liability | - | (110) |
| | \$ 14,268 | \$ 174 |

(b) Cash paid for:

| | 2007 | 2006 |
|----------|--------|--------|
| Interest | \$ 238 | \$ 472 |

(c) Non-cash transactions:

| | 2007 | 2006 |
|---|----------|-------|
| Issuance of additional common shares in connection with the acquisition of PharmaForm | \$ 4,379 | \$ - |
| Issuance of contingent shares in connection with the acquisition of PharmaForm | 4,074 | - |
| Issuance of additional common shares in connection with the acquisition of Seyvika | - | 1,032 |
| Settlement of convertible debentures through issuance of common shares | - | 6,200 |
| Services rendered in exchange for shares | 90 | 24 |
| Property and equipment financed through capital leases | 462 | 464 |

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24. Related party transactions:

During 2007 and 2006, the Company incurred legal and tax consulting fees totalling \$387 and \$370, respectively, for professional services provided by two firms associated with the Board of Directors.

During 2007 and 2006, the Company also incurred \$212 and \$213 in expenses for IT consulting services provided by a firm owned by the Chief Executive Officer (CEO). In addition, during 2007 and 2006, the Company incurred expenses of \$488 and \$2,645, respectively, for management services provided by PRI International Consulting Inc., a company directly controlled by the CEO.

In 2007, the Company repaid \$1.5 million of long-term debt payable to non-controlling shareholders. During 2007 and 2006, the Company incurred interest expense of \$65 and \$112, respectively, associated with this debt. As a tenant under a facilities lease held by one of these non-controlling shareholders, the Company also incurred rent expense of \$2,051 and \$880 during the years ended December 31, 2007 and 2006.

During 2007, the Company incurred expenses totaling \$705 for consulting services paid to three current shareholders and the former principal owners of PharmaForm. One of these shareholders is also a member the board of directors.

During the corporate reorganization and disposal of LAB Research Inc. (from August 3 to November 9, 2006), the Company purchased \$362 of inhalation toxicology services from LRI.

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

25. Financial instruments:

(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 and accounts receivable. Cash is maintained with a high credit quality financial institution. For accounts receivable, the Company performs periodic credit evaluations and typically does not require collateral. Allowances are maintained for potential credit losses consistent with the credit risk, historical trends, general economic conditions and other information.

For the year ended December 31, 2007, the Company's three largest customers accounted for approximately 36% of sales. One of these customers accounts for approximately 29% of accounts receivable at year end.

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25. Financial instruments (continued):

(b) Foreign currency risk:

The Company is subject to foreign currency exchange risk as its revenues are primarily received in U.S. dollars and other currencies while a portion of its expenses are paid in Canadian dollars. Its consolidated profitability could therefore be affected by the Canadian/U.S. dollar exchange rate and other exchange rates relative to the Canadian 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 December 31, 2007 and 2006, the Company had not entered into any derivative financial instruments.

(c) Interest rate risk:

The Company's exposure to interest rate fluctuations is with respect to the capital loan in Euros from the Finnish governmental body, which bear interest at floating rates.

(d) Fair value:

Fair value estimates are made as of a specific point in time using available information about the financial instrument. These estimates are subjective in nature and often cannot be determined with precision.

The Company has determined that the carrying values of the Company's short-term financial assets and liabilities are reasonable estimates of their fair values due to the relatively short periods to maturity of these instruments.

The fair value of the capital loan from the Finnish governmental body approximates its carrying values because interest is based on market-related variable rates. The fair value of the other long-term debt is as follows:

| | 2007 | | 2006 | |
|--------------------------------|-----------------|------------|-----------------|------------|
| | Carrying amount | Fair value | Carrying amount | Fair value |
| Long-term debt in Euros (€404) | \$ - | \$ - | \$ 533 | \$ 533 |
| Long-term debt in Euros (€700) | - | - | 923 | 923 |
| Note payable | 1,084 | 1,084 | - | - |
| Capital loan in Euros (€188) | 275 | 275 | 249 | 186 |
| Capital lease obligations | 541 | 541 | - | - |

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26. Segment disclosures:

Following the corporate reorganization and business acquisition described in notes 4 and 6, the Company only operates one reportable segment, Pharma. Prior to these transactions, the Company had two reportable segments: Research services (disposed of in 2006) and Pharma. Segmented financial information for the year ended December 31, 2006 has been restated to conform to the new reporting structure as follows:

| | Year ended December 31, 2006 | | | |
|---|------------------------------------|----------|-----------|-----------|
| | Research Services (7 months) | Pharma | Corporate | Total |
| Revenues | \$ 23,156 | \$ 2,249 | \$ 561 | \$ 25,966 |
| Direct costs | 14,088 | - | - | 14,088 |
| Selling, general and administrative | 4,706 | 3,584 | 5,013 | 13,303 |
| Research and development | - | 11,521 | - | 11,521 |
| Stock-based compensation | 30 | 259 | 597 | 886 |
| Amortization | 1,677 | 1,279 | 396 | 3,352 |
| Interest expense | 304 | 122 | 1,010 | 1,436 |
| Foreign exchange | 22 | 717 | 257 | 996 |
| Restructuring | - | 3,859 | - | 3,859 |
| Gain on disposal of LRI | - | - | (30,111) | (30,111) |
| Share in net income of investee company | - | - | (265) | (265) |
| Income tax expense (recovery) | 2,612 | (86) | 4,574 | 7,100 |
| Segment net earnings (loss) | (283) | (19,006) | 19,090 | (199) |

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26. Segment disclosures (continued):

Revenues were derived from customers located in the following geographic areas:

| | 2007 | 2006 |
|----------------|-----------|-----------|
| United States | \$ 9,882 | \$ 6,869 |
| Denmark | 11 | 5,172 |
| Austria | - | 195 |
| Canada | 522 | 3,201 |
| Finland | 5 | - |
| France | - | 9 |
| Germany | - | 2,432 |
| Hungary | - | 177 |
| Norway | - | 290 |
| Spain | - | 606 |
| United Kingdom | - | 612 |
| Sweden | - | 1,356 |
| Switzerland | - | 1,607 |
| Australia | - | 302 |
| Korea | 32 | 257 |
| Belgium | 643 | 451 |
| Asia - other | 1,496 | 2,003 |
| Europe - Other | 41 | 427 |
| | \$ 12,632 | \$ 25,966 |

Property and equipment and intangible assets by geographic areas are as follows:

| | 2007 | 2006 |
|---------------|-----------|----------|
| Finland | \$ 4,011 | \$ 4,625 |
| Poland | 4 | - |
| Canada | 709 | 395 |
| Barbados | 3,323 | 3,392 |
| United States | 17,800 | - |
| | \$ 25,847 | \$ 8,412 |

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26. Segment disclosures (continued):

| | 2006 |
|--|-----------------|
| Expenditures for segment property and equipment and intangible assets: | |
| Research Services | \$ 1,686 |
| Pharma | 1,623 |
| | <u>\$ 3,309</u> |

Three customers accounted for greater than 10% of sales in 2007:

| | |
|------------|--------|
| Customer A | 12.47% |
| Customer B | 11.83% |
| Customer C | 11.41% |

27. Comparative figures:

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

28. Subsequent events:

- (a) On February 4, 2008, the Company received notice from the United States Food and Drug Administration ("FDA") that, due to Good Laboratory Practice ("GLP") deviations, the six month inhalation toxicology studies of Fentanyl TAIFUN® dry powder inhaler performed for the Company on dogs and rats by a CRO were deemed invalid. No toxicological reasons were cited. The Company intends to repeat the inhalation toxicology studies in their entirety in the United States using a different CRO in 2008. The cost of the repeated studies is estimated to be \$4.5 million. The Company is seeking to recover the cost of the repeated studies from the CRO that conducted the invalidated studies but there is no assurance that this effort will be successful. The Company will be concurrently conducting a Phase III clinical trial outside the United States, primarily in Europe and Asia.
- (b) 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 Cdn \$10,350,000. 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 are expected to be Cdn \$1.0 million. The Company has also granted the underwriters an option to purchase 603,750 common shares at a price of Cdn \$1.20 per share that expires two years from the closing date.