

Consolidated Financial Statements of

AKELA PHARMA INC.

Years ended December 31, 2008 and 2007

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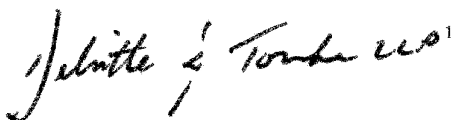
AUDITORS' REPORT TO THE SHAREHOLDERS

We have audited the consolidated balance sheet of Akela Pharma Inc. as at December 31, 2008 and the consolidated statements of operations and comprehensive loss, shareholders' equity and cash flows for the year 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 audit.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2008 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

The consolidated financial statements as at and for the year ended December 31, 2007 were audited by other auditors who expressed an opinion without reservation under date of March 28, 2008.



Montréal, Canada

March 17, 2009, except as to note 27c), which is as of March 26, 2009

(1) Chartered accountant auditor permit no 13556

AKELA PHARMA INC.

Consolidated Financial Statements

Years ended December 31, 2008 and 2007
(in thousands of US dollars)

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AKELA PHARMA INC.

Consolidated Balance Sheets

Years ended December 31, 2008 and 2007

(in thousands of US dollars)

	2008	2007
Assets		
Current assets:		
Cash	\$ 2,345	\$ 6,688
Restricted cash (note 13)	600	-
Accounts receivable (note 9)	6,070	4,806
Prepaid expenses	346	462
	<u>9,361</u>	<u>11,956</u>
Restricted cash and deposits (note 13)	1,258	600
Property and equipment (note 10)	5,229	5,220
Intangible assets (note 11)	4,755	14,170
Goodwill (note 5)	6,457	6,457
Other assets (note 12)	1,397	738
	<u>\$ 28,457</u>	<u>\$ 39,141</u>
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 7,917	\$ 8,873
Deferred revenue	4,515	2,598
Current portion of long-term debt (note 14)	1,311	499
	<u>13,743</u>	<u>11,970</u>
Deferred revenue	16,266	10,145
Long-term debt (note 14)	4,894	5,824
Future income taxes (note 15)	-	1,154
Shareholders' equity:		
Common shares (note 16)	66,346	54,227
Warrants (note 18)	2,814	364
Additional paid-in capital	8,105	11,702
Accumulated other comprehensive income (note 2)	3,110	3,110
Deficit	(86,821)	(59,355)
	<u>(83,711)</u>	<u>(56,245)</u>
Total shareholders' equity	(6,446)	10,048
Commitments, contingencies and guarantees (note 21)		
Subsequent events (note 27)		
	<u>\$ 28,457</u>	<u>\$ 39,141</u>

See accompanying notes to audited consolidated financial statements.

Approved on behalf of the Board of Directors:

(Signed) Yves Glaude, Director

(Signed) John Dempsey, Director

AKELA PHARMA INC.

Consolidated Statements of Operations and Comprehensive Loss

Years ended December 31, 2008 and 2007

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

	2008	2007
Revenues	\$ 14,774	\$ 12,632
Expenses:		
Direct costs	7,730	5,897
Selling, general and administrative	7,103	14,016
Research and development	11,563	17,744
Stock-based compensation <i>(note 19)</i>	477	997
Depreciation of property and equipment	1,866	1,122
Amortization of intangible assets	2,875	2,722
Interest on long-term debt	158	194
Foreign exchange loss (gain)	471	(1,249)
	32,243	41,443
Loss before under noted items	(17,469)	(28,811)
Other expense:		
Impairment of intangible and other assets <i>(note 6)</i>	(9,635)	-
US listing charges <i>(note 7)</i>	-	(3,988)
Loss before income taxes	(27,104)	(32,799)
Recovery of (provision for) income taxes <i>(note 15)</i> :		
Current	-	(62)
Future	1,115	166
	1,115	104
Net loss and comprehensive loss	\$ (25,989)	\$ (32,695)
Basic and diluted net loss per share <i>(note 20)</i>	\$ (1.35)	\$ (2.79)
Basic and diluted weighted average number of shares outstanding <i>(note 20)</i>	19,276,943	11,720,507

See accompanying notes to audited consolidated financial statements.

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Consolidated Statements of Shareholders' Equity

Years ended December 31, 2008 and 2007

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	Common Shares		Warrants	Additional Paid-in Capital	Accumulated other comprehensive		Total
	Number	Dollars			income	Deficit	
Balance, December 31, 2006	10,891,218	\$ 49,758	\$ 366	\$ 6,629	\$ 3,110	\$ (26,660)	\$ 33,203
Purchase of PharmaForm <i>(note 5)</i>	862,791	4,379	-	4,074	-	-	8,453
Services rendered <i>(note 16 (b))</i>	14,285	90	-	-	-	-	90
Expiration of warrants	-	-	(2)	2	-	-	-
Stock-based compensation <i>(note 19)</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
Issuance of units <i>(note 16 (b))</i>	8,625,000	8,045	2,450	-	-	(1,477)	9,018
Purchase of PharmaForm <i>(note 5)</i>	1,222,283	4,074	-	(4,074)	-	-	-
Stock-based compensation <i>(note 19)</i>	-	-	-	477	-	-	477
Net loss	-	-	-	-	-	(25,989)	(25,989)
Balance, December 31, 2008	21,615,577	\$ 66,346	\$ 2,814	\$ 8,105	\$ 3,110	\$ (86,821)	\$ (6,446)

See accompanying notes to audited consolidated financial statements.

AKELA PHARMA INC.

Consolidated Statements of Cash Flows

Years ended December 31, 2008 and 2007
(in thousands of US dollars)

	2008	2007
Cash flows from operating activities:		
Net loss	\$ (25,989)	\$ (32,695)
Adjustments for:		
Depreciation of property and equipment	1,866	1,122
Amortization of intangible assets	2,875	2,722
Impairment of intangible and other assets (note 6)	9,635	-
Stock-based compensation (note 19)	477	997
Unrealized foreign exchange loss (gain)	54	(1,268)
Services rendered for shares	-	90
Future income taxes (note 15)	(1,115)	(166)
Net changes in operating assets and liabilities (note 22(a))	5,486	14,268
	(6,711)	(14,930)
Cash flows from financing activities:		
Restricted cash (note 13)	-	(600)
Repayments of long-term debt	(626)	(1,816)
Proceeds from issuance of units (note 16 (b))	10,200	-
Unit issue costs (note 16 (b))	(1,182)	-
	8,392	(2,416)
Cash flows from investing activities:		
Acquisition of PharmaForm, net of cash (note 5)	-	(8,196)
Deposits (note 13)	(1,258)	-
Acquisition of property and equipment	(4,315)	(2,815)
Addition to intangible assets	(340)	(734)
	(5,913)	(11,745)
Effect of exchange rate changes	(111)	475
Net decrease in cash	(4,343)	(28,616)
Cash, beginning of period	6,688	35,304
Cash, end of period	\$ 2,345	\$ 6,688

See accompanying notes to audited consolidated financial statements.

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Notes to Consolidated Financial Statements

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1. Nature of operations and basis of presentation:

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.

The accompanying consolidated 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 and working capital. As of December 31, 2008, the Company has net current liabilities of \$4,382.

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 and securing financing for its drug development activities. These endeavors are dependent on a number of circumstances outside the Company’s control and there is uncertainty about the Company’s ability to successfully conclude on these matters. As such, the realization of assets and discharge of liabilities in the ordinary course of business are subject to significant uncertainty. Management’s actions and plans with respect to addressing the going concern uncertainty include the following:

- a) In February 2009, Akela announced measures to cut costs in order to preserve cash for its continued operations (see note 27). The reduction in costs is targeted to Akela’s development programs, as well as its service business, PharmaForm. Akela initiated phase III clinical trials in its lead program, Fentanyl TAIFUN®, in the fourth quarter of 2008, and will continue the program with focused scope by limiting the size and the number of clinical trial sites. Having completed a successful phase IIa study of its GHRH product, as well as a regulatory advice process with the FDA, the Company is pursuing out-licensing of the product for further development. The measures undertaken are necessary to conserve cash and allow sufficient time for the Company to continue its efforts in financing, and merger and acquisition activities.
- b) On March 10, 2009, Akela agreed to accept a payment of \$2,000 Cdn (\$1,562 US) and 500,000 warrants with an exercise price of \$0.50 Cdn (\$0.39 US) from LAB Research Inc. as full and final settlement of its lawsuit relating to a failed Fentanyl TAIFUN® toxicology study (see note 27).
- c) The Company has and is continuing to implement plans to increase its operational efficiency and profitability, as well as to reduce operational costs (see note 27).

Management believes that the above actions, together with securing financing for our drug development activities, 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 pursue drug development activities.

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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 were as of that date denominated in US 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. The change in the functional currency resulted in a currency translation adjustment of \$3,110 as of December 31, 2006, which is reflected in accumulated other comprehensive income, a separate component of shareholders' equity.

3. Significant accounting policies:

(a) New accounting policies:

- i) Effective January 2008, the Company adopted the Canadian Institute of Chartered Accountants ("CICA") Handbook Section 1535, *Capital Disclosures*, CICA Handbook Section 3862, *Financial Instruments – Disclosure*, and CICA Handbook Section 3863, *Financial Statements - Presentation*. Handbook section 1535 establishes standards for disclosing information about an entity's capital and how it is managed. Sections 3862 and 3863, which replace existing Section 3861, *Financial Instruments – Disclosure and Presentation*, are enhanced and expanded to complement the changes in accounting policy adopted in the prior year in accordance with Section 3855, *Financial Instruments – Recognitions and Measurement*.
- ii) The CICA amended Handbook Section 1400, *General Standards of Financial Statement Presentation*, to include a requirement that Management make an assessment of an entity's ability to continue as a going concern when preparing financial statements. This change, including the related disclosure requirements, came into effect for the Company on January 1, 2008.

The additional disclosures required as a result of the adoption of these standards appear in notes 1, 24 and 25.

(b) Principles of consolidation:

The consolidated financial statements include the consolidated accounts of the Company and its wholly-owned subsidiaries. All significant intercompany balances and transactions have been eliminated on consolidation.

(c) 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, 2008 and 2007, the Company had no cash equivalents.

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(d) *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 over the estimated useful lives 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	Term of lease
Automotive equipment	5 to 7 years

(e) *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 the estimated useful lives 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 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

(f) *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 write downs 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.

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(g) *Financial instruments:*

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 initially at fair value. Loans and receivables, investments held-to-maturity and other financial liabilities are subsequently measured at amortized cost. 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 or the losses are permanent.

Cash and cash equivalents are classified as held for trading. Restricted cash and deposits are classified as held-to-maturity. Accounts receivable are classified as loans and receivables and accounts payable and accrued liabilities and long-term debt are classified as other financial liabilities.

(h) *Transaction costs:*

Transaction costs related to held-for-trading financial assets are expensed as incurred. Transaction costs related to other liabilities and loans and receivables are added to the carrying value of the asset or netted against the carrying value of the liability and are then recognized over the expected life of the instrument using the effective interest method.

(h) *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.

(i) *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.

(j) *Revenue recognition:*

The Company derives its revenues from licensing and co-development agreements and through providing contract services such as drug formulation, drug development and limited run drug manufacturing for pharmaceutical and biotech companies. Deferred revenues associated with co-development represent deferred license fees and payments received in advance of services being performed, milestones being reached or from final deliverables being provided. Upfront and milestone payments which require the Company's ongoing involvement are deferred and amortized into income over the estimated period of service.

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

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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.

Arrangements 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.

(k) Research and development expenses:

Research and development costs (development costs did not meet the criteria for capitalization pursuant to Canadian generally accepted accounting principles, "GAAP") 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.

(l) 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.

(m) 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

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in the case of 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.

The foreign subsidiaries of the Company are considered to be integrated. As a result, the subsidiary accounts are translated into US dollars using the temporal method. Under this method, monetary assets and liabilities are translated at the exchange rates in effect as the balance sheet date and any resulting foreign exchange gain or loss is reflected in the consolidated statement of operations. Non-monetary assets and liabilities are translated at historic rates. Revenue and expenses are translated at the average exchange rate during the period. Foreign exchange gains or losses are included in the consolidated statement of operations.

(n) 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.

(o) 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.

(p) Leases:

Leases are classified as either capital or operating in nature. Capital leases are those which substantially transfer the benefits and risks of ownership to the lessee. Assets acquired under capital leases are amortized over their expected useful lives using the straight-line method. Obligations under capital leases are reduced by the principle portion of lease payments. The imputed interest portion of lease payments is charged to expense.

(q) 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 require the use of management estimates; such as estimating the future cash flows for purposes of assessing the going concern assumption, 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 assets and liabilities in connection with business combinations and goodwill impairments, as well as estimating stock-based compensation and the recoverability of research tax credits receivable and long-lived asset impairment assessments, future tax assets and the fair value of financial instruments. 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.

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(r) *Future accounting changes:*

- i) Section 3064, *Goodwill and Intangible Assets*, replacing Section 3062, *Goodwill and Other Intangible Assets*, and Section 3450, *Research and Development Costs*. Various changes have been made to other sections of the CICA Handbook for consistency purposes. The new section, issued in February 2008, is applicable to financial statements relating to fiscal years beginning on or after October 1, 2008. It establishes standards for the recognition, measurement, presentation and disclosure of goodwill subsequent to its initial recognition and of intangible assets by profit-oriented enterprises. Standards concerning goodwill are unchanged from the standards included in the previous Section 3062. The Company is currently evaluating the impact of the adoption of this new Section and amendments to the consolidated financial statements.
- ii) *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 has not yet determined the impact of the adoption of this new Section on its consolidated financial statements.
- iii) 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.
- iv) 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.
- v) Section 1602, *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 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.

4. Development and license agreements:

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

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.

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The Company will manufacture and Janssen will market and distribute the product. Under the terms of the agreement, the Company received a signing fee of \$10,700 (€ 8,000) which has been deferred and is being recognized ratably over the estimated development period. The Company can receive up to an additional \$67,000 (€ 44,000) for meeting development, regulatory and commercial sales milestones. The Company could also receive royalty revenues and revenues from the sales of the product to Janssen. In December 2007, the Company extended the territory coverage of the initial license and development agreement to include Canada for a consideration of \$1,100 which has been deferred and is being recognized ratably over the estimated development period. In May 2008, the original agreement was amended in support of the development effort and to secure timely advancement of the Phase III clinical trials. Under the terms of the amended agreement, advanced milestone payments of \$3,500 (€ 2,500) were payable on the first local regulatory approval of the Phase III protocol and \$2,800 (€ 2,000) on the first clinical site readiness. An additional milestone of \$3,600 (€ 2,500) was due as of the inclusion of the 7th patient in the Phase III clinical study. The Company triggered the advance milestones in August and September 2008 and the resulting payments received have been deferred and are being recognized ratably over the estimated development period. Akela achieved the final milestone in December 2008, the proceeds of which were received in January 2009. (See Note 21).

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 has received a signing fees of \$600 (€ 500) 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.

5. Business acquisition:

On January 25, 2007, the Company completed the acquisition of all of the outstanding membership interests of Formulation Technologies, L.L.C. (doing business as "PharmaForm") a privately held company headquartered in Austin, Texas. The acquisition of PharmaForm added FDA and DEA approved specialized drug formulation and 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 payment at closing amounted to \$12,999 including \$8,620 of cash (including transaction costs) and 862,791 common shares valued at approximately \$4,379. Under the terms of the share purchase agreement additional consideration was payable to the previous owners of PharmaForm if its gross revenues exceed \$10,000 for the 2007 calendar year. On December 31, 2007, this milestone had been achieved and shares having a value of \$4,074 were issued on March 31, 2008 ("Phase II distribution").

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

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

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Future contingent payments under the purchase agreement include:

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

As of December 31, 2008, the maximum remaining contingent consideration payable by the Company is approximately \$9,000, most of which is payable in common shares of the Company. Any further purchase price consideration paid by the Company will be accounted for as additional goodwill. All obligations to make contingent payments will terminate on January 25, 2012. Each of the Phase I and III contingent payments will be made in common shares in an amount of \$4,375 plus \$100 per Phase, payable either in cash or in common shares at the option of the selling shareholders. As of December 31, 2008, the requisite product development milestones described under the terms the Phase I and III contingent payments had not been achieved.

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

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.

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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)
	\$ 17,073
Consideration:	
Cash	\$ 7,500
862,791 common shares	4,379
1,222,283 common shares, phase II distribution	4,074
Transaction costs, of which \$828 were incurred prior to December 31, 2006	1,120
	\$ 17,073

6. Impairment of intangible and other assets:

Given the Company's cost of capital, current limited availability of liquid resources and the continued and additional financing required, the availability of which is uncertain, to sustain Akela's development programs, management determined that the carrying value of certain assets would not be recoverable as of December 31, 2008. An impairment of intangible and other long-term assets associated with Fentanyl Taifun® and Akela's phase II product candidates, principally CGRP, resulted in charges of \$5,947 and \$3,688, respectively; a total one-time noncash write off of \$9,635. As part of the company's cost reduction effort announced in February 2009, management has decided to continue the Fentanyl Taifun® program with focused scope by limiting the size and the number of clinical trial sites. The Company has given notice of its intent to terminate its licensing agreement to CGRP, and the GHRH program has been placed on hold until an out-licensing agreement or program specific financing is secured. (See notes 1, 11 and 12).

				2008
	Cost	Accumulated amortization	Impairment	Net carrying amount
Intellectual property rights acquired	\$ 9,591	\$ 3,327	\$ 3,354	2,910
Licenses	3,484	1,507	1,977	-
Patents	2,136	347	1,789	-
Trademarks	18	14	4	-
Deposits for leases and laboratory equipment	3,908	-	2,511	1,397
	\$ 19,137	\$ 5,195	\$ 9,635	\$ 4,307

The Company's impairment triggered the recovery of \$935 in deferred tax liabilities associated with the carry value of intellectual property (see note 15).

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7. 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.

8. Restructuring:

In order to streamline its operations, the Company adopted a plan in December 2006 to transfer certain activities from Finland to Austin, Texas by October 31, 2007. In connection with this plan, the Company terminated approximately 35 employees, and recorded a restructuring charge of \$3,858 which included a \$3,523 impairment loss on property and equipment and \$265 for employee severance. At December 31, 2008 and December 31, 2007, nil and \$128, respectively of accrued severance costs remain unpaid and are included in "Accrued liabilities" on the consolidated balance sheet.

On March 5, 2007, the Finnish subsidiary and its landlord agreed to an early termination of their lease agreement. The agreement required 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 March 2007.

9. Accounts receivable:

	2008	2007
Trade	\$ 5,875	\$ 4,417
Sales taxes	62	248
Other	133	141
	<u>\$ 6,070</u>	<u>\$ 4,806</u>

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10. Property and equipment:

	2008		
	Cost	Accumulated amortization	Net carrying amount
Laboratory equipment	\$ 4,552	\$ 998	\$ 3,554
Computer equipment and software	935	625	310
Furniture and office equipment	477	137	340
Leasehold improvements	2,321	1,365	956
Automotive equipment	152	83	69
	\$ 8,437	\$ 3,208	\$ 5,229

	2007		
	Cost	Accumulated amortization	Net carrying amount
Laboratory equipment	\$ 2,940	\$ 353	\$ 2,587
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
	\$ 6,582	\$ 1,362	\$ 5,220

Depreciation expense related to assets under capital leases was \$127 (2007-\$20). During 2008, \$3,808 of fully depreciated manufacturing equipment associated with the Company's Finnish subsidiary was written off. (See note 8).

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11. Intangible assets:

	2008			
	Cost	Accumulated amortization	Impairment	Net carrying amount
Intellectual property rights acquired	\$ 9,591	\$ 3,327	\$ 3,354	2,910
Licenses	3,484	1,507	1,977	-
Customer contracts and relationships	2,000	1,278	-	722
Patents	2,136	347	1,789	-
Non-competition agreement	1,400	894	-	506
FDA/DEA certifications	1,000	383	-	617
Trademarks	18	14	4	-
	\$ 19,629	\$ 7,750	\$ 7,124	\$ 4,755

	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

At December 31, 2008 management determined that the carrying value of intangibles associated with Fentanyl Taifun® and Akela's phase II product candidates, principally CGRP, would not be recoverable. An impairment of intellectual property rights, licenses, patents and trademarks associated with these product lines resulted in charges of \$3,436 and \$3,688, respectively. (See notes 1, 6 and 12).

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12. Other assets:

	2008		2007	
Deposits for leases and laboratory equipment	\$	1,397	\$	738
	\$	1,397	\$	738

At December 31, 2008 management determined that the carrying value of certain deposits for the development of commercial TAIFUN® injection moulds would not be recoverable. At December 31, 2008, the Company recorded an impairment charge of \$2,511 to write down these deposits to reflect a reasonable estimate of their fair value as of that date. (See notes 1, 6 and 11).

13. Restricted cash and deposits:

Restricted cash and deposits as of December 31, 2008 consists of a \$600 certificate of deposit pledged as collateral on a \$1,200 term loan repayable in May 2012 (see note 14) and a \$1,258 cash deposit required as security for a 15 year office lease commencing on November 1, 2008 for the Company's new laboratory facility in Austin, Texas.

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14. Long-term debt:

	December 31, 2008	December 31, 2007
Capital loans in Euros (2008 - €2,539 ; 2007 - €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 four years; interest or other remuneration are conditional on specified equity requirements in the Company's Finnish subsidiary. For the years ended December 31, 2008 and 2007 no interest was payable on this unsecured debt.	3,542	3,702
Capital loans in Euros (2008 - €188; 2007 - €188) bearing interest at 5%; interest or other remuneration are conditional on specified equity requirements in the Company's Finnish subsidiary. For the years ended December 31, 2008 and 2007 no interest was payable on this unsecured debt.	263	275
Note payable in Euros (2008 - €494; 2007 - €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 with capital repayments beginning in 2011. At December 31, 2008, the effective interest rate on this unsecured debt was 1.46%.	689	721
Note payable, bearing 8.75% interest, repayable over 60 months to May 2012, secured by a 1 st lien on accounts receivable and property and equipment and by \$600 of restricted cash (see note 13). At December 31, 2008 the current and debt coverage ratios required as part of Akela's covenant with the lender were not achieved. As the lender has the right to demand immediate repayment, the outstanding balance of this note has been classified as current. No demand for repayment of this debt has been made. (See note 26).	874	1,084
Capital lease obligations, bearing interest from 6% to 10.11%, secured by related laboratory equipment	819	541
Auto loan, bearing 8.5% interest, secured by the related automobile	18	-
	6,205	6,323
Current portion of long-term debt	1,311	499
	\$ 4,894	\$ 5,824

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

2009	1,311
2010	293
2011	337
2012	230
2013	229
Thereafter	3,805
	<u>\$ 6,205</u>

Minimum lease payments included above under obligations for capital leases are as follows: 2009, \$434; 2010, \$296; 2011, \$107.

15. 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:

	2008	2007
Loss before income taxes	(27,646) \$	(32,799)
Combined Canadian federal and Quebec provincial income taxes at 30.9% (2007 - 32%)	(8,543)	(10,497)
Adjustments for:		
Difference with foreign tax rates	750	3,090
Foreign exchange	1,834	-
Tax rates variation	1,455	-
Change in valuation allowance and benefit of losses not recorded	3,752	6,968
Stock-based compensation	156	347
Permanent differences and other	(519)	(12)
Income tax (recovery) provision	\$ (1,115) \$	(104)

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

	2008	2007
Current income taxes	\$ -	\$ 62
Future income taxes	(1,115)	(166)
	<u>\$ (1,115)</u>	<u>\$ (104)</u>

The Company's impairment of intangibles and other assets in 2008 triggered the recovery of \$935 in deferred tax liabilities associated with the carrying value of intellectual property (see notes 6 and 11).

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The future income tax balances are summarized as follows:

	2008	2007
Future income tax assets:		
Non-capital losses	\$ 22,621	\$ 19,307
Share issue costs	478	746
Research and development expenses	4,858	4,549
Intangible assets	519	319
Deferred revenues	5,436	3,324
Other	639	-
	34,551	28,245
Future income tax liabilities:		
Unrealized foreign exchange gain	(2,554)	-
Intangible assets	-	(1,154)
	(2,554)	(1,154)
Less valuation allowance	(31,997)	(28,245)
Net future income tax liabilities	\$ -	\$ (1,154)
Presented as:		
Long-term liabilities	\$ -	\$ (1,154)
	\$ -	\$ (1,154)

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	\$ 18,060	\$ -	\$ -
Non-capital losses expiring:			
2012	-	-	2,614
2013	-	-	6,912
2014	1,319	1,321	5,145
2015	4,417	4,416	9,085
2016	-	-	16,937
2017	2,364	2,353	16,983
2018	2,951	2,951	19,805

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16. Capital stock:

Effective October 10, 2007, the Company's Board of Directors, as authorized by the shareholders, declared 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. These consolidated financial statements have been presented as if the stock split had occurred January 1, 2007.

(a) Capital stock consists of an unlimited number of preference and common shares:

(i) Preference shares

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

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

(ii) Common shares

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

(b) Issuance of capital stock:

On March 27, 2008, the Company concluded a public offering of 8,625,000 units, each unit consisting of one common share and one-half of one common share purchase warrant, for aggregate proceeds of \$10,200 (Cdn \$10,350). The proceeds of the units offering were allocated based on the relative fair value of the common shares, \$8,045 (Cdn \$8,164), and common share purchase warrants, \$2,155 (Cdn \$2,186), using the Black-Scholes pricing model at the date of grant. 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.

As compensation for the offering, the Company granted the underwriters common share purchase warrants (Compensation Options) bearing a fair value of \$295 (Cdn \$299). Each Compensation Option is exercisable to purchase 603,750 common shares at a price of Cdn \$1.20 per share that expires two years from the closing date.

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Expenses in connection with the offering were approximately \$1,477 (Cdn \$1,499), which includes the fair value of the Compensation Options, \$295, and \$1,182 for underwriters' fees (\$714), legal and other offering costs (\$468).

The fair value of the common share purchase warrants and compensation options was determined using the following Black-Scholes pricing model assumptions:

	Purchase Warrants	Compensation Options
Strike price (Cdn)	\$ 1.50	\$ 1.20
Risk-free interest rate	2.64%	2.57%
Expected volatility	71.03%	73.76%
Expected life in years	3	2

On March 31, 2008, the Company issued 1,222,283 shares of common stock to the former owners of PharmaForm as consideration for meeting a gross revenue milestone as of December 31, 2007. This \$4,074 Phase II distribution of common shares was recorded as a reclassification from additional paid in capital. (See note 5).

During 2007, the Company issued 14,285 shares of common stock having a value of \$90 to an outside consultant for services rendered.

17. Stock option plans:

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. Effective June 2007, no further options can be granted under the 2002 Stock Option Plan.

In June 2007, the shareholders approved the 2007 Stock Incentive Plan. Under the 2007 Stock Incentive Plan, the aggregate number of common shares available for issuance is 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, under all security based compensation arrangements, cannot exceed 10% of the issued and outstanding common shares.

The Company may also issue restricted and unrestricted stock awards at a price that may be less than fair market value, subject to restrictions and conditions, if applicable, as the administrator may determine at the time of the grant.

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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, 2008 and 2007, were as follows:

	Number	Weighted Average Exercise Price (CDN \$'s)
Balance, December 31, 2006	942,809	7.84
Granted	279,633	6.95
Cancelled	(96,049)	8.66
Balance, December 31, 2007	1,126,393	7.43
Granted	478,000	1.19
Balance, December 31, 2008	1,604,393	\$ 5.57
Options exercisable, December 31, 2008	1,021,395	\$ 7.44

Range of exercise prices (CDN)	Options outstanding	Weighted average exercise price (CDN)	Options exercisable	Weighted average exercise price (CDN)	Weighted average remaining contractual life (years)
\$10.86 - 10.99	21,428	\$ 10.99	14,286	\$ 10.99	7.33
\$8.51 - 10.85	141,420	\$ 9.75	141,420	\$ 9.75	4.60
\$7.01 - 8.50	258,308	\$ 7.53	236,879	\$ 7.55	6.58
\$6.81 - 7.00	473,833	\$ 6.97	402,406	\$ 6.96	6.62
\$6.51 - 6.80	159,620	\$ 6.64	159,620	\$ 6.64	6.63
\$5.81 - 6.50	71,784	\$ 6.18	66,784	\$ 6.19	7.91
\$0.61 - 1.38	478,000	\$ 1.19	-	-	-
\$0.61 - 10.99	1,604,393	\$ 5.57	1,021,395	\$ 7.44	6.43

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18. Warrants and broker units:

As of December 31, 2008, the following warrants were outstanding (see note 16):

Warrants		Common share equivalents	Exercise price (CDN)	Expiration Date
Number	Fair value at issuance (USD)			
1	\$ 364	252,898	\$ 8.96	April 22, 2010
4,312,500	2,155	4,312,500	\$ 1.50	March 28, 2011
603,750	295	603,750	\$ 1.20	March 28, 2010
4,916,251	\$ 2,814	5,169,148		

19. Stock-based compensation:

For the year ended December 31, 2008, the Company granted 478,000 (2007 – 279,633) options. The Company recognized total stock-based compensation of \$477 (2007 – \$997).

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

	2008	2007
Risk-free interest rate	3.02%	4.18%
Expected volatility	79.17%	63.95%
Expected life in years	6.00	6.00
Expected dividend yield	-	-

The following table summarizes the weighted average grant-date fair value per share for options granted during the years ended December 31, 2008 and 2007:

	Number of options	Weighted average grant-date fair value (CDN \$'s)
Exercise price per share equal to market price per share:		
2008	478,000	0.81
2007	279,633	4.31

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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20. Earnings per share:

Because the Company incurred losses in 2008 and 2007, 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
Balance—December 31, 2007	1,126,393	1
Balance—December 31, 2008	1,604,393	4,916,251

21. Commitments, contingencies and guarantees:

(a) Commitments:

The aggregate maturities of the contractual obligations are as follows:

	2009	2010	2011	2012	2013	2014+	Total
Operating leases	1,797	2,003	1,217	1,253	1,253	12,253	\$ 19,776
Capital leases *	896	385	109	-	-	-	1,390
Service contracts	921	795	560	47	-	-	2,323
Clinical studies	1,587	-	-	-	-	-	1,587
Product development	330	-	-	-	-	-	330
Long-term debt *	1,171	13	243	267	243	3,782	5,719
	6,702	3,196	2,129	1,567	1,496	16,035	\$ 31,125

* Long-term debt and capital leases include principal and related interest and \$411 in purchase commitments to acquire laboratory equipment and software.

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 December

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31, 2008, the minimum amount of this contingency is \$2.2 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 expenses. Failure to comply with these conditions will 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 100% of 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 December 31, 2008, the Company has not recorded a liability with respect to this guarantee.

(b) Contingencies:

The Company's Finnish subsidiary received certain low interest loans and grants from a Finnish governmental agency. In the summer of 2007, following the Company's decision to down-size its Finnish operations, it was notified that this agency was reviewing loans and grants previously made totaling €3,150 and €956, respectively. The agency has concluded that the loans would not be collected prematurely at this time but has made a demand for repayment of the grants, together with interest. The Company has filed an appeal against this decision with the Turku Administrative Court, and 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. At December 31, 2008 and 2007, the Company has not recorded a liability with respect to the grants as the Company has inter palia pointed out that all the funding has been used according to the relevant applications and there has been no misuse of the funds. The matter is still pending at the Turku Administrative Court.

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

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third-party with respect to the Company's activities under the agreement. At December 31, 2008 and 2007, the Company has not recorded a liability with respect to these guarantees as the Company is not aware of any such claim and does not expect to make any payments for the aforementioned items and the standby liability is nominal.

22. Supplemental cash flow disclosure and other information:

(a) Net changes in operating assets and liabilities:

	2008	2007
Accounts receivable	\$ (1,264)	\$ (2,001)
Prepaid expenses	116	(511)
Accounts payable and accrued liabilities	(1,404)	5,995
Deferred revenue	8,038	10,785
	\$ 5,486	\$ 14,268

(b) Cash paid for:

	2008	2007
Interest	\$ 135	\$ 238

(c) Non-cash transactions:

	2008	2007
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 warrants to underwriters as compensation for March 27, 2008 public offering (note 16(b))	295	-
Services rendered in exchange for shares	-	90
Property and equipment financed through capital leases	712	462

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23. Related party transactions:

During 2008 and 2007, the Company incurred legal and tax consulting fees totaling \$201 and \$395, respectively, for professional services provided by two firms associated with the Board of Directors.

During 2008 and 2007, the Company also incurred \$71 and \$212 in expenses for IT consulting services provided by a firm owned by our former Chief Executive Officer (CEO), a current member of the Board of Directors. In addition, during 2008 and 2007, the Company incurred expenses of \$307 and \$488, respectively, for management services provided by PRI International Consulting Inc., a company directly controlled by this board member.

In 2007, the Company repaid \$1.5 million of long-term debt payable to non-controlling shareholders. During 2007, the Company incurred interest expense of \$65 on 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 during 2007.

During 2008 and 2007, the Company incurred expenses totaling \$632 and \$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.

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

24. Financial instruments:

(a) *Classification:*

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

December 31, 2008	Held-for-trading	Loans and receivables	Held-to-maturity	Other financial liabilities	Carrying value	Fair value
Cash	\$ 2,345				\$ 2,345	\$ 2,345
Accounts receivable		6,070			6,070	6,070
Restricted cash and deposits			1,858		1,858	1,858
Accounts payable and accrued liabilities				7,917	7,917	7,917
Long-term debt				6,205	6,205	2,110

December 31, 2007	Held-for-trading	Loans and receivables	Held-to-maturity	Other financial liabilities	Carrying value	Fair value
Cash	\$ 6,688				\$ 6,688	\$ 6,688
Accounts receivable		4,806			4,806	4,806
Restricted cash		600	600		1,200	1,200
Accounts payable and accrued liabilities				8,873	8,873	8,873
Long-term debt				6,323	6,323	6,323

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(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) *Held-for-trading*

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

(iii) *Held-to-maturing*

Restricted cash and deposits – Restricted cash and deposits are classified as “held to maturity” as these are cash deposits which have been pledged as collateral and security on certain debt and leases which have fixed maturities. Due to its inherent liquidity and the fact that it must be available to finance the Company's operations, the carrying value is considered a reasonable approximation fair value.

(vi) *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 year-end market 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 December 31, 2008 and 2007, the carrying amount of financial assets that the Company has pledged as collateral for long-term debt facilities was approximately \$9.5 million and \$8.8 million, respectively.

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25. Financial risk management:

The following is a discussion of the Company's exposure to and management of financial 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 years ended December 31, 2008 and 2007, the Company wrote off \$100 and nil of receivables and recorded an additional provision of \$150 and nil 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 twelve months ended December 31, 2008 only one customer accounted for greater than 10% of sales. During 2008, approximately 14% of the Company's revenues were derived from this customer and as of December 31, 2008, this customer accounted for approximately 57% of accounts receivable.

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

	As of December 31, 2008
Total accounts receivable	\$ 6,220
Of which:	
Not overdue	5,406
Past due for more than one day but for not more than three months	554
Past due more for than three months but for not more than six months	260
Total accounts receivable, gross	\$ 6,220
Allowance for doubtful accounts	(150)
Total accounts receivable, net	\$ 6,070

(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 profitability could therefore be affected by the Canadian and Euro/US dollar exchange rate and other exchange rates relative to the US dollar, which exchange rates may fluctuate over time and cannot be accurately predicted. From time to time, the Company engages in the use of derivative financial instruments to manage its currency exposure. At December 31, 2008 and 2007, the Company had not entered into any derivative financial instruments.

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The following is a breakdown of financial instruments by foreign currency as of December 31, 2008:

(in thousands of US dollars)	December 31,				
	\$Cdn	Euro	\$Bds	INR	Total
Cash	\$ 461	\$ 717	\$ 24	\$ 151	1,353
Accounts receivable	64	3,665	4	-	3,733
Accounts payable and accrued liabilities	1,429	1,978	210	13	3,630
Long-term debt	-	4,494	-	18	4,512
	\$ 1,954	\$ 10,854	\$ 238	\$ 182	\$ 13,228

The following exchange rates applied during the reporting period and for the twelve months ended December 31, 2008:

<u>Currency</u>	<u>Exchange</u>	<u>Average</u>	<u>Closing</u>
Canadian dollar	US/Cdn	0.9428	0.8210
Euro	US/Euro	1.4695	1.3951
Barbadian	US/Bds	0.5076	0.5096
Indian Rupee	US/INR	0.0232	0.0207

Based on the Company's foreign currency exposure, varying the above exchange rates to reflect a 5% strengthening of the U.S. dollar would have decreased the net loss by \$100, assuming all other variables remained constant with an equal and opposite effect if the U.S. dollar weakened by 5%.

(c) *Interest rate risk:*

The Company's exposure to interest rate risk primarily arises from a loan in Euros from the Finnish governmental body, which bears interest at floating rates. As of December 31, 2008, \$0.7 million of the Company's total debt portfolio was subject to movement in floating interest rates. A 1% change in interest rates would have an effect on the loss from continuing operations before income taxes for the twelve months ended December 31, 2008 of approximately \$7. The Company currently does not have any outstanding credit facilities, other than those described in note 14 Long-term debt.

(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.

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The following are the contractual maturities of financial liabilities as of December 31, 2008:

	Carrying Amount	Less than 1 year	1 to 3 years
Accounts Payable and accrued liabilities	\$ 7,917	7,917	-
Operating leases	19,776	1,797	3,220
Capital leases *	1,390	896	879
Service contracts	2,323	921	1,355
Clinical studies	1,587	1,587	-
Product development	330	330	-
Long-term debt *	5,719	1,171	256
	\$ 39,042	14,619	5,710

* Long-term debt and capital leases include principal and related interest and \$411 in purchase commitments to acquire laboratory equipment and software.

Given the Company's current limited availability of liquid resources as compared to the timing of the payments and liabilities, and the continued and additional financing required in the current financial conditions, the Company's liquidity risk is considered to be high.

26. Capital Management

The Company's objectives when managing capital are:

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

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

In order to ensure the availability of immediate capital, the Company implemented a cost reduction plan in February 2009 (see note 27) which includes a reduction in the scope of Akela's product development programs and an acceleration in the productivity of the Akela's subsidiary, PharmaForm, a profitable provider of contract formulation and drug development services. To ensure the availability of current capital resources in the coming twelve months, the Company may also attempt to issue new equity securities, issue new debt or pursue various other funding alternatives.

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At December 31, 2008 the Company did not achieve the following externally imposed capital requirements associated with a term loan repayable in May 2012.

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

As the lender has the right to demand immediate repayment, the outstanding loan balance, \$874, and a \$600 cash deposit pledged as collateral have been classified as current. No demand for repayment of this note has been made. (See notes 13 and 14).

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

27. Subsequent events:

- (a) In February 2009, Akela announced measures to cut costs in order to preserve cash for its continued operations. The reduction in costs is targeted to Akela's development programs, as well as its service business, PharmaForm. The Company initiated its Phase III clinical trial for its lead compound, Fentanyl TAIFUN®, in December 2008 and will continue this program with a more focused scope. The Company expects to record a one time charge of approximately \$700 (\$0.03 per share) in employee severance in the first quarter of 2009.
- (b) On March 10, 2009, the Company agreed to accept a payment of \$2,000 Cdn (\$1,562 US) and 500,000 warrants with an exercise price of \$0.50 Cdn (\$0.39 US) from LAB Research Inc. as full and final settlement of its lawsuit relating to a failed Fentanyl TAIFUN® toxicology study.
- (c) On March 26, 2009, the Company entered into an agreement to combine Akela and Nventa Biopharmaceuticals Corporation ("Nventa") by way of a plan of arrangement under the Business Corporations Act (British Columbia). The board of directors of both companies unanimously approved the agreement. The transaction will be effected by an exchange of Akela common shares for the outstanding shares of Nventa on the basis of 0.0355 Akela shares for each Nventa share (or 1 Akela share for 28.169 Nventa shares), resulting in an approximate 70/30 ownership split between Akela and Nventa shareholders, respectively, in the combined entity. The public company will retain Akela's name, will operate under Akela's management, and will continue to be listed on the Toronto Stock Exchange under the ticker symbol AKL. Nventa will have the right to nominate two directors to the board of directors of Akela. The transaction is subject to a number of conditions including approval of the Toronto Stock Exchange for the listing of the common shares of the Company issuable to the shareholders of Nventa and to the favourable votes of not less than two-thirds of the votes cast in respect of the transaction by the shareholders of Nventa at a meeting of shareholders. In addition, both parties have the right to terminate their obligations under the agreement in certain events, including the entering into of a superior proposal, and upon payment, in the event of termination in certain circumstances, of a break fee of \$250,000. Subject to the satisfaction of certain customary closing conditions, including a minimum amount of \$1.5M of net cash in Nventa, the transaction is expected to close in May 2009.