Cipher Pharmaceuticals Inc.

Consolidated Financial Statements

December 31, 2016

March 1, 2017

Independent Auditor's Report

To the Shareholders of
Cipher Pharmaceuticals Inc.

We have audited the accompanying consolidated financial statements of Cipher Pharmaceuticals Inc. and its subsidiaries, which comprise the consolidated balance sheets as at December 31, 2016 and December 31, 2015 and the consolidated statements of income (loss) and comprehensive loss, changes in shareholders' equity and cash flows for the years then ended, and the related notes, which comprise a summary of significant accounting policies and other explanatory information.

Management's responsibility for the consolidated financial statements
Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's responsibility
Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

Opinion
In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Cipher Pharmaceuticals Inc. and its subsidiaries as at December 31, 2016 and December 31, 2015 and their financial performance and their cash flows for the years then ended in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board.

(Signed) "PricewaterhouseCoopers LLP"

Chartered Professional Accountants, Licensed Public Accountants

Cipher Pharmaceuticals Inc.
Consolidated Statements of Financial Position

As at December 31
(in thousands of United States dollars)

	Note	2016	2015
		$	$
ASSETS			
Current assets			
Cash		**34,486**	27,182
Accounts receivable		**14,644**	16,303
Inventory	8	**1,272**	1,248
Prepaid expenses and other assets	7	**1,767**	4,045
		52,169	48,778
Property and equipment, net	9	**790**	286
Intangible assets, net	10,11	**17,582**	46,114
Goodwill	10,11	**-**	6,112
Deferred tax assets	16	**6,864**	8,356
Total assets		**77,405**	109,646
LIABILITIES			
Current liabilities			
Accounts payable and accrued liabilities		**16,003**	13,354
Provisions	12	**4,769**	4,423
Current portion of deferred revenue		**176**	743
		20,948	18,520
Deferred revenue		**487**	102
Senior secured notes, net of issuance cost	7	**36,377**	34,578
Derivative financial instrument	7	**583**	1,758
Other long term liabilities		**996**	431
Total liabilities		**59,391**	55,389
SHAREHOLDERS' EQUITY			
Share capital	13	**16,192**	14,947
Contributed surplus		**6,024**	4,363
Accumulated other comprehensive loss		**(9,514)**	(9,514)
Retained earnings		**5,312**	44,461
Total shareholders' equity		**18,014**	54,257
Total liabilities and shareholders' equity		**77,405**	109,646

The accompanying notes are an integral part of these consolidated financial statements

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Approved on behalf of the Board:

(signed) "John Mull"

John Mull
Chair of the Board

(signed) "Harold Wolkin"

Harold Wolkin
Director

Cipher Pharmaceuticals Inc.

Consolidated Statements of Income (Loss) and Comprehensive Loss

For the years ended December 31
(in thousands of United States dollars, except per share data)

	Note	2016	2015
		$	$
Revenues			
Licensing revenue		**25,555**	25,963
Product revenue		**15,185**	8,446
Net revenues		**40,740**	34,409
Operating expenses			
Cost of products sold	8	**4,587**	2,525
Research and development	14	**561**	502
Selling and marketing	14	**14,459**	9,254
General and administrative	14	**23,739**	20,389
Impairment of intangibles	11	**23,111**	-
Impairment of goodwill	11	**6,112**	-
Total operating expenses		**72,569**	32,670
Other expenses (income)			
Interest on senior secured notes		**7,777**	3,824
Change in fair value of derivative financial instrument		**(1,175)**	(2,374)
Interest income		**(54)**	(371)
Foreign exchange (gain) loss		**(720)**	1,807
Total other expenses		**5,828**	2,886
Loss before income taxes		**(37,657)**	(1,147)
Income taxes (recovery)	16	**1,492**	(2,916)
Income (loss) for the year		**(39,149)**	1,769
Item that may be reclassified to profit or loss			
Foreign currency translation adjustment		**-**	(4,688)
Loss and comprehensive loss for the year		**(39,149)**	(2,919)
Net loss per common share			
Basic	17	**(1.49)**	0.07
Diluted	17	**(1.49)**	0.07

The accompanying notes are an integral part of these consolidated financial statements

Cipher Pharmaceuticals Inc.
Consolidated Statements of Changes in Shareholders' Equity

For the years ended December 31
(in thousands of United States dollars)

	Note	Share Capital		Contributed Surplus	Other Comprehensive Loss	Retained Earnings	Total Shareholders' Equity
		000's	$	$	$	$	$
Balance, January 1, 2015		25,673	13,438	2,776	(4,826)	42,692	54,080
Income for the year		-	-	-	-	1,769	1,769
Exercise of stock options	13	315	1,101	(520)	-	-	581
Shares issued under the share purchase plan	13	70	408	-	-	-	408
Share-based compensation expense	13	-	-	2,107	-	-	2,107
Foreign currency translation adjustment		-	-	-	(4,688)	-	(4,688)
Balance, December 31, 2015		26,058	14,947	4,363	(9,514)	44,461	54,257
Loss for the year		-	-	-	-	(39,149)	(39,149)
Exercise of stock options	13	116	521	(253)	-	-	268
Shares issued under the share purchase plan	13	103	458	-	-	-	458
Shares issued under the restricted share plan	13	36	266	(266)	-	-	-
Share-based compensation expense	13	-	-	2,180	-	-	2,180
Balance, December 31, 2016		**26,313**	**16,192**	**6,024**	**(9,514)**	**5,312**	**18,014**

The accompanying notes are an integral part of these consolidated financial statements

Cipher Pharmaceuticals Inc.
Consolidated Statements of Cash Flows

For the years ended December 31
(in thousands of United States dollars)

	Note	2016	2015
		$	$
Cash provided by (used in)			
Operating activities			
Income (loss) for the year		**(39,149)**	1,769
Items not affecting cash:			
Depreciation of property and equipment	9	**229**	61
Amortization of intangible assets	10	**5,496**	4,404
Impairment of intangible assets	10,11	**23,111**	-
Impairment of goodwill	10,11	**6,112**	-
Share-based compensation	13	**2,249**	2,168
Foreign exchange (gain) loss on cash		**(10)**	3,273
Change in fair value of derivative		**(1,175)**	(2,374)
Interest on senior secured notes	7	**7,777**	3,824
Deferred income taxes	16	**1,492**	(2,904)
Changes in non-cash operating items:			
Accounts receivable		**1,659**	(3,191)
Inventory		**(24)**	(211)
Prepaid expenses and other assets		**468**	(1,546)
Accounts payable and accrued liabilities		**2,607**	2,397
Provisions		**346**	948
Other long term liabilities		**463**	431
Deferred revenue		**(182)**	(1,285)
Net cash generated from operating activities		**11,469**	7,764
Investing activities			
Purchase of property and equipment	9	**(557)**	(171)
Acquisition of intangible assets	10	**(75)**	(7,394)
Acquisition of Innocutis, net of cash acquired	6	**-**	(45,341)
Net cash used in investing activities		**(632)**	(52,906)
Financing activities			
Proceeds from senior secured notes		**-**	40,000
Interest and financing costs paid	7	**(4,168)**	(6,924)
Payment of finance lease liability		**(32)**	-
Proceeds from shares issued under the share purchase plan		**389**	347
Proceeds from exercise of stock options		**268**	581
Net cash generated from (used in) financing activities		**(3,543)**	34,004
Increase (decrease) in cash		**7,294**	(11,138)
Impact of foreign exchange on cash		**10**	(7,048)
Cash, beginning of year		**27,182**	45,368
Cash, end of year		**34,486**	27,182

The accompanying notes are an integral part of these consolidated financial statements

(in thousands of United States dollars, except per share amounts)

1. NATURE OF OPERATIONS

Cipher Pharmaceuticals Inc. ("Cipher") and its subsidiaries (together the "Company") is a specialty pharmaceutical company with a diversified portfolio of commercial and early to late stage products. The Company acquires products that fulfill unmet medical needs, manages the required clinical development and regulatory approval process, and markets those products either directly in Canada and the United States ("U.S.") or indirectly through partners in the U.S., Canada and South America. The Company is building its business through product licensing and acquisitions. Cipher was incorporated under the Business Corporations Act of Ontario on January 9, 2004 and is located at 2345 Argentia Road, Mississauga, Ontario.

On April 13, 2015, the Company purchased 100% of the outstanding members' interests of Innocutis Holdings, LLC ("Innocutis"). The Company acquired Innocutis as part of its strategy to expand into the U.S. (see Note 6).

2. BASIS OF PREPARATION

The Company prepares its consolidated financial statements in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board. The Board of Directors approved these consolidated financial statements on March 1, 2017.

The significant accounting policies used in the preparation of these financial statements are described below.

The financial statements have been prepared on a going concern basis under the historical cost convention, except for certain financial instruments, which are measured at fair value as described below. Management assesses the Company's ability to continue as a going concern at each reporting date, using quantitative and qualitative information available.

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

Reclassification of comparative period presentation

Certain prior year amounts have been reclassified for consistency with the current period presentation. These reclassifications had no effect on the reported results of operations, only classifications of certain operating expenses. Specifically, share-based compensation expense has been allocated to both general and administrative ("G&A") expense, and selling and marketing expense, whereas it was previously all recognized in G&A expense. This allocation was to align the costs of all employee remuneration with the related functional departments. In addition, certain department costs that were previously considered as part of research and development expense were determined to be G&A in nature. Lastly, foreign exchange (gains) losses have been reclassified from G&A expenses to other expenses (income) and amortization of intangible assets has been reclassified to G&A in order to better present the consolidated statements of income (loss) and comprehensive loss by function.

The following table shows the net impact of the reclassification of expenses discussed above:

	Dec 31, 2015 Reclassification	Dec 31, 2015	Net change
Operating expenses	$	$	$
Research and development	502	2,143	(1,641)
Selling and marketing	9,254	8,811	443
General and administrative	20,389	16,594	3,795
Amortization of intangible assets	-	4,404	(4,404)
Other expenses			
Foreign exchange loss	1,807	-	1,807

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Translation of foreign currencies

The financial statements are presented in United States dollars ("U.S. dollars"), which is the Company's functional currency. Revenues and expenses denominated in foreign currencies are translated into U.S. dollars using the exchange rate in effect at the transaction date.

Monetary assets and liabilities are translated using the rate in effect at the balance sheet date and non-monetary items are translated at historical exchange rates. Related exchange gains and losses are included in the consolidated statement of income (loss) and comprehensive loss.

Financial instruments

Financial assets and liabilities are recognized when the Company becomes a party to the contractual provisions of the instrument. Financial assets are derecognized when the rights to receive cash flows from the assets have expired or have been transferred and the Company has transferred substantially all risks and rewards of ownership. Financial assets and liabilities are offset, and the net amount reported in the balance sheet, when there is a legally enforceable right to offset the recognized amounts and there is an intention to settle on a net basis, or realize the asset and settle the liability simultaneously.

At initial recognition, the Company classifies its financial instruments in the following categories depending on the purpose for which the instruments were acquired:

i) Financial assets and liabilities at fair value through profit or loss: A financial asset or liability is classified in this category if acquired principally for the purpose of selling or repurchasing in the short term. The Company's derivative financial instrument is classified as a financial liability at fair value though profit and loss. Financial instruments in this category are recognized initially and subsequently at fair value. Transaction costs are expensed in the statements of income (loss) and comprehensive loss. Gains and losses arising from changes in fair value are presented in the statements of income (loss) and comprehensive loss in the period in which they arise.

ii) Available-for-sale investments: These investments are non-derivatives that are either designated in this category or not classified in any of the other categories. The Company does not have any instruments classified in this category. Available-for-sale investments are recognized initially at fair value plus transaction costs and are subsequently carried at fair value. Gains or losses arising from changes in fair value are recognized in other comprehensive income. When an available-for-sale investment is sold or impaired, the accumulated gains or losses are moved from accumulated other comprehensive income to the statement of income (loss) and comprehensive loss and are included in other gains and losses.

iii) Loans and receivables: These are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. The Company's loans and receivables comprise cash and accounts receivable, and are included in current assets due to their short-term nature. Loans and receivables are initially recognized at the amount expected to be received less, when material, a discount to reduce the loans and receivables to fair value. Subsequently, loans and receivables are measured at amortized cost using the effective interest method less a provision for impairment, if needed.

iv) Financial liabilities at amortized cost: This classification includes accounts payable and accrued liabilities, other long term liabilities and senior secured notes (the "Notes"). Financial liabilities at amortized cost are initially recognized at the amount required to be paid less, when material, a discount to reduce the payables to fair value. Subsequently, financial liabilities at amortized cost are measured at amortized cost using the effective interest method. Financial liabilities are classified as current liabilities if payment is due within twelve months. Otherwise, they are presented as non-current liabilities.

Fair value of financial instruments

Fair value is defined as the price that would be received from the sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The best evidence of fair value is quoted bid or ask prices in an active market. Quoted prices are not always available for over-the-counter transactions, as well as transactions in inactive or illiquid markets. In these instances, pricing models, normally with observable market based inputs, are used to estimate fair value. Financial instruments traded in a less active market have been valued using indicative market prices, present value or other valuation techniques. Where financial instruments trade in inactive markets or when using models where observable parameters do not exist, greater management judgement is required for valuation purposes. In addition, the calculation of estimated fair value is based on market conditions at a specific point in time and therefore may not be reflective of future fair values.

Determination of fair value

The Company categorizes its fair value measurements according to a three-level hierarchy. The hierarchy prioritizes the inputs used by the Company's valuation techniques. A level is assigned to each fair value measurement based on the lowest level input significant to the fair value measurement in its entirety. The three levels of the fair value hierarchy are defined as follows:

Level 1 - Unadjusted quoted prices at the measurement date for identical assets or liabilities in active markets.

Level 2 - Observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar assets and liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3 - Significant unobservable inputs that are supported by little or no market activity.

At December 31, 2016, the Company's financial instruments consisted of cash, accounts receivable, accounts payable and accrued liabilities, other long term liabilities, the Notes, and a derivative financial instrument. The derivative financial instrument is measured at fair value with any changes recognized through the statements of income (loss) and comprehensive loss and is classified as Level 2. Cash, accounts receivable, accounts payable and accrued liabilities and other long term liabilities are measured at amortized cost and their fair values approximate carrying values.

Impairment of financial assets

At each reporting date, the Company assesses whether there is objective evidence that a financial asset is impaired. If such evidence exists, the Company recognizes an impairment loss. Impairment losses on financial assets carried at amortized cost are reversed in subsequent periods if the amount of the loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized.

Cash

Cash includes deposits held at call with banks and other short-term, highly liquid investments readily convertible to cash on hand and are subject to an insignificant risk of changes in value.

Accounts receivable

Accounts receivable consist of amounts due from licensing partners for royalties and product sales in the normal course of business. Trade receivables are carried at amounts due, net of a provision for amounts estimated to be uncollectible.

Inventory

Inventory, which is comprised of finished goods and raw materials, is valued at the lower of cost and net realizable value. Cost is determined using the weighted-average cost method. Net realizable value is the estimated selling price less applicable selling cost. If the carrying value exceeds net realizable amount, a provision is recognized. The provision may be reversed in a subsequent period if the circumstances which caused it no longer exist.

Prepaid expenses and other assets

Prepaid expenses consist of amounts paid in advance for items that have future value to the Company, such as insurance policy payments, U.S. Food and Drug Administration fees, database subscription fees and other goods or services paid in advance, including deposits.

Property and equipment

Property and equipment are recorded at historical cost less accumulated depreciation and accumulated impairment losses. The useful lives of property and equipment are reviewed at least annually and the depreciation charge is adjusted for prospectively. Depreciation is computed using the straight-line method, over the following estimated useful lives of the assets or lease terms:

Computer equipment	3 years
Vehicles	4 years
Furniture and fixtures	5 years
Leasehold improvements	over the term of the lease

Goodwill

Goodwill arises on business combinations and represents the excess of the consideration transferred over the fair value of the identifiable net assets acquired. For the purpose of impairment testing, goodwill acquired in a business combination is allocated to each of the CGUs, or groups of CGUs, that is expected to benefit from the synergies of the combination. Each unit or group of units to which the goodwill is allocated represents the lowest level within the entity at which the goodwill is monitored for internal management purposes. Goodwill is monitored at the operating segment level. Goodwill impairment reviews are undertaken annually or more frequently if events or changes in circumstances indicate a potential impairment. The carrying value of the groups of CGUs which contains goodwill is compared to the recoverable amount, which is the higher of value in use and the fair value less costs of disposal. Any impairment is recognized immediately as an expense and is not subsequently reversed.

Intangible assets

Intangible assets include product rights that consist of marketing and other rights relating to products and licensing rights and these are recorded at cost less accumulated amortization and accumulated impairment losses. Intangible assets have a finite life and are amortized using the straight-line method over their estimated useful lives. The useful lives of the intangible assets are reviewed at least annually. Amortization is recognized straight-line over the contract term or life of the patent, as applicable.

Amortization of intangible assets is recorded as follows:

Product rights and other	Straight line over 1 to 10 years
Licensing and intellectual property rights	Straight line over 3 to 18 years

Impairment of non-financial assets

Intangible assets that have an indefinite useful life or intangible assets not ready to use are not subject to amortization and are tested annually for impairment. Assets that are subject to amortization are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognized for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs of disposal and value in use. For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are largely independent cash inflows (CGU). Prior impairments of non-financial assets (other than goodwill) are reviewed for possible reversal at each reporting date.

Accounts payable and accrued liabilities

Accounts payable are obligations to pay for goods and services that have been incurred in the ordinary course of business and are classified as current liabilities if payment is due within one year or less. If not, they are presented as non-current liabilities.

Under certain agreements, the Company has the right to set-off financial assets with financial liabilities with respect to advances, rebates and licensing payments, however in the consolidated statements of position these amounts are presented gross.

Provisions

Provisions are recognized when present obligations (legal or contractual) as a result of a past event will lead to a probable outflow of economic resources and amounts can be estimated reliably. Provisions are measured at management's best estimate of the expenditure required to settle the present obligation, based on the most reliable evidence available at the reporting date, including the risks and uncertainties associated with the present obligation.

Deferred revenue

Deferred revenue consists of amounts received from license partners in advance of revenue recognition. Amounts expected to be recognized within one year or less are classified as current liabilities with the balance being classified as non-current liabilities.

Share capital

Common shares are classified as equity. Incremental costs directly attributable to the issuance of shares are recognized as a deduction from equity.

Revenue recognition

Revenue comprises the fair value of the consideration received or receivable for the sale of products or delivery of services in the ordinary course of the Company's activities. The Company recognizes revenue when the amount of revenue can be reliably measured, it is probable that future economic benefit will flow to the entity and when specific criteria have been met for each of the activities as described below.

The Company recognizes revenue from licensing and distribution agreements, which may include multiple elements. Agreements containing multiple elements are divided into separate units of accounting if certain criteria are met, including whether the delivered element has stand-alone value to the customer and whether there is objective and reliable evidence of the fair value of the undelivered element. The consideration received is allocated among the separate elements based on each element's fair value. The applicable revenue recognition criteria are then applied to each unit of accounting. Otherwise, the applicable revenue recognition criteria are applied to combined elements as a single unit of accounting. The contractual obligations associated with these agreements vary and may include: planning and managing clinical trials, responsibility for regulatory filings with the key regulatory authorities, maintaining intellectual property and managing product supply arrangements for finished goods.

The Company records revenue on a gross basis for sales in which the Company acts as the principal (product revenue) and on a net basis (licensing revenue) for sales in which the Company in substance acts as an agent in the transaction. For certain licensing partners, in accordance with the terms of the respective agreements, the Company is required to arrange for the supply of finished product from Galephar Pharmaceutical Research Inc. ("Galephar"). Under the terms of the Company's arrangement with Galephar, the Company retains 50% of all amounts earned under the licensing and distribution agreements with the other 50% due to Galephar or other third parties. Accordingly, associated licensing revenues are recognized net of the amounts due to Galephar or other third parties.

Licensing revenue: Licensing revenue is comprised of up-front payments, pre-commercialization milestones, post-commercialization milestones, royalties and product supply fees. For up-front licensing payments and pre-commercialization milestones, revenue is deferred and recognized on a straight-line basis over the estimated term that the Company provides services and when the costs of fulfilling the Company's contractual obligations can be measured reliably. Post-commercialization milestone payments are recognized as revenue when the underlying condition is met, the milestone is not a condition of future deliverables and collectability is reasonably assured. Otherwise, these milestone payments are recognized as revenue over the remaining term of the underlying agreement or the estimated service term for which the Company maintains contractual obligations. Royalty revenue is recognized in the period in which the Company earns the royalty. Product supply fees are recognized when the finished products are shipped from Galephar to the Company's licensing partners, at which time ownership is transferred. Up-front payments, pre-and post-commercialization milestones, royalties and product supply fees represent the Company's 50% share of revenue from agreements with licensing partners, after amounts due to Galephar or other third parties.

Product revenue: Product revenue is recognized when it is probable that the economic benefits will flow to the Company, the significant risks and benefits of ownership are transferred (upon delivery of product to the Company's customers), the price is fixed or determinable and collectability is reasonably assured. Product revenue represents the amounts receivable after the deduction of discounts, estimate future rebates, returns and other adjustments. The methodology and assumptions used to estimate rebates, returns and other adjustments are monitored and adjusted in light of contractual and historical information.

Cost of products sold

Cost of sales includes the cost of finished goods, royalties to license holders, inventory provisions and direct overhead expenses necessary to acquire the finished goods.

Research and development

The Company conducts research and development programs and incurs costs related to these activities, including employee compensation, materials, professional services and services provided by contract research organizations. Research and development costs, net of related tax credits and contractual reimbursements from development partners, are expensed in the periods in which they are incurred.

Income taxes

Income tax comprises current and deferred tax. Current tax is the expected tax payable on the taxable income for the year using tax rates enacted or substantively enacted at the end of the reporting period and any adjustment to tax payable in respect of previous years.

Deferred tax is recognized in respect of temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the financial statements. Deferred income tax is determined on a non-discounted basis using tax rates and laws that have been enacted or substantively enacted at the balance sheet date and are expected to apply when the deferred tax asset or liability is settled.

Deferred tax assets are recognized to the extent that it is probable that the assets can be recovered.

Stock-based compensation

The fair value of options granted to employees and directors is estimated on the date of the grants using the Black-Scholes option pricing model. Stock options vest over four years (25% per year), expire after ten years and can only be settled for shares. Each tranche in an award is considered as a separate award with its own vesting period and grant date fair value. Share-based compensation expense is recognized over the tranche's vesting period based on the number of awards expected to vest, by increasing contributed surplus. The number of awards expected to vest is reviewed annually, with any impact being recognized immediately. Share-based compensation expense is included within the respective functional departments in operating expenses in the statements of income (loss) and comprehensive loss and in contributed surplus in the statements of financial position. The consideration received on the exercise of stock options is credited to share capital at the time of exercise.

Restricted stock units ("RSUs") are notional common shares of the Company to be issued to employees and directors of the Company. RSUs vest three years from the date of grant (one-third per year) and can only be settled in shares. The Company amortizes the fair value of the RSUs over the service period of the individual RSU grant, which generally equals the vesting period. RSU forfeitures are estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

Performance stock units ("PSUs") are notional common shares of the Company issued to senior employees of the Company. PSUs cliff vest three years from the date of grant and can only be settled in shares. Awards of PSUs are dependent upon the achievement of performance targets set by the Board of Directors for a three year period. Compensation expense is recognized over the three year vesting period for the PSUs based on the progress towards achieving the performance targets.

Leases

Leases are classified as finance leases whenever the terms of the lease transfer substantially all the risks and rewards of ownership to the Company. All other leases are classified as operating leases. The capitalized finance lease obligation reflects the present value of future lease payments, discounted at the appropriate interest rate. Assets under finance leases are amortized over the term of the lease.

All other leases are accounted for as operating leases with rental payments being expensed on a straight-line basis.

Termination benefits

The Company recognizes termination benefits when it is demonstrably committed to either terminating the employment of current employees according to a detailed formal plan without possibility of withdrawal, or providing benefits as a result of an offer made to encourage voluntary termination. Benefits falling due more than twelve months after the end of the reporting period are discounted to their present value.

Earnings per share

Basic earnings per share ("EPS") is calculated using the treasury stock method, by dividing the net income (loss) for the year by the weighted average number of common shares outstanding during the year. Diluted EPS is calculated by adjusting the weighted average number of common shares outstanding for dilutive instruments.

Change in presentation and functional currency

Effective April 2015, Cipher changed its functional currency from Canadian dollars to U.S. dollars. The Company also changed its presentation currency from Canadian dollars to U.S. dollars. The change in presentation currency was made to better reflect the Company's business activities and to improve investor's ability to compare the Company's financial results with other publicly traded businesses in the industry. In making the change to a U.S. dollar presentation currency, the Company followed the guidance in IAS 21: *The Effects of Changes in Foreign Exchange Rates* (IAS 21) and applied the change retrospectively as if the new presentation currency had always been the Company's presentation currency. In accordance with IAS 21, the financial statements for all the periods presented were translated to the new U.S. dollar presentation currency.

The functional currency of an entity is the currency of the primary economic environment in which the entity operates. Following the change in functional currency outlined above, the functional currency of Cipher and its subsidiaries is the U.S. dollar. The functional currency determinations were conducted through an analysis of the consideration factors identified in IAS 21.

Accounting standards issued but not yet adopted

IFRS 15, Revenue from Contracts with Customers: This standard replaces International Accounting Standards ("IAS") 11 *Construction Contracts*, IAS 18, *Revenue* and IFRIC 13, *Customer Loyalty Programmes* and was issued in May 2014. This standard outlines a single comprehensive model for entities to account for revenue arising from contracts with customers. The latest date of mandatory implementation of IFRS 15 is for annual reporting periods beginning on or after January 1, 2018. The Company is in the process of evaluating the impact on the consolidated financial statements.

IFRS 9, Financial Instruments: The final version of IFRS 9, *Financial Instruments*, was issued by the IASB in July 2014 and will replace IAS 39, *Financial Instruments: Recognition and Measurement*. IFRS 9 introduces a model for classification and measurement, a single, forward-looking ‘expected loss’ impairment model and a substantially reformed approach to hedge accounting. The new single, principle based approach for determining the classification of financial assets is driven by cash flow characteristics and the business model in which an asset is held. The new model also results in a single impairment model being applied to all financial instruments, which will require more timely recognition of expected credit losses. It also includes changes in respect of own credit risk in measuring liabilities elected to be measured at fair value, so that gains caused by the deterioration of an entity's own credit risk on such liabilities are no longer recognized in profit or loss. IFRS 9 is effective for annual reporting periods beginning on or after January 1, 2018, however is available for early adoption. The Company has not yet assessed the impact of IFRS 9 and has not yet determined when it will adopt the new standard.

IFRS 16, Leases: On January 13, 2016, the IASB published a new standard, IFRS 16. The new standard will eliminate the distinction between operating and finance leases and will bring most leases on the balance sheet for lessees. This standard is effective for annual reporting periods beginning on or after January 1, 2019. The Company has determined that all its leases will be recorded on the consolidated statements of financial position.

IFRS 2, Share-based Payment: In June 2016, the IASB issued final amendments to IFRS 2, clarifying how to account for certain types of share- based payment transactions. The amendments, which were developed through the IFRS Interpretations Committee, provide requirements on the accounting for: (i) the effect of vesting and non-vesting conditions on the measurement of cash-settled share-based payments; (ii) share-based payment transactions with a net settlement feature for withholding tax obligations; and (iii) a modification to the terms and conditions of a share-based payment that changes the classifications of the transaction from cash-settled to equity-settled. The amendments are effective for annual reporting periods beginning on or after January 1, 2018. The Company has not yet evaluated the impact on the consolidated financial statements.

Other accounting standards or amendments to existing accounting standards that have been issued, but have future effective dates, are either not applicable or are not expected to have a significant impact on the Company's consolidated financial statements.

4. CRITICAL ACCOUNTING ESTIMATES AND JUDGMENTS

The Company makes estimates and judgments concerning the future that will, by definition, seldom equal actual results. The following are the critical estimates and judgments applied by management that most significantly affect the Company's financial statements. The critical estimates and judgments that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year are addressed below.

i) Revenue recognition:

Returns - The provision for returns is a complex estimate used in the recognition of revenue. The Company has a returns policy that allows wholesalers to return product within a specified period prior to and subsequent to the expiration date. Provisions for returns are recognized in the period in which the underlying sales are recognized, as a reduction of product sales revenue. The Company estimates provisions for returns based upon historical experience, representing management's best estimate. While such experience has allowed for reasonable estimations in the past, history may not always be an accurate indicator of future returns. The Company continually monitors provisions for returns and makes adjustments when it believes that actual product returns may differ from established reserves.

Rebates - The provision for rebates is a complex estimate used in the recognition of revenue. Rebates are granted under contractual and other arrangements with certain customers. Products sold in the U.S. are covered by various programs under which products are sold at a discount. All rebates are recognized in the period in which the underlying sales are recognized as a reduction of revenue. The Company estimates its provision for rebates based on current contractual terms and conditions as well as historical experience and changes to business practices. While such experience has allowed for reasonable estimations in the past, history may not always be an accurate indicator of future rebate provisions. The Company continually monitors the provision for rebates and makes adjustments when it believes that actual rebates may differ from established provisions.

ii) Deferred income taxes: Management uses estimates when determining deferred income taxes. These estimates are used to determine the recoverability of tax loss carry forward amounts, research and development expenditures and investment tax credits. Significant judgment is required to determine the probable future cash flows in order to recognize the deferred tax asset. Changes in market conditions, changes in tax legislation, patent challenges and other factors, including the approval or launch of generic versions of any of the Company's products, could adversely affect the ongoing value of deferred tax assets. The carrying amount of deferred income tax assets is reassessed at each reporting period and reduced to the extent that it is no longer probable that sufficient taxable income will be available to utilize all or part of the deferred income tax assets. Unrecognized deferred income tax assets are reassessed at each reporting period and are recognized to the extent that it is probable that there will be sufficient taxable income for the asset to be recovered.

iii) Estimated useful lives of intangible assets: Management estimates the useful lives of intangible assets based on the period during which the assets are expected to be available for use and also estimates their recoverability to assess if there has been an impairment. The amounts and timing of recorded expenses for amortization and impairments of intangible assets for any period are affected by these estimates. The estimates are reviewed at least annually and are updated if expectations change as a result of technical or commercial obsolescence, generic threats and legal or other limits to use. It is possible that changes in these factors may cause significant changes in the estimated useful lives of the Company's intangible assets in the future.

iv) Impairment of non-financial assets: The Company reviews amortized non-financial assets for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets may be impaired. It also reviews goodwill annually for impairment. If the recoverable amount of the respective non-financial asset is less than its carrying amount, it is considered to be impaired. In the process of measuring the recoverable amount, management makes assumptions about future events and circumstances. The actual results may vary and may cause significant adjustments.

v) Inventory obsolescence: The Company's obsolescence provision is determined at each reporting period and the changes recorded in the consolidated statements of income (loss) and comprehensive loss. This calculation requires the use of estimates and forecasts of future sales. A change in any of the significant assumptions or estimates used could result in a material change to the provision.

vi) Accounting for business combinations: The Company assesses whether an acquisition should be accounted for as an asset acquisition or a business combination under IFRS 3, *Business Combinations* ("IFRS 3"). This assessment requires management to make judgements on whether the assets acquired and liabilities assumed constitute a business as defined in IFRS 3 and if the integrated set of activities, including inputs, processes acquired, is capable of being conducted and managed as a business and the Company obtains control of the business. The Company's acquisition of Innocutis was accounted for as a business combination (Note 6) and all other acquisitions (Note 10) were accounted for as asset acquisitions.

5. RISK MANAGEMENT

Financial risk management

In the normal course of business, the Company is exposed to a number of financial risks that can affect its operating performance. These risks are: credit risk, liquidity risk and market risk. The Company's overall risk management program and business practices seek to minimize any potential adverse effects on the Company's financial performance.

i) Credit risk

Credit risk is the risk of a financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligation. Financial instruments that potentially expose the Company to significant concentration of credit risk consist of cash and accounts receivable. The Company's investment policies are designed to mitigate the possibility of deterioration of principal, enhance the Company's ability to meet its liquidity needs and provide high returns within those parameters. Cash is on deposit with Canadian and U.S. chartered banks. Management monitors the collectability of accounts receivable and estimates an allowance for doubtful accounts.

As at December 31, 2016, the allowance for doubtful accounts was nil (2015 - $7) and the accounts that were past due amounted to $32 (2015 - $138).

The Company has concentration risk, as approximately 58.5% of total sales came from two customers (wholesalers and licensing partners) and 72.5% of total accounts receivable came from two customers (wholesalers and licensing partners).

ii) Liquidity risk

Liquidity risk is the risk that the Company will encounter difficulties in meeting its financial liability obligations as they become due. The Company has a planning and budgeting process in place to help determine the funds required to support the Company's normal operating requirements on an ongoing basis.

The Company has financed its cash requirements primarily through operations and issuances of the Notes. The Company controls liquidity risk through management of working capital, cash flows and the availability and sourcing of financing.

(in thousands of United States dollars, except per share amounts)

The following table outlines the Company's undiscounted contractual obligations as at December 31, 2016.

Description	Less than one year	Years two and three	Beyond three years	Total
	$	$	$	$
Accounts payable and accrued liabilities	15,961	-	-	15,961
Long term liabilities	-	902	-	902
Finance lease obligations	47	94	13	154
Notes	-	-	42,000	42,000
Total	16,008	996	42,013	59,017

The finance lease obligations are recorded at the present values on the consolidated statements of financial position in accounts payable and accrued liabilities for the current portion of $42 (2015 - $nil) and other long term liabilities for the non-current portion of $102 (2015 - $nil). The discount rate used was 3.25%.

iii) Market risk

Currency risk - The Company is exposed to currency risk related to the fluctuation of foreign exchange rates. The Company operates primarily in U.S. dollars. The Company is exposed to currency risk through its net assets denominated in Canadian dollars ("CDN $"). A change of 10 basis points in the US/CDN exchange rate on December 31, 2016 balance would have had a $19 impact on net income (loss). The following is a summary of the net financial assets denominated in Canadian dollars as of December 31, 2016:

	CDN $
Cash	336
Accounts receivable	751
Accounts payable and accrued liabilities	(2,753)
Finance lease obligations	(195)
Net financial assets	(1,861)

Interest rate risk - Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. The Notes bears interest at fixed rates and as such are not subject to interest rate cash flow risk resulting from market fluctuations in interest rates.

Capital risk management

The Company's managed capital is comprised of cash, the Notes and shareholders' equity. The Company's objective when managing its capital structure is to safeguard its ability to continue as a going concern in order to provide returns for shareholders, finance strategic growth plans and financial obligations as they become due. In order to maintain or adjust the capital structure, the Company may issue new common shares from time to time. Historically, the Company relied on cash on hand, cash flows from operations and the issuance of debt to finance growth initiatives.

6. BUSINESS COMBINATION

On April 13, 2015, the Company acquired 100% of the outstanding Innocutis members' interests. The Company acquired Innocutis as part of its strategy to expand in the U.S. and to expand product line offerings to new and existing customers. The principal business of Innocutis is a pharmaceutical and medical device company specializing in the development and commercialization of therapies and devices focused on the medical treatment of dermatological conditions. The operating results of Innocutis have been consolidated with Cipher effective April 13, 2015 and make up the U.S. segment (Note 19). The total purchase price of $45,506 was paid in cash and includes a working capital adjustment of $72. A portion of the purchase price was held in escrow for any potential claims against the purchase price. During the year, the escrow was released.

Goodwill of $6,112 arising from the acquisition is attributable to the acquired work force and synergies expected from combining the operations of the Company. The goodwill recognized is expected to be deductible for income tax purposes. Refer to Note 11 for discussion on impairment of goodwill.

(in thousands of United States dollars, except per share amounts)

The following table provides the fair value of the assets acquired and the liabilities assumed at the date of acquisition.

	$
Cash	165
Accounts receivable	1,867
Inventory	853
Property and equipment	27
Goodwill	6,112
Intangible assets	41,919
Accounts payable and accrued liabilities	(1,962)
Provisions	(3,475)
Purchase price	45,506

Acquisition related costs of $990 have been charged to G&A expenses in the comparative consolidated statements of income (loss) and comprehensive loss.

Had Innocutis been consolidated from January 1, 2015, the consolidated statements of (income) loss and comprehensive loss would show pro-forma revenue of $36,086 and a net loss before income taxes of $4,004 for the year ended December 31, 2015.

The acquisition agreement also includes additional Innocutis management incentive payments of up to $3,000 in cash over a three year period, based on the achievement of certain financial performance targets. The first component of the incentive program related to the achievement of an EBITDA target for 2015 was not achieved and as a result the maximum that could be paid in the future is $2,000. No amounts have been accrued as at December 31, 2016.

7. SENIOR SECURED NOTES

In connection with the acquisition of Innocutis, the Company closed a private offering of $100,000 in aggregate principal amount of the Notes due in 2020. The Company received an initial draw down of $40,000, which was used to fund the majority of the purchase price for Innocutis. The balance of the Notes were not drawn as of June 30, 2016 and expired on that date. The Notes bear interest at a fixed rate of 10.25% per annum, payable quarterly in arrears on the last day of each quarter, and will mature in five years, unless repaid earlier. Upon repayment of the principal in part or in full, a 5% borrowing fee is assessed and payable. The Company has the option to repay the Notes in part or in full prior to the maturity date subject to a prepayment premium that declines with time. If the Company, prepays the Notes from the proceeds received from the disposition of assets, a prepayment premium would be applied. The Notes are secured by all present and future assets of the Company and have certain restrictive covenants, including quarterly consolidated net revenue, minimum cash balance of $6,000 and consolidated leverage ratio. The Company is in compliance with these covenants at December 31, 2016.

In connection with the offering, the Company issued 600,000 common share purchase warrants to the lender with an option for a cashless exercise in which the settlement price caused the conversion ratio to be variable. Accordingly, the warrants are classified as a financial liability. Gains and losses on re-measurement are presented separately in the consolidated statements of income (loss) and comprehensive loss. The exercise price of the warrants is $9.22 (equal to the five day volume-weighted average price on the Toronto Stock Exchange prior to closing, converted to U.S. dollars) and expire seven years from the date of issuance. A pricing model with observable market-based inputs was used to estimate the fair value of the warrants issued. The estimated fair value of the warrants at April 13, 2015, December 31, 2015 and December 31, 2016 were $4,132, $1,758 and $583 respectively.

The variables used to compute the fair value of the warrants are as follows:

	Apr 13, 2015	**Dec 31, 2015**	**Dec 31, 2016**
Share price	$9.22	$4.68	$3.65
Expected life	7.0 years	6.2 years	5.2 years
Expected volatility	83.6%	79.1%	56.0%

(in thousands of United States dollars, except per share amounts)

The following is the continuity of the Notes for the year ended December 31, 2016:

	$
Balance, December 31, 2014	-
Notes face value	40,000
Fair value of warrants on initial recognition	(4,132)
Deferred financing cost	(2,119)
Interest expense	2,995
Interest paid	(2,995)
Accretion expense	829
Balance, December 31, 2015	34,578
Interest expense	4,168
Interest paid	(4,168)
Accretion expense	1,799
Balance, December 31, 2016	**36,377**

Debt issuance costs of $1,810 which were included in prepaid expenses and other assets as at December 31, 2015, were written off during the year and are included in interest on the Notes in the consolidated statements of income (loss) and comprehensive loss, as the availability of the additional $60,000 of the undrawn portion of the Notes expired on June 30, 2016.

The Notes are measured at amortized cost. At December 31, 2016, the fair value of the Notes is $39,374. The fair value was determined based on cash flows discounted using the current borrowing rate.

8. INVENTORY

Inventory consists of the following:

	Dec 31, 2016	**Dec 31, 2015**
	$	$
Finished goods	**1,953**	1,200
Raw materials	**128**	129
Obsolescence provision	**(809)**	(81)
	1,272	1,248

Inventory amounts charged to cost of products sold during the year is $1,630 (2015 - $1,536). In addition, the increase in inventory obsolescence of $728 and write downs of inventory during the year of $201 (2015 - $79) was charged directly to cost of products sold.

(in thousands of United States dollars, except per share amounts)

9. PROPERTY AND EQUIPMENT

	Computer Equipment	Vehicles	Furniture and Fixtures	Leasehold Improvements	Total
Cost	$	$	$	$	$
Balance, December 31, 2015	271	-	226	59	556
Additions	197	176	315	45	733
Disposals	(33)	-	(83)	-	(116)
Balance, December 31, 2016	**435**	**176**	**458**	**104**	**1,173**
Accumulated depreciation					
Balance, December 31, 2015	162	-	101	7	270
Depreciation	94	28	84	23	229
Disposals	(33)	-	(83)	-	(116)
Balance, December 31, 2016	**223**	**28**	**102**	**30**	**383**
Net book value					
As at December 31, 2015	109	-	125	52	286
As at December 31, 2016	**212**	**148**	**356**	**74**	**790**

Depreciation expense of $229 (2015 - $61) is recorded in G&A in the consolidated statements of income (loss) and comprehensive loss. During the year, the Company wrote off fully depreciated assets no longer in use of $116 (2015 - $142).

10. GOODWILL AND INTANGIBLE ASSETS

Goodwill acquired through acquisition of Innocutis was allocated to the U.S. operations, which is comprised of a group of CGUs for the purposes of impairment testing. This group of CGUs is also the same as the operating and reportable segment.

Cost	$
Balance, December 31, 2014	-
Acquisition (Note 6)	6,112
Balance, December 31, 2015	6,112
Impairment (Note 11)	(6,112)
Balance, December 31, 2016	**-**

Intangible assets

In 2014, the Company acquired the assets of Melanovus Oncology, Inc. The assets included seven pre-clinical compounds for the treatment of melanoma and other cancers as well as an exclusive global license to a library of compounds and related intellectual property from The Penn State Research Foundation. The transaction included a payment of $510 for the asset purchase and an up-front license fee of $252 to The Penn State Research Foundation. The licensing agreement provides for future payments up to $1,300 based on clinical development and regulatory milestones as well as royalties on commercial sales.

In 2015, the Company in-licensed the Canadian distribution rights to Ozenoxacin, a topical treatment for impetigo, from Ferrer International SA, a privately-held Spanish pharmaceutical company. An up-front payment of $242 was made upon execution of the agreement and a second milestone payment for $201, which is based on a development milestone, was made in 2015. The licensing agreement provides for one additional milestone in the amount of $150 for regulatory approval, as well as royalties on commercial sales.

(in thousands of United States dollars, except per share amounts)

In 2015, the Company acquired the worldwide rights to three products from Astion Pharma A/S, a Denmark-based specialty pharmaceutical company, for $4,995. The products include: Dermadexin, a patent-protected topical barrier-repair cream for the treatment of seborrheic dermatitis, Pruridexin, a patent-protected topical cream for the treatment of chronic pruritus, and ASF-1096 a product candidate. The transaction includes future milestones of up to $24,566 based on future clinical, regulatory and commercial sales milestones.

In 2015, the Company in-licensed the Canadian distribution rights to CF101, a novel chemical entity being developed by Can-Fite Biopharma for moderate to severe plaque psoriasis and rheumatoid arthritis. An up-front payment of $1,329 was made upon execution of the agreement and the transaction includes future milestones of up to $1,445 based on future regulatory and commercial sales milestones, as well as royalties on commercial sales.

In 2015, the Company in-licensed the Canadian rights to Vaniqa and Actikerall from Almirall SA, a Spanish pharmaceutical company.

Both products have been approved by Health Canada and are marketed in Canada. An up-front payment of $353 was paid upon execution of the agreement and the transaction includes future milestones of approximately $225 based on commercial sales targets for Actikerall.

In 2016, the Company acquired the worldwide rights from Dalhousie University to develop and commercialize an investigational tattoo removal cream product. An upfront payment of $75 was made upon execution of the agreement and the transaction includes potential milestones of up to CDN$3,600 based on future regulatory and commercial sales milestones, as well as royalties on commercial sales.

	Product Rights and Other	Licensing and Intellectual Property Rights	Total
Cost	$	$	$
Balance, December 31, 2014	6,065	849	6,914
Acquisition (Note 6)	41,919	-	41,919
Additions	-	7,394	7,394
Foreign exchange	(82)	(219)	(301)
Balance, December 31, 2015	47,902	8,024	55,926
Additions	-	75	75
Disposals	(151)	-	(151)
Balance, December 31, 2016	**47,751**	**8,099**	**55,850**
Accumulated amortization and impairment			
Balance, December 31, 2014	5,441	-	5,441
Amortization	3,808	596	4,404
Foreign exchange	(30)	(3)	(33)
Balance, December 31, 2015	9,219	593	9,812
Amortization	4,573	923	5,496
Impairment (Note 11)	23,111	-	23,111
Disposals	(151)	-	(151)
Balance, December 31, 2016	**36,752**	**1,516**	**38,268**
Net book value			
As at December 31, 2015	38,683	7,431	46,114
As at December 31, 2016	**10,999**	**6,583**	**17,582**

Amortization expense of $5,496 (2015 - $4,404) is recorded to G&A in the consolidated statements of income (loss) and comprehensive loss. During the year, the Company wrote off fully amortized product rights no longer in use of $151 (2015 - $nil).

(in thousands of United States dollars, except per share amounts)

11. IMPAIRMENT OF GOODWILL AND INTANGIBLE ASSETS

At December 31, 2016, the Company identified indicators of impairment as a result of certain products not meeting expectations in the U.S. segment. The Company determined these products would not perform as expected given that certain Company initiatives to increase product sales were unlikely to materialize. Contemporaneously, the Company performed its annual impairment test for goodwill as at December 31, 2016.

The Company performed an impairment test by comparing the recoverable amount of each CGU to its carrying value. The impairment test is performed on individual product rights which is considered to be the lowest level for which there are separately identifiable cash flows. The company estimated recoverable amount based on fair value less costs to dispose based primarily on certain non-binding offers recently received. There is no guarantee that the Company will consummate a sales transaction and actual sale proceeds could vary from the Company's estimate.

The Company identified an impairment to certain intangible assets, where the carrying value exceeded its recoverable amount. Accordingly, the Company has recognized a total intangible asset impairment charge of $23,111 recorded in operating expenses in the consolidated statements of income (loss) and comprehensive loss.

Goodwill acquired through acquisition of Innocutis was allocated to the U.S. operations, which is comprised of a group of CGUs for the purposes of impairment testing. The Company has written off all of the goodwill in the US segment. A total goodwill impairment charge of $6,112 recorded in operating expenses in the consolidated statements of income (loss) and comprehensive loss.

The fair value less costs to dispose amount was a Level 3 measurement in the fair value hierarchy as a result of significant unobservable inputs used in determining the recoverable amount.

12. PROVISIONS

Provisions relates to estimates made for returns, rebates and other price adjustments. Although the estimates for rebates and other price adjustments relate to revenue recognition transactions, namely product sales, the payments made for the underlying transactions are made directly to the claimants concerned and not to the original customer. Actual costs for these charges and estimates are recorded when incurred. The recorded provisions are for the uninvoiced portion of these costs and estimates. The provision for product returns relates to potential returns due to expiration or other return rights under the terms of distribution and supply agreements with customers. The adequacy of the provisions are evaluated based on product sales activity and estimates of expiring products in the distribution chain.

The following is the continuity of the provisions for the year ended December 31, 2016:

	$
Balance, December 31, 2014	-
Assumed through business acquisition (Note 6)	3,475
Additions	948
Balance, December 31, 2015	4,423
Additions	10,013
Payments	(9,667)
Balance, December 31, 2016	**4,769**

13. SHARE CAPITAL

Authorized share capital

The authorized share capital consists of an unlimited number of preference shares, issuable in series, and an unlimited number of voting common shares, with no par value.

The Company has three stock-based compensation plans: the Stock Option Plan ("SOP"), the Employee and Director Share Purchase Plan ("ESPP") and the Restricted Share Units and Performance Share Units Plan ("PR Plan").

On May 6, 2016, shareholders of Cipher approved resolutions which provide that the maximum number of common shares issuable in aggregate pursuant to outstanding awards or grants under the SOP, the ESPP and the PR Plan at any time shall be 15% of the number of common shares then issued and outstanding.

Share purchase plan

The Company's ESPP allows employees and directors to share in the growth of the Company through share ownership. Through the ESPP, employees and directors may contribute amounts to purchase shares of the Company at a 15% discount from the prevailing trading price. Plan members must hold their shares for a period of at least six months before they can be sold. During the year ended December 31, 2016, 102,466 shares were issued under the ESPP (2015 - 70,682). Included in share-based compensation expense is $69 (2015 - $61), which is the discount on the shares issued during the year.

Stock option plan

The following is a summary of the changes in the stock options outstanding from January 1, 2015 to December 31, 2016:

	Number of options (in thousands)	Weighted average exercise price $
Balance outstanding - January 1, 2015	1,284	4.03
Granted in 2015	533	9.79
Exercised in 2015	(315)	1.96
Forfeited/cancelled in 2015	(88)	8.33
Balance outstanding - December 31, 2015	1,414	6.39
Granted in 2016	688	4.94
Exercised in 2016	(116)	2.49
Forfeited/cancelled in 2016	(429)	6.59
Balance outstanding - December 31, 2016	1,557	5.98

At December 31, 2016, 858,994 options were fully vested and exercisable (2015 - 538,368).

The following information relates to stock options that were outstanding as at December 31, 2016:

Range of exercise prices	Number of options (in thousands)	Weighted average remaining contractual life (years)
CDN$		
1.03-4.60	400	3.0
4.61-6.20	137	9.5
6.21-13.88	1,020	8.2
	1,557	6.9

During 2016, the Company granted 687,740 stock options under the stock option plan. The options vest over a four year period based on the grant date, 25% per year and have a ten year life. Expected volatility is based on the Company's historical volatility, while estimated forfeitures are not considered significant. There is no expected dividend.

(in thousands of United States dollars, except per share amounts)

The exercise prices and Black Scholes assumptions are as follows:

Grant Date	Number Granted	Exercise Price	Black Scholes Value	Risk-free Interest Rate	Expected Life (years)	Expected Volatility
February 26, 2016	250,370	CDN$6.79	CDN$3.79	1.19%	5.6	62.8%
February 26, 2016	210,751	US$4.93	US$2.75	1.19%	5.6	62.8%
March 24, 2016	42,336	US$4.65	US$2.49	1.27%	5.6	59.5%
May 9, 2016	40,000	CDN$7.59	CDN$4.36	1.18%	6.1	62.4%
August 12, 2016	11,675	US$4.84	US$2.77	0.86%	6.5	62.6%
August 12, 2016	9,084	CDN$6.28	CDN$3.61	0.86%	6.5	62.6%
August 15, 2016	60,000	CDN$6.19	CDN$3.40	0.86%	6.5	61.7%
August 29, 2016	18,682	US$3.89	US$2.37	0.86%	6.5	66.1%
September 7, 2016	7,161	CDN$5.39	CDN$3.29	0.82%	6.5	66.2%
September 12, 2016	37,681	CDN$5.18	CDN$3.07	0.82%	6.5	65.9%

Total compensation expense for these stock options is estimated to be $2,224, which will be recognized on a graded basis over the vesting period of the stock options.

During the year, 115,966 stock options were exercised in exchange for 115,966 common shares. The Company's stock option plan provides that an option holder may elect to receive an amount of shares equivalent to the growth value of vested options, which is the difference between the market price and the exercise price of the options. The total cash consideration received by the Company for stock option exercises in 2016 was $268 (2015 - $581).

The total stock option expense for the year ended December 31, 2016 is $1,440 (2015 - $2,107).

Restricted Share Unit (RSU) and Performance Share Unit (PSU) Plan

On May 13, 2015, the Company adopted a RSU and PSU plan. RSUs and PSUs are notional share units exchangeable for common shares of the Company. RSUs are granted to all employees and directors of the Company and PSUs are granted to certain executives. RSUs granted to employees vest annually over a three year period and RSUs granted to directors vest over a one year period. PSUs vest based upon the achievement of financial performance goals for the Company for the three year period ended December 31, 2018. If certain targets are achieved, up to four times the PSU's granted will be exchanged for an equal number of common shares.

A summary of the RSUs and PSUs granted and outstanding as at December 31, 2016 is as follows:

	RSUs	PSUs
	Number of Units	Number of Units
	000's	000's
Balance, January 1, 2015	-	-
Granted in 2015	69	30
Forfeited/cancelled in 2015	(10)	(5)
Balance, December 31, 2015	59	25
Granted during the year	292	118
Vested during the year	(36)	-
Forfeited/cancelled during the year	(113)	(65)
Balance, December 31, 2016	**202**	**78**

The total expense for RSUs and PSUs for the year ended December 31, 2016 is $740 (2015 - $243).

(in thousands of United States dollars, except per share amounts)

14. EXPENSES BY NATURE

The consolidated statements of income (loss) and comprehensive loss include the following expenses by nature:

Employee salaries and benefits expenses

	Dec 31, 2016	Dec 31, 2015
	$	$
Salaries, bonuses and benefits	**12,627**	9,014
Share-based compensation	**2,249**	2,168
Termination benefits	**1,168**	293
Total employee costs	**16,044**	11,475
Research and development	**159**	70
Selling and marketing	**7,111**	5,102
General and administrative	**8,774**	6,303
	16,044	11,475

During the year, the Company recorded lease payments of $453 (2015 - $198) in G&A in the consolidated statements of income (loss) and comprehensive loss.

15. COMPENSATION OF KEY MANAGEMENT

Key management includes directors and named executives of the Company. The compensation paid or payable to key management for services is shown below:

	Dec 31, 2016	Dec 31, 2015
	$	$
Salaries and short-term employee benefits, including bonuses	**1,648**	1,705
Directors fees	**368**	288
Share-based compensation	**1,134**	1,286
Termination benefits	**1,000**	-
	4,150	3,279

During the year the Company incurred a termination benefit expense relating to two senior executives of the Company. In 2015, an advance of $60 to an executive officer was repaid.

16. INCOME TAXES

The components of the deferred income tax recovery are as follows:

	Dec 31, 2016	Dec 31, 2015
	$	$
Deferred income tax recovery	**1,492**	(2,916)

(in thousands of United States dollars, except per share amounts)

The income tax recovery differs from the amount computed by applying the statutory income tax rate to the loss for the year. The sources and tax effects of the differences are as follows:

	Dec 31, 2016	Dec 31, 2015
	$	$
Statutory income tax rate of 26.5% applied to loss for the year (2015 - 26.5%)	**(9,980)**	(304)
Permanent differences	**(123)**	(339)
Effect of tax rates in foreign jurisdictions	**(4,489)**	(1,218)
Foreign exchange	**(107)**	862
Change in deferred tax assets not previously recognized - Canada	**(80)**	(6,172)
Change in deferred tax assets not recognized - United States	**16,271**	4,255
Recovery of income taxes	**1,492**	(2,916)

At each balance sheet date, the Company assesses whether the realization of future tax benefits is sufficiently probable to recognize a deferred tax asset. This assessment requires the exercise of judgement, which includes a review of projected taxable income. In 2016, the Company recognized an additional deferred tax asset on the balance sheet of $80 (2015 - $6,172) arising from accumulated capital losses carried forward from previous years and a corresponding deferred tax recovery on the consolidated statements of income (loss) and comprehensive loss.

Deferred income tax assets of the Company are comprised of the following:

	Dec 31, 2016	Dec 31, 2015
	$	$
Non-capital losses and SR&ED	**3,468**	5,193
Tax credits	**2,269**	2,269
Temporary differences	**1,127**	894
	6,864	8,356

The movement in the deferred income tax asset is as follows:

	2016	D 2015
	$	$
Balance, January 1,	**8,356**	5,936
Tax provision	**14,699**	999
Effect of foreign exchange	**-**	(496)
Recognition of previously unrecognized tax assets	**80**	6,172
Deferred tax assets not recognized	**(16,271)**	(4,255)
Balance, December 31,	**6,864**	8,356

(in thousands of United States dollars, except per share amounts)

The significant components of unrecognized deferred tax assets are summarized as follows:

	Dec 31, 2016	Dec 31, 2015
	$	$
Canada		
Capital losses	**183**	263
	183	263
United States		
Non-capital losses	**4,222**	1,152
Temporary differences	**16,304**	3,102
	20,526	4,254
	20,709	4,517

As at December 31, 2016 the Company has non-capital loss carry forwards of $11,503 in the U.S. with expiry dates between 2035 and 2036.

The Company has Scientific Research and Experimental Development ("SR&ED") expenditures of $13,087 which can be carried forward indefinitely to reduce future years' Canadian taxable income.

The Company has $3,022 of investment tax credits on SR&ED expenditures that are available to be applied against Canadian federal and provincial taxes otherwise payable in future years and expire in varying amounts from 2022 to 2031.

17. EARNINGS PER SHARE

Earnings per share is calculated using the weighted average number of shares outstanding. The weighted average number of shares outstanding for the year ended December 31, 2016 was 26,197,942 (for the year ended December 31, 2015 - 25,943,650).

Diluted earnings per share is calculated using the weighted average number of shares outstanding taking into consideration the weighted average impact of dilutive securities. The dilutive weighted average for the year ended December 31, 2016 was 27,061,443 (for the year ended December 31, 2015 - 26,381,704). For the year ended December 31, 2016, the computation of diluted loss per share is equal to the basic loss per share due to the anti-dilutive effect of the share-based compensation.

18. COMMITMENTS AND CONTINGENCIES

In 2015, the Company entered into a new lease for office space in Charleston, South Carolina. The new lease commenced on February 22, 2016 and ends on January 31, 2023. In 2015, the Company also entered into an operating lease for its Canadian office facilities which ends on December 31, 2018. The total minimum annual payments under the leases are as follows:

	$
2017	491
2018	502
2019	338
2020	348
2021	358
2022 and thereafter	400

Directors and officers are indemnified by the Company for various items including, but not limited to, costs to settle lawsuits or actions due to their association with the Company, subject to certain restrictions. The Company has purchased directors and officer’s liability insurance to mitigate the cost of any potential future lawsuits or actions. The term of the indemnification covers the period during which the indemnified party served as a director or officer of the Company.

In the normal course of business, the Company has entered into agreements that include indemnities in favour of third parties, such as purchase and sale agreements, confidentiality agreements, engagement letters with advisors and consultants, leasing contracts, license agreements, information technology agreements and various product, service, data hosting and network access agreements. These indemnification arrangements may require the applicable entity to compensate counterparties for losses incurred by the counterparties as a result of breaches in representations, covenants and warranties provided by the Company or as a result of litigation or other third party claims or statutory sanctions that may be suffered by the counterparties as a consequence of the relevant transaction. In some instances, the terms of these indemnities are not explicitly defined.

(in thousands of United States dollars, except per share amounts)

In 2012, the Company entered into an agreement to acquire the exclusive license and distribution rights in Canada to market the Beteflam Patch (previously called the Betesil Patch) from Institut Biochemique SA ("IBSA"). If certain milestones within that agreement are achieved in 2017, the Company will owe a milestone payment of up to CDN $750 payable in 2018.

In the normal course of business, the Company may be the subject of litigation or other potential claims. While management assesses the merits of each lawsuit and defends itself accordingly, the Company may be required to incur significant expenses or devote significant resources to defending itself against litigation. At December 31, 2016 no amounts were accrued (2015 - nil).

Licensing Agreements with Galephar

In 2002, the Company entered into a Master Licensing and Clinical Supply Agreement ("the Agreement") with Galephar, a Puerto Rico based pharmaceutical research and manufacturing company. Under the Agreement, the Company acquired the rights to package, test, obtain regulatory approvals and market CIP-FENOFIBRATE, CIP-ISOTRETINOIN and CIP-TRAMADOL ER ("the CIP Products") in various countries. In accordance with the Agreement, the Company retains 50% of all revenue from licensing and distribution arrangements entered into with respect to the CIP Products, with the other 50% due to Galephar. Where the Company has opted to market and sell a CIP Product directly in a territory, the Company pays a royalty to Galephar. Galephar retains the right to manufacture and supply the CIP Products. With respect to licensing and distribution arrangements, the Company manages the product supply arrangements with their respective marketing partners and Galephar; product is shipped directly from Galephar to the respective marketing partners. Where the Company has opted to market and sell the CIP Product directly, the Company purchases the finished goods from Galephar directly.

With respect to CIP-ISOTRETINOIN, the Company has entered into licensing and distribution arrangements for the U.S. and Brazil, while opting to market and sell the product directly in Canada. The Company also has in place various licensing and distribution arrangements with respect to CIP-FENOFIBRATE and CIP-TRAMADOL ER in Canada, the U.S. and Central and South America.

During the year, Galephar entered into a contract with another party (the “Assignee”) to assign certain rights relating to CIP-ISOTRETINOIN in the U.S. under the Agreement. The Company is a party to this contract, agreeing to remit revenue on the same terms as the Agreement, from licensing and distribution within the U.S. for CIP-ISOTRETOIN directly to the Assignee.

19. SEGMENTED INFORMATION

The Company's operations are categorized into one industry segment, being specialty pharmaceuticals. The Company is managed geographically in Canada and the United States commencing in Q2 2015 with the acquisition of Innocutis. Before the acquisition of Innocutis the Company only had one segment.

For the year ended December 31, 2016

	Canada	United States	Total
External revenue by segment	$	$	$
Licensing revenue	25,555	-	25,555
Product revenue	4,096	11,089	15,185
Net revenues	29,651	11,089	40,740
Segment profit (loss)	5,426	(37,255))	(31,829)
Other expenses			5,828
Income taxes			1,492
Loss for the year			**(39,149)**

(in thousands of United States dollars, except per share amounts)

For the year ended December 31, 2015

	Canada	United States	Total
	$	$	$
External revenue by segment			
Licensing revenue	25,963	-	25,963
Product revenue	2,896	5,550	8,446
Net revenues	28,859	5,550	34,409
Segment profit (loss)	12,123	(10,384)	1,739
Other expenses			2,886
Income taxes			(2,916)
Income for the year			1,769

Other financial information by segment:

	Canada	United States	Total
	$	$	$
Total assets as at December 31, 2016	59,822	17,583	77,405
Intangible assets	6,645	10,937	17,582
Amortization of intangible assets	1,008	4,488	5,496
Intangible asset additions	75	-	75
Depreciation	115	114	229
Property and equipment additions	211	522	733
Impairment of intangible assets	-	23,111	23,111
Impairment of goodwill	6,112	-	6,112

	Canada	United States	Total
	$	$	$
Total assets as at December 31, 2015	65,981	43,665	109,646
Goodwill and intangible assets	13,688	38,538	52,226
Amortization of intangible assets	1,023	3,381	4,404
Intangible asset additions	7,394	41,919	49,313
Depreciation	49	12	61
Property and equipment additions	270	27	297