



STRENGTH
THROUGH
EXECUTION

ANNUAL REPORT 2002



COMPANY PROFILE

Paladin Labs Inc. is a specialty pharmaceutical company focused on acquiring or in-licensing innovative urology, endocrinology and women's health products for the Canadian market.

Paladin's strategy is to leverage its sales and marketing capabilities to enhance the performance of its new and existing products. Growth will be sustained through the acquisition of Canadian rights to promotion-sensitive pharmaceuticals and promising products in late-stage clinical development.

Headquartered in Montreal, Paladin is a publicly traded company listed on the Toronto Stock Exchange (TSX) under the symbol PLB.

2002 HIGHLIGHTS

JANUARY

- Paladin and Pharmacia Canada Inc. complete distribution agreement for the rights to a portfolio of endocrinology and women's health brands including Dostinex® and Estring®

MARCH

- Paladin successfully completes a \$21 million special warrant private placement
- Paladin announces submission to Health Canada for non-prescription status for Plan B™

JUNE

- Paladin obtains Health Canada's approval for Androderm® 5 mg format for the treatment of male testosterone deficiency

SEPTEMBER

- Paladin and Novo Nordisk Canada Inc., sign distribution agreement for GlucaGen® for the treatment of hypoglycemia in insulin-dependent diabetics and for relaxation of the gastrointestinal tract during routine radiology procedures
- Paladin named to the Deloitte & Touche Canadian Technology Fast 50, a ranking of the 50 fastest growing technology companies in Canada

OCTOBER

- Paladin and Hydro Med Sciences, Inc., sign exclusive license agreement for Histrelin Hydrogel Implant, a once-yearly implant for prostate cancer

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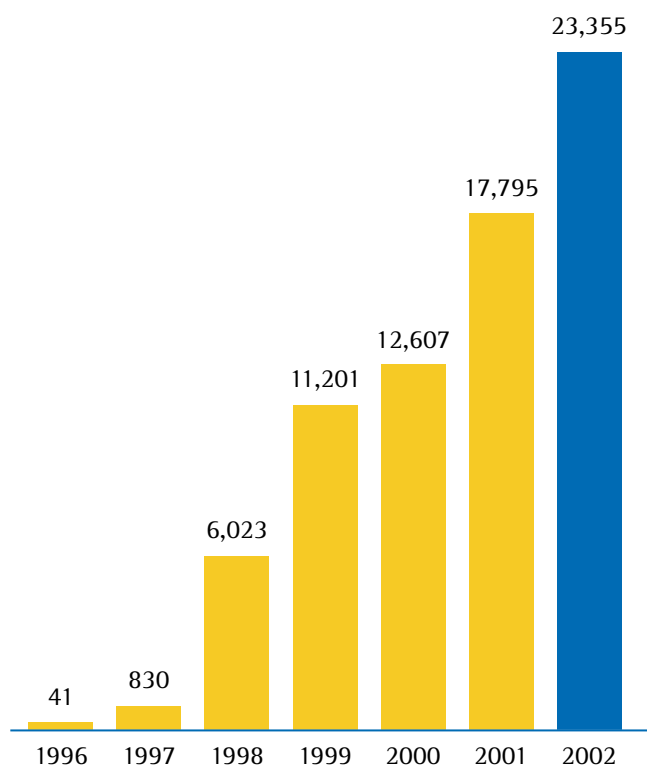
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FINANCIAL DATA

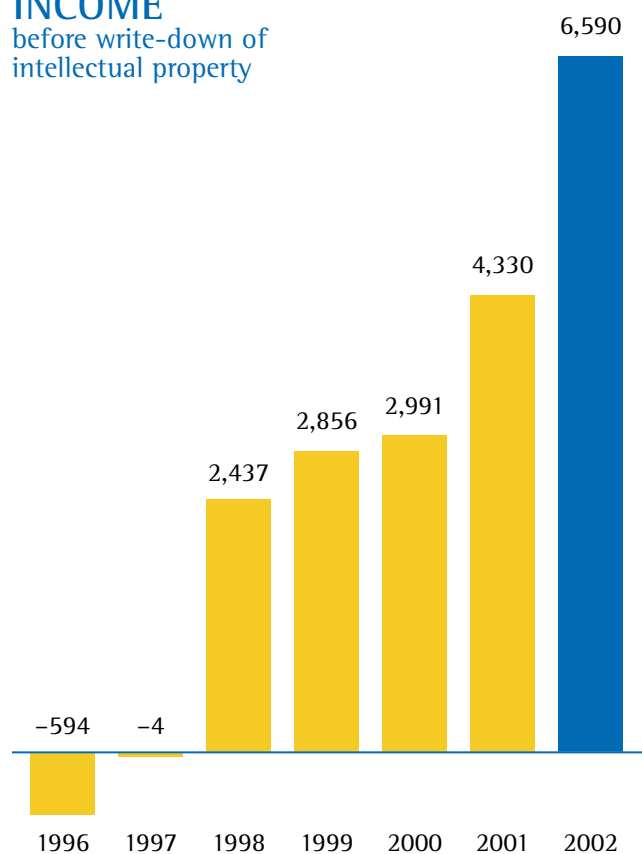
(In thousands of Canadian dollars except for share and per share amounts)

	1996	1997	1998	1999	2000	2001	2002
Revenues	41	830	6,023	11,201	12,607	17,795	23,355
Income (Loss) before write-down of intellectual property and taxes	(594)	(4)	2,437	2,856	2,991	4,330	6,590
Net Income (Loss)	(1,868)	(1,006)	836	2,016	2,797	1,485	5,162
Earnings (Loss) Per Share (Basic)	(0.50)	(0.25)	0.13	0.22	0.24	0.12	0.37
Cash Flows From Operating Activities	(285)	(446)	1,343	2,896	1,507	5,154	8,634
Cash & Marketable Securities	759	563	8,545	9,886	24,339	22,448	45,612
Shareholders' Equity	3,146	2,390	9,886	13,830	35,769	37,836	63,178
Shares Issued (Dec 31)	3,823,991	3,990,659	9,057,731	9,466,338	12,394,038	12,539,247	14,780,205

REVENUES



INCOME before write-down of intellectual property



MESSAGE TO SHAREHOLDERS

DEAR SHAREHOLDERS,

The growth trend established since our founding continued in 2002. We expanded our product pipeline, launched new products and strengthened our network of physician relationships. We also completed a \$21 million equity financing to support our future growth initiatives. Through the continued execution of our focused strategy, we have firmly established Paladin as one of the leading specialty pharmaceutical companies in Canada.

FINANCIAL PERFORMANCE

For the year ended December 31, 2002, Paladin achieved record revenue of \$23.4 million, a 31 percent increase over the prior year. We generated record net income of \$5.2 million, or \$0.36 per share, compared to net income of \$1.5 million or \$0.12 per share in 2001. Our growth is the result of strong market performance from our established product lines, such as Androderm® and Plan B™, as well as first time revenues from newly acquired brands including Dostinex®, Estring® and the Locacorten®-Vioform® line of products.

STRENGTHENING OUR FOUNDATION

This year has seen the expansion of our pipeline of promising late-stage development products, further strengthening our foundation for growth. In September, we obtained from Novo Nordisk the Canadian distribution rights to GlucaGen®, a drug indicated for the treatment of hypoglycemia in insulin-dependent diabetics. We will work with Novo Nordisk to file a New Drug Submission (NDS) for GlucaGen® in 2003. In October, we entered into a licensing agreement with Hydro Med Sciences for the Canadian rights to Histrelin Hydrogel Implant, a unique, once-yearly implant for the treatment of advanced prostate cancer. We anticipate that a NDS for the implant will be filed in Canada by the end of our first quarter of 2004.

Additionally, Paladin advanced its existing pipeline products closer to commercialization. To that end, we filed a NDS with Health Canada for the approval of Statex® SR (sustained-release morphine sulfate tablets), a twice-daily morphine product used for the relief of severe pain, and a NDS for the approval of Circadin®, a controlled release melatonin tablet indicated for the treatment of sleep disorders in the elderly. Further, we applied to Health Canada for non-prescription status for Plan B™, the first progestin-only pill indicated to prevent pregnancy after a contraceptive failure or unprotected sex.



Jonathan Ross Goodman, B.A., LL.B., M.B.A.
President & CEO

BUILDING OUR CAPABILITIES

In October 2002, we announced plans to expand our sales and marketing activities for Androderm®, Dostinex®, Estrin®[®], Muse®, Oesclim® and Plan B™. Currently at an early stage in their life cycles, these key products represent a unique growth opportunity for Paladin. Our goal is to increase brand awareness among Canadian physicians and aggressively pursue greater market share through strategic sales initiatives. As part of these initiatives, we are increasing our sales presence which will extend our reach among Canadian physicians from 1,375 doctors to more than 7,500. We expect our expanded sales and marketing infrastructure to not only make Paladin a more attractive partner to prospective licensors, but to also result in enhanced long-term value for our shareholders.



EXECUTING OUR STRATEGY

With over \$37 million in working capital, Paladin is well positioned to exploit the \$11.5 billion Canadian pharmaceutical market. Our strategic focus will remain on acquiring products within our key therapeutic areas from large pharmaceutical companies that meet our disciplined investment criteria, and seeking additional opportunities to in-license innovative, late-stage development products.

We will continue our successful strategy of leveraging our strong network of specialist physician relationships to achieve cost-effective incremental sales growth, and we will establish greater sales reach in support of our key products to capitalize on emerging opportunities.

We are confident in our strategy, we have demonstrated our ability to execute and have established a solid track record of profitable growth. We intend to continue to build on our strengths and remain focused on creating long-term value for our shareholders. On behalf of the Board of Directors and everyone at Paladin, I would like to thank our stakeholders for your continued support.

Sincerely,

A handwritten signature in black ink, appearing to read "Jonathan Ross Goodman".

Jonathan Ross Goodman,
B.A., LL.B., M.B.A.
President & CEO



Tom Koutsavlis
*Vice President,
Scientific Affairs*

Samira Sakhia
Chief Financial Officer

Jonathan R. Goodman
President & CEO

Mark Beudet
*Vice President,
Marketing & Sales*

PALADIN'S PRODUCT LINE

Existing New in 2002

Product	Indication	Licensor/Vendor	Phase			Regulatory Approval	Sales and Marketing
			Phase 1	Phase 2	Phase 3		
Urology							
MUSE	Erectile Dysfunction	VIVUS, Inc.	Existing	Existing	Existing	Existing	Existing
Valtatin	Bladder Cancer	Anthra Pharmaceuticals, Inc.	Existing	Existing	Existing	Existing	Existing
Pacis	Bladder Cancer	Shire Pharmaceuticals Group plc	Existing	Existing	Existing	Existing	Existing
Urispas	Urinary Incontinence	Altana Pharma Inc.	Existing	Existing	Existing	Existing	Existing
Cystistat	Interstitial Cystitis	Bioniche Life Sciences, Inc.	Existing	Existing	Existing	Existing	Existing
NMP-22	Bladder Cancer Detection	Matritech, Inc.	Existing	Existing	Existing	Existing	Existing
pms-Yohimbine	Alpha-adrenergic blocking agent	Pharmascience Inc.	Existing	Existing	Existing	Existing	Existing
Rogitine	Alpha adrenoreceptor antagonist	Novartis Pharmaceuticals Canada Inc.	Existing	Existing	Existing	Existing	Existing
Aptosyn	Prostate Cancer	Cell Pathways, Inc.	Existing	Existing	Existing	Existing	Existing
Histreltin Hydrogel Implant	Prostate Cancer	Hydro Med Sciences, Inc.	Existing	Existing	Existing	Existing	Existing
Endocrinology							
Androderm	Hypogonadism	Watson Laboratories, Inc.	Existing	Existing	Existing	Existing	Existing
Dostinex	Hyperprolactinemia	Pharmacia Canada Inc.	Existing	Existing	Existing	Existing	Existing
Tapazole	Hyperthyroidism	Eli Lilly and Company	Existing	Existing	Existing	Existing	Existing
Propyl-Thyracil	Hyperthyroidism	Merck Frosst Canada & Co.	Existing	Existing	Existing	Existing	Existing
Glucagen	Hypoglycemia	Novo Nordisk Canada Inc.	Existing	Existing	Existing	Existing	Existing
Circadin	Insomnia	Neurim Pharmaceuticals (1991) Ltd.	Existing	Existing	Existing	Existing	Existing
DHEA	Addison's Disease	Neuroscience Pharma Inc.	Existing	Existing	Existing	Existing	Existing
Women's Health							
Plan B	Emergency Contraceptive	Women's Capital Corporation	Existing	Existing	Existing	Existing	Existing
Estring	Urogenital-menopause symptoms	Pharmacia Canada Inc.	Existing	Existing	Existing	Existing	Existing
Dalacin Vaginal Cream	Bacterial vaginosis	Pharmacia Canada Inc.	Existing	Existing	Existing	Existing	Existing
Oesclim	Menopause symptoms	Laboratoires Fournier S.A.	Existing	Existing	Existing	Existing	Existing
Prostin	Labour induction	Pharmacia Canada Inc.	Existing	Existing	Existing	Existing	Existing
Prepidil	Cervical ripening	Pharmacia Canada Inc.	Existing	Existing	Existing	Existing	Existing
Estradiol Gel	Menopause symptoms	BioSante Pharmaceuticals, Inc.	Existing	Existing	Existing	Existing	Existing
Estradiol + Testosterone Gel	Menopause symptoms	BioSante Pharmaceuticals, Inc.	Existing	Existing	Existing	Existing	Existing
Dermatology							
Canthacur	Plantar Warts	Pharmascience Inc.	Existing	Existing	Existing	Existing	Existing
Histofreezer	Common Warts	OraSure Technologies, Inc.	Existing	Existing	Existing	Existing	Existing
Podofilm	Genital Warts	Pharmascience Inc.	Existing	Existing	Existing	Existing	Existing
Wartec	Genital Warts	Stiefel Laboratories Inc.	Existing	Existing	Existing	Existing	Existing
Allergens	Allergy Testing	Hermal GmbH	Existing	Existing	Existing	Existing	Existing
Locacorten-Vioform Line*	Topical Antimicrobial Corticosteroids	Novartis Pharmaceuticals Canada Inc.	Existing	Existing	Existing	Existing	Existing
Other Products							
Fiorinal	Tension Headaches / Mixed Migraines	Novartis Pharmaceuticals Canada Inc.	Existing	Existing	Existing	Existing	Existing
Cedocard	Anti-Anginal	Altana Pharma Inc.	Existing	Existing	Existing	Existing	Existing
Cerumol	Ear Wax removal	Laboratories for Applied Biology Ltd.	Existing	Existing	Existing	Existing	Existing
Nitrol	Anti-Anginal	Aventis S.A.	Existing	Existing	Existing	Existing	Existing
Ridaura	Rheumatoid Arthritis	Prometheus Laboratories, Inc.	Existing	Existing	Existing	Existing	Existing
Stalex	Narcotic Analgesic	Pharmascience Inc.	Existing	Existing	Existing	Existing	Existing
Stalex SR	Narcotic Analgesic	Amarin Corporation plc	Existing	Existing	Existing	Existing	Existing
Antizol	Ethylene Glycol or Methanol Poisoning	Orphan Medical Inc.	Existing	Existing	Existing	Existing	Existing
Generic Products							
pms - Lithium Carbonate	Anti-Manic Agent	Pharmascience Inc.	Existing	Existing	Existing	Existing	Existing
pms - Tryptophan	Affective Disorders	Pharmascience Inc.	Existing	Existing	Existing	Existing	Existing
pms - Valproic Acid	Anti-Convulsant	Pharmascience Inc.	Existing	Existing	Existing	Existing	Existing
pms - Selegilene	Parkinson's Disease	Pharmascience Inc.	Existing	Existing	Existing	Existing	Existing
pms - Fluxovate	Urinary Incontinence	Pharmascience Inc.	Existing	Existing	Existing	Existing	Existing

*The Locacorten Vioform Line consists of: Locacorten Vioform cream, Locacorten Vioform eardrops and Vioform Hydrocortisone cream.

KEY PRODUCTS

Strength through execution:

- Promoting products with strong opportunities
- Aggressively building brand awareness among Canadian physicians
- Creating shareholder value

The only transdermal testosterone patch available in Canada

 **ANDRODERM**TM
Testosterone Transdermal System

A preferred treatment for hyperprolactinemia

 **DOSTINEX**[®]

A novel non-systemic estrogen therapy

 Pr **Estring**[®]

The only emergency contraceptive pill approved in Canada

 **plan B**^{TM/MC}
(LEVONORGESTREL)

KEY PRODUCTS



Androderm®, the only transdermal testosterone patch available in Canada, is indicated for the treatment of testosterone deficiency in men. In 2002, Paladin launched Androderm® in a once-daily 5 mg format.

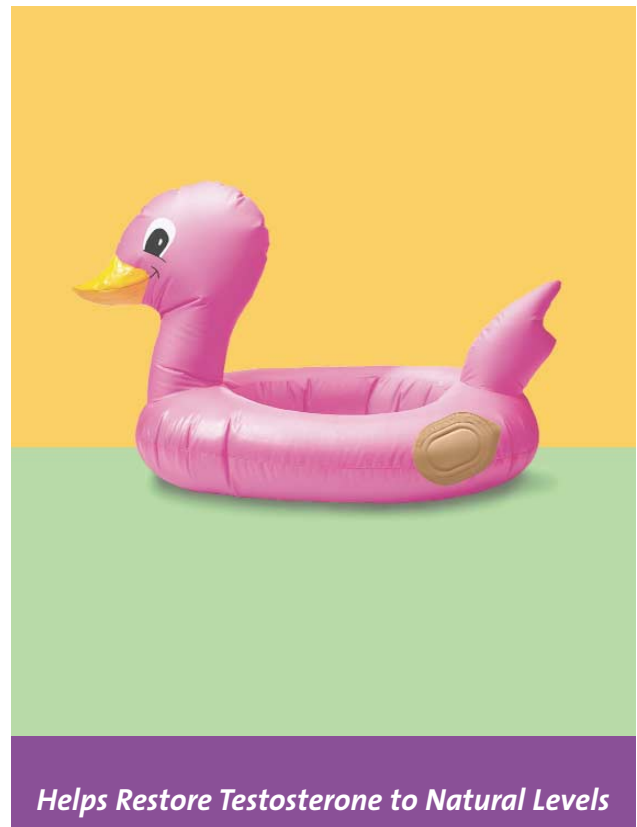
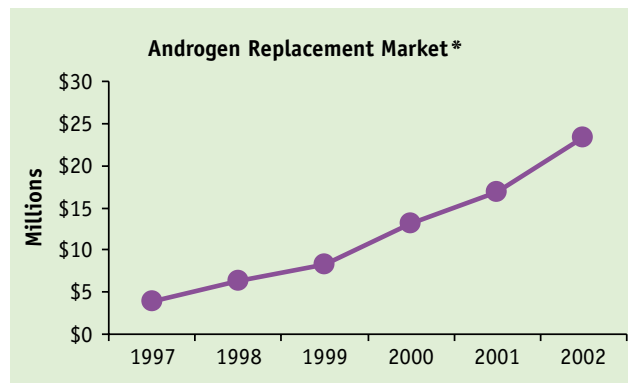
Low testosterone levels may cause symptoms such as*:

- Low energy
- Poor libido
- Weaker erections
- Depression
- Hot flashes

The Androderm® Advantage*

Helps restore testosterone to natural levels in an easy-to-use format:

- In clinical trials, 92 percent of patients achieved serum testosterone in the normal range, with positive effects on energy, libido and sexual function
- Provides consistent testosterone therapy over a 24-hour period in a way that closely matches the body's natural rhythm of testosterone production



Market Opportunity*

Estimated 1 million hypogonadal men in Canada, of whom 5 percent currently receive testosterone replacement therapy

Growing acceptance by Canadian physicians to treat andropause, the male equivalent to female menopause

Canadian testosterone replacement therapy market valued at \$23 million in 2002

Market has grown at a compounded annual growth rate of 29 percent over the past four years

*Source: Morley, J.E. et al. Metab Clin Exp 1997; 46-4104.

Harman et al., Longitudinal Effects of Aging on Serum Total and free Testosterone Levels in Healthy Men, Journal of Clinical Endocrinology & Metabolism, 2001: 86(2): 724-31, and 1991 Statistics Canada data.

IMS Health, Canadian Drug Store and Hospital Purchases Audit, 2002.



Dostinex® is indicated for the treatment of hyperprolactinemia, a condition characterized by an excess secretion of the hormone prolactin.

Hyperprolactinemia is a chronic condition characterized by elevated levels of serum prolactin:

- Caused by the presence of a benign pituitary tumor
- Symptoms in women include infertility, absence of menstrual periods, and the discharge of breast milk
- In men, hyperprolactinemia can cause lowered testosterone levels resulting in decreased libido, impotence and infertility

The Dostinex® Advantage*

Superior efficacy when compared to bromocriptine, the older therapy:

- Greater reduction in the prolactinoma tumor mass
- Superior efficacy in normalizing prolactin levels
- Less development of patient resistance or intolerance
- Effective in bromocriptine resistant cases
- Weekly as opposed to daily dosing improves patient compliance



Market Opportunity*

Dostinex® competes in a market currently valued at \$10 million

Approximately 10,000 patients are treated every year in Canada for hyperprolactinemia

Increased adoption of Dostinex® over bromocriptine among Canadian endocrinologists

*Source: The prevalence of hyperprolactinemia in an unselected normal population is 0.4% (Billir, 1998). Based on population data taken from Statistics Canada 2002, the patient population is estimated to be 126,000.

Billir BMK, Daniels GH: Neuroendocrine regulation and diseases of the anterior pituitary and hypothalamus. In Harrison's Principles of Internal Medicine. Fourteenth edition. Edited by AS Fauci, E Braunwald, KJ Isselbacher, et al. New York, McGraw Hill, 1998, pp 1972-1999.

October 2002 Statistics Canada Population Indicators.

IMS Health, Canadian Drug Store and Hospital Purchases Audit, 2001.

KEY PRODUCTS



Estring® is a localized Hormone Replacement Therapy (HRT) indicated for the treatment of postmenopausal urogenital discomfort caused by estrogen deficiency.

Estring® provides continuous long-lasting relief for:

- Vaginal dryness, soreness, and itching
- Urinary urgency
- Pain during sexual intercourse
- Painful or difficult urination

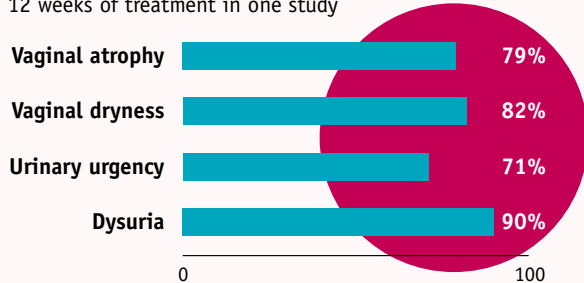
The Estring® Advantage

- Continuous relief through local delivery of low-dose estrogen
- Localized effect without appreciable systemic estradiol increases or estrogenic side effects
- Improved compliance due to ease-of-use



Oh! What a relief...

Percentage of Estring® users showing improvement from postmenopausal urogenital symptoms after 12 weeks of treatment in one study



Market Opportunity*

Over four million postmenopausal women in Canada

Canadian female HRT market valued at over \$150 million

Market is dominated by systemic HRT, which has come under scrutiny in recent studies

10 to 25 percent of women using systemic HRT continue to have urogenital discomfort

Localized therapy prescriptions currently represent less than 25 percent of the potential market

*Source: Ayton RA et al. A comparative study of safety and efficacy of continuous low dose oestradiol released from a vaginal ring compared with a conjugated equine oestrogen vaginal cream in the treatment of postmenopausal urogenital atrophy.

Laurie A. Willhite et al. Urogenital atrophy: Prevention and treatment. *Pharmacotherapy* 21(4):464-480, 2001. 2001 Pharmacotherapy Publications.

Br J Obstet Gynecol 1996;103:351-358.

8 IMS Health, Canadian CompuScript, June 2002: Canadian Drug Stores and Hospital Purchases Audit, 2002.

Based on population data Statistics Canada 2001.

Estring Product Monograph.

plan B™ (LEVONORGESTREL)

Plan B™ is the only emergency contraceptive (EC) pill approved in Canada. Plan B™ is indicated for use in preventing pregnancy after known or suspected contraceptive failure or unprotected sex.

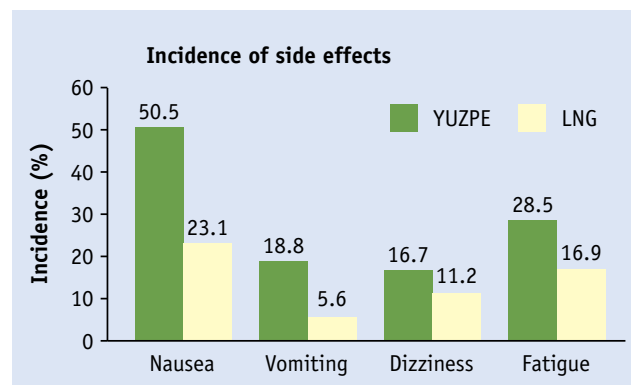
Simple dosing regimen

Comes pre-packaged with two tablets in a convenient, two-step regimen. The first pill must be taken within 72 hours of intercourse, the second 12 hours later.

The Plan B™ Advantage*

Demonstrated superior efficacy and significantly reduced nausea and vomiting when compared to the Yuzpe regimen of combined oral contraceptives in clinical trial:

- Reduced the risk of pregnancy if taken within 24 hours of intercourse by 95 percent versus 77 percent with the older Yuzpe regimen
- Reduced the risk of pregnancy if taken within 72 hours of intercourse by 85 percent versus 57 percent with the older Yuzpe regimen of combined oral contraceptives
- Women on Plan B™ reported 50 percent less nausea and 70 percent less vomiting than Yuzpe regimen users



In case of emergency, do you have your plan B?

Market Opportunity*

An estimated 50 percent of the 470,000 pregnancies in Canada annually are unintended

Current oral EC prescriptions represent less than 10 percent of the potential market

In 2002, Paladin submitted an application to Health Canada to change Plan B™ from prescription to non-prescription status

Provincial regulatory bodies in British Columbia and Quebec have authorized pharmacists to prescribe Plan B™ without a physician prescription

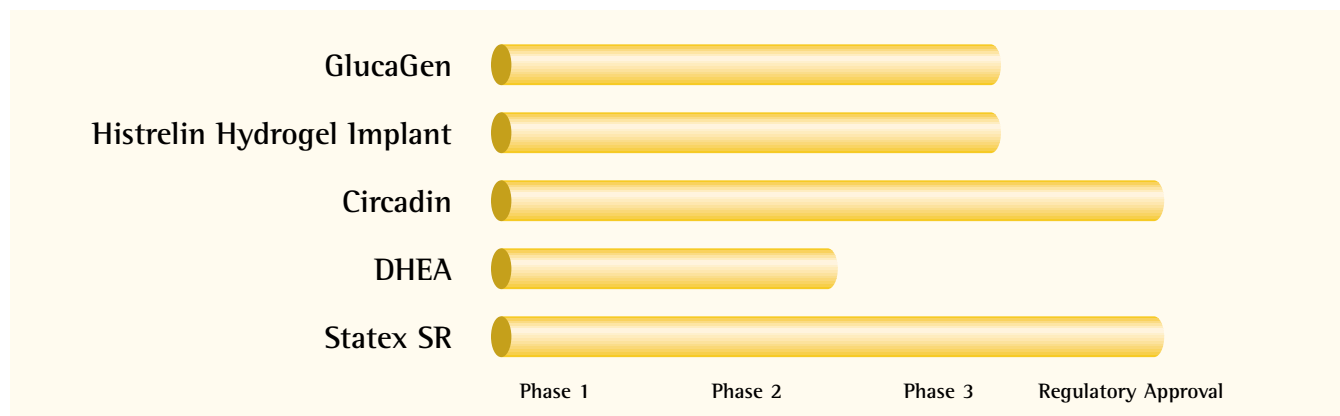
*Source: Task Force on Postovulatory Methods of Fertility Regulation. Randomized controlled trial of levonorgestrel versus the Yuzpe regimen of combined oral contraceptives for emergency contraception. *Lancet* 1998;352:428-433.

October 2002 Statistics Canada Population Indicators.

IMS Health, Canadian CompuScript, 2001.

Warner MS, Couchenour RL. *Pharmacotherapy* 2002, 22(1): 43-53.

PIPELINE PRODUCTS



GlucaGen®

In September 2002, Paladin obtained the Canadian distribution rights to GlucaGen® from Novo Nordisk Canada. GlucaGen® (recombinant glucagon for injection) is chemically identical to human glucagon. This naturally occurring peptide selectively converts liver glycogen to glucose, relaxes smooth muscles and increases the strength of cardiac contractions. Glucagon is indicated for the emergency treatment of hypoglycemia in insulin-dependent diabetics as well as for relaxation of the gastrointestinal tract during routine radiology procedures.

According to the Canadian Diabetes Association*, between 35 and 65 percent of Type I diabetics experience severe hypoglycemia each year, a condition that may result in prolonged loss of consciousness or even death. GlucaGen® rapidly restores blood glucose levels in unconscious patients which enables them to regain consciousness and ingest other sources of glucose.

IMS Canada reports that, as of June 2002, the annual market for glucagon totaled \$2.4 million, and grew at a compounded annual growth rate of 13 percent between 1997 and 2000. We expect to file a NDS for GlucaGen® with the Biologics and Gene Therapies Directorate of Health Canada in fiscal 2003.

*Source: 2001 Canadian Diabetes Association Clinical Practice Guidelines for the Prevention and Management of Hypoglycemia in Diabetes

Histrelin Hydrogel Implant

Paladin obtained the exclusive sales and marketing license for Histrelin Hydrogel Implant from Hydro Med Sciences in October 2002. Histrelin Hydrogel Implant is a unique, once-yearly implant indicated for the treatment of advanced prostate cancer. As it provides 12 months of continuous, steady-state drug delivery with a single treatment, it represents a compelling alternative to leuprolide, goserelin and buserelin injections, which are currently administered once every one, three or four months.

The National Cancer Institute of Canada* estimates that excluding skin cancers, prostate cancer is the most common cancer among Canadian men. Every year in Canada, some 16,000 new cases are diagnosed and of those diagnosed, as many as 4,000 die.

In 2001 the total LHRH agonist market in Canada for the treatment of prostate cancer was \$69 million, according to IMS Canada. Since 1998, growth in this market, on a prescription basis, has occurred at a compounded annual growth rate of 8 percent.

The implant is currently being investigated in a multi-center, pivotal Phase III trial in Canada and the United States. Based on encouraging interim data from this trial, we anticipate that a regulatory submission will be filed in Canada by the end of our first quarter of fiscal 2004.

*Source: National Cancer Institute of Canada: Canadian Cancer Statistics 1999

Circadin®

In 2002, Paladin filed a NDS with Health Canada, on behalf of Neurim Pharmaceuticals, for Circadin® (controlled release melatonin tablets) for use in the treatment of sleep disorders in the elderly.

Circadin® contains 2 mg of melatonin in a controlled-release formulation. While in the United States, the FDA considers melatonin a health food supplement, Health Canada classifies it as a new chemical entity. As such, it needs a full NDS before it can be sold commercially in Canada. Currently, there are no legal sales of melatonin in Canada. Circadin® has the potential to be the first melatonin product approved for sale in Canada. This represents a great opportunity for Paladin given Circadin's sales performance in the United States is estimated at US \$80 million.

DHEA (Fidelin™)

DHEA (dehydroepiandrosterone) is a prevalent adrenal hormone and neurosteroid that decreases with aging. A recent paper in the New England Journal of Medicine revealed that in a Phase II trial, women with Addison's Disease (adrenal insufficiency) had a statistically significant improvement in well-being and sexual function after taking 50 mg of DHEA daily. Like Circadin®, Health Canada classifies DHEA as a new chemical entity that requires a full NDS and regulatory approval before it can be sold commercially. As a non-regulated drug, DHEA's OTC market is estimated to be in excess of US \$50 million.

Paladin continues to develop this product with the aim of gaining Canadian regulatory approval, and making DHEA available to Canadian specialty physicians. In 2001, we advanced the clinical program by continuing to study DHEA for the treatment of adrenal insufficiency (primary and secondary) and by exploring how to collaborate with international companies to accelerate clinical development. During 2002, we also developed our own formulation of DHEA and initiated a pharmacokinetic study to assess the profile of this formulation.

Statex® SR

In 2002, Paladin filed a NDS for the approval of Statex® SR with Health Canada. Statex® SR (12-hour sustained-release morphine sulfate) is a twice-daily morphine product used for the relief of severe pain requiring the prolonged use of an opioid analgesic preparation. It was developed by Amarin Corporation plc and licensed from Drug Royalty Corporation in November 1996.

The results of a multi-center double-blind clinical equivalence study, performed by the National Cancer Institute of Canada (Clinical Trials Group), demonstrated that, in terms of average scores in pain, nausea, drowsiness and insomnia, Statex® SR is equivalent to Purdue Pharma L.P.'s MS-Contin®, a leading controlled release morphine sulfate tablet brand.

MANAGEMENT DISCUSSION AND ANALYSIS

All numbers are in thousands of Canadian dollars except for share and per share amounts

The following analysis explains the variations in the results of operations, financial position and cash flows for Paladin Labs Inc. ("Paladin" or the "Company"). This discussion should be read in conjunction with the information contained in the Company's financial statements and the related notes to the financial statements.

Overview

Paladin is a speciality pharmaceutical company focused on acquiring or in-licensing innovative pharmaceutical products for the Canadian market. Through a national sales force, the Company markets its pharmaceutical products to Canadian physicians in its key therapeutic areas.

Paladin's strategy is to acquire promotion sensitive products with existing sales and to increase sales of these products through focused marketing and promotion. The Company also in-licenses late-stage development products, obtains regulatory approval for them and then launches them in the Canadian market. This strategy allows Paladin to take advantage of the consolidation in the pharmaceutical industry. Furthermore, this strategy provides emerging biotechnology companies with a proven Canadian partner with both regulatory and marketing expertise.

In 2002, Paladin made solid progress in acquiring the rights to innovative products, submitting products for regulatory approval and launching pharmaceutical products into the Canadian market:

- Paladin acquired the Canadian distribution rights to GlucaGen®, indicated for the treatment of hypoglycemia in insulin dependent diabetics, from Novo Nordisk Canada Inc. and in-licensed Histrelin Hydrogel Implant, a once yearly therapy for advanced prostate cancer, from Hydro Med Sciences, Inc.
- Paladin filed New Drug Submissions with Health Canada for the approval of: i) Statex® SR (sustained-release morphine sulfate tablets), a twice-daily morphine product used for the relief of severe pain; and, ii) Circadin®, a controlled release melatonin tablet indicated for the treatment of sleep disorders in the elderly.
- In addition, the Company submitted an application to Health Canada to have Plan B™ granted non-prescription status. Plan B™ is the first progestin-only pill indicated to prevent pregnancy after a contraceptive failure or unprotected sex.
- Paladin launched ten new products in the Canadian market in 2002, including: Dostinex®, Estring®, Androderm® 5 mg format, the Locacorten®-Vioform® line of products and Rogitine®.

Paladin's revenues reached \$23,355 for the year ended December 31, 2002. For the year ended December 31, 2002, the Company's net income was \$5,162 or \$0.36 per diluted share compared to \$1,485 or \$0.12 per diluted share for the year ended December 31, 2001.

As at December 31, 2002, the Company's total assets were \$68,655, and shareholders' equity was \$63,178. The Company's cash, cash equivalents, short-term, and long-term marketable securities amounted to \$45,612 as at December 31, 2002.

Paladin's revenue is principally derived from sales of pharmaceutical products to large pharmaceutical wholesalers and large chain pharmacies.

Paladin utilizes a "pull-through" marketing approach that is typical of pharmaceutical companies. Paladin's sales representatives demonstrate the features and benefits of its products to physicians who may write prescriptions for Paladin's products. These physicians write prescriptions for their patients, who, in turn, take the prescriptions to pharmacies to be filled. The pharmacies then place orders with the wholesalers, or, in case of large chain pharmacies, their distribution centers, to whom Paladin sells its products.

The Company's expenses have been comprised primarily of selling and administrative expenses (including marketing expenses), cost of goods sold (including royalty payments to those companies from whom Paladin licenses its products) and research and development expenses. In addition, because Paladin acquires many of the products that it markets, a substantial portion of the Company's expenses are related to amortization of intangible assets and deferred charges.

Paladin's annual and quarterly operating results are primarily affected by the following factors: the level of acceptance of Paladin's products by physicians and their patients; and wholesaler buying patterns. Wholesaler buying patterns, including a tendency to increase inventory levels prior to an anticipated or announced price increase, affect the Company's operating results by shifting revenue between quarters. To ensure that Paladin maintains good relations with wholesalers, Paladin typically gives wholesalers prior notice of price increases to enable them to purchase products that they will later sell at higher prices. The level of patient and physician acceptance of Paladin's products, as well as the availability of similar therapies, impact Paladin's revenues by driving the level and timing of prescriptions for its products.

Critical Accounting Policies

Paladin's financial statements are prepared in accordance with Canadian generally accepted accounting principles, applied in a consistent basis. Paladin's critical accounting policies include the use of estimates, revenue recognition, the recording of research and development expenses and the useful lives or fair value of intangible assets.

Use of Estimates

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates and such differences could be material. Significant estimates made by management include the calculation of reserves for doubtful accounts, product returns, useful lives of long-lived assets, fair value of intangible assets, contingency provisions and other accrued charges. These estimates were made using the historical information available and management's best estimate of future events.

Revenue Recognition

Revenue is recognized when the product is shipped to the Company's customers, provided the Company has not retained any significant risks of ownership or future obligations with

respect to the product shipped. Revenue from product sales is recognized net of sales discounts and allowances. In certain circumstances, returns or exchange of products are allowed under the Company's policy and provisions are maintained accordingly.

Intangible Assets

Intellectual property acquired is recorded at cost and consists primarily of process know-how covered by certain patented and non-patented information. Pharmaceutical product licenses, rights and intellectual property are amortized on a straight-line basis over the lesser of the term of the agreement, the life of the patent or twenty years. The terms generally range from 10 to 20 years. Management reviews the carrying value based on projected future results annually and whenever events or changes in circumstances indicate that the asset may be impaired. Any impairment in the carrying value results in a write-down of the pharmaceutical product license and right and intellectual property which is charged to income during the year.

Research and Development Expenses

Research costs are charged against income in the year of expenditure, net of related tax credits. Development costs are charged against income in the year of expenditure unless a development project meets the criteria under generally accepted accounting principles for deferral and amortization. The Company has not deferred any such development costs to date.

Quarterly Information

(In thousands of Canadian dollars except per share information)

	2002				2001			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Sales	5,344	5,687	6,087	6,237	3,485	4,515	4,859	4,936
Income before write-down of intellectual property and income taxes	1,636	1,688	1,808	1,459	614	1,151	1,578	987
Net Income (loss)	1,401	1,440	1,533	788	515	995	1,473	(1,498)
Basic and fully diluted EPS	\$0.11	\$0.10	\$0.10	\$0.05	\$0.04	\$0.08	\$0.12	\$(0.12)

Results of Operations

Year Ended December 31, 2002 Compared to Year Ended December 31, 2001.

Revenues

Revenues increased \$5,560 or 31%, to \$23,355 for the year ended December 31, 2002 from \$17,795 for the year ended December 31, 2001. This increase was due to strong market performance from our established product lines, such as Androderm® and Plan B™, as well as first time revenue from newly acquired brands including Dostinex®, Estring® and the Locacorten®-Vioform® line of products.

Gross Profit

Total gross profit increased \$4,961 or 41%, to \$16,968 for the year ended December 31, 2002 from \$12,007 for the year ended December 31, 2001. Gross profit, as a percentage of revenues, improved to 73% for the year ended December 31, 2002 from 67% for the year ended December 31, 2001. This increase resulted primarily from the additions to the Company's product portfolio, whereby, the Company earns a distribution fee and consequently does not have cost of sales related to these products.

Selling and Administrative Expense

Selling and administrative expense increased \$2,303 or 33%, to \$9,343 for the year ended December 31, 2002 from \$7,040 for the year ended December 31, 2001. This increase was primarily attributed to increased marketing spending associated with new product launches and to higher staffing costs related to expanded infrastructure necessitated by the Company's product line growth during the past year. Selling and administrative expense, as a percentage of revenues, remained unchanged at 40% for 2002 and 2001. As the Company expands its sales and marketing infrastructure in 2003, it is expected that selling and administrative expense, as a percentage of revenues, will be between 55% and 60% for the year ended December 31, 2003.

Research and Development Expense

Research and development expense increased \$90 or 9% to \$1,084 for the year ended December 31, 2002 from \$994 for the year ended December 31, 2001.

This increase was primarily due to higher staffing costs and associated costs required to support DHEA and other products in various stages of development including further Canadian regulatory expense for currently marketed products.

Amortization Expense

Amortization expense increased \$1,058 or 162%, to \$1,710 for the year ended December 31, 2002 from \$652 for the year ended December 31, 2001. This increase reflected the impact of amortization expense related to the Company's acquisition of licenses, rights and intellectual property during the year ended December 31, 2001, as well as the year ended December 31, 2002.

Interest Income

Interest income increased \$56 or 6% to \$1,065 for the year ended December 31, 2002 from \$1,009 for the year ended December 31, 2001, reflecting the effect of the investment of the proceeds of the May 2002 equity issue offset by the effect of lower interest rates during the year ended December 31, 2002.

Other Income

During the year, the Company received \$695 related to certain license and trademark license agreements.

Write-Down of Intellectual Property

During 2002 and 2001, the Company recorded write-downs and gains associated with the intellectual property described below.

During 2001, Connetics Corporation announced that it would no longer continue its relaxin program and the Company wrote-off the unamortized balance of \$1,675 relating to this license on December 31, 2001.

During 2001, Synsorb Biotech Inc. announced that it decided to terminate further development of SYNSORB Cd® and the Company wrote-off the unamortized balance of \$85 relating to this license.

During 2001, the Company surrendered its right to the E2 Patch and BioSante Pharmaceuticals, Inc. ("BioSante") withdrew E2-NETA and provided consideration of 173,611 shares of BioSante. The Company recorded a gain of \$108.

The Company entered into a Marketing and Distribution agreement with SkyePharma, Inc. relating to DepoCyt™ on June 2000. During 2001, management reviewed the valuation of the license for DepoCyt™ and determined that there was an impairment in the carrying value of this license. Consequently, the Company recorded a write-down of \$750.

During 2002, the Company returned the rights to DepoCyt™ to SkyePharma, Inc. and recorded a gain of \$47.

The Company entered into a License and Trade-Mark License agreement with Novartis in November 2001 relating to Rogitine®. During 2002, management reviewed the valuation of the license for Rogitine® and determined that there was an impairment in the carrying value of this license. Consequently, the Company recorded a write-down of \$474.

Income Tax Expense

Income tax expense increased \$559 or 126% to \$1,002 for the year ended December 31, 2002 from \$443 for the year ended December 31, 2001. The effective tax rate was 16% for the year ended December 31, 2002 compared to 23% for the year ended December 31, 2001. For the year ended December 31, 2001, the Company recorded a charge of \$168 in tax expense for the impact of expected changes in tax rates related to loss carry forwards.

Net Income

Due to the factors set forth above, net income increased \$3,677 or 248%, to \$5,162 for the year ended December 31, 2002 from \$1,485 for the year ended December 31, 2001.

Liquidity and Capital Resources

The Company believes that its existing cash and cash equivalents and short-term and long-term marketable securities, as well as cash generated from operations are sufficient to finance its current operations and working capital needs and future product acquisitions. At present, the Company is actively pursuing product acquisitions that may require the use of substantial capital resources. There are no present agreements or commitments with respect to any such acquisitions.

Cash flows from operating activities were \$8,634 and \$5,154 for the years ended December 31, 2002 and 2001, respectively. Cash flows from operating activities represent the cash flows from net earnings, excluding revenues and expenses not affecting cash, principally amortization, write-down of intellectual property, future income taxes and imputed interest.

Higher cash flows from operating activities for fiscal 2002 was mainly the result of an increase in net income, amortization, and net change in non-cash balances relating to operations.

The Company's investing activities used cash of \$28,772 and \$6,593 for the years ended December 31, 2002 and 2001, respectively. During the year ended December 31, 2002, the Company invested \$4,496 in acquisitions of patents, pharmaceutical product licenses and rights and intellectual property and had a decrease in accounts payable related to acquisition of intellectual property of \$1,731. The Company received \$639 from SkyePharma, Inc. related to the disposal of DepoCyt™. In addition, the Company had a \$23,122 increase in short-term and long-term marketable securities. The principle uses of cash in fiscal 2001 were acquisitions of patents, pharmaceutical product licenses and rights and intellectual property of \$9,627 offset by an increase in accounts payable related to acquisition of intellectual and had a reduction in short-term marketable securities of \$1,011.

Cash flows from financing activities were \$20,180 and \$559 for the years ended December 31, 2002 and 2001, respectively. For the year ended December 31, 2002, cash was provided for the issuance of special warrants less related issuance of costs. In addition, cash was provided from common stock option exercises and the issuance of common shares under the stock purchase plan. For the year ended December 31, 2001, cash flows from financing activities was primarily from common stock option exercises and the issuance of common shares under the stock purchase plan.

The Company owns common shares of Anthra Pharmaceutical, Inc. ("Anthra") with a carrying value of \$1,500. Anthra is a private corporation based in the United States and it is not practicable within constraints of timeliness or cost to determine the fair value of the common shares. However, the Company's assessment of the carrying value of the investment in Anthra has indicated that there were a number of factors which could result in a near term impairment of the value of the Company's investment which could be material.

Risk Factors

Volatility of Share Price

The market price of Paladin's shares is subject to volatility. Deviations in actual financial results as compared to the expectations of securities analysts who follow the Company can have a significant effect on the trading volumes and/or valuation of Paladin's shares. Changes in accounting standards could or could not have an impact on the financial statements' presentation.

Interest Rate Risk

The Company's short-term, and long-term marketable securities are subject to interest rate risks. As outlined in notes 4 and 6 to the financial statements, the Company holds corporate bonds, government bonds, and discount notes. The purpose of these short-term and long-term marketable securities is to fund acquisitions of patents, pharmaceutical product licenses and rights and intellectual property.

Product Commercialization Risk

The Company's strategy includes in-licensing late-stage development products. This strategy entails external and environmental risks including: the uncertainties involved in clinical testing, the cost and time involved in obtaining regulatory approvals, the uncertainties related to obtaining commercially viable pricing as well as appropriate reimbursement levels. While Management strives to have a portfolio of products that are in late-stage clinical development and believes that these products offer revenue generating potential, there can be no assurance that this will prove correct.

Generic Product Risk

Although most of the Company's revenue is generated from products not subject to competition from generic products, there is no proprietary protection for many of our branded pharmaceutical products. The entrance into the market of a generic pharmaceutical product may have a material adverse effect on the Company's business, financial condition and results of operations.

Dependence on Affiliate

The Company outsources several business activities to an affiliate, including: laboratory studies, product formulation, clinical data analysis, product manufacturing and product distribution. Although all such transactions are conducted at arm's length, should this affiliate terminate these contracts, the Company's business may be adversely affected by the interruption in services.

Forward-Looking Statements

This document contains forward-looking statements, which reflect the Company's current expectations regarding future events. The forward-looking statements involve risk and uncertainties, including the difficulty in predicting product approvals, acceptance and demand for new pharmaceutical products, the impact of competitive products and pricing, new product development and timing of launch, availability of raw materials, the regulatory environment, fluctuations in operating results and other risks. Many risks are inherent in the pharmaceutical industry; others are more specific to Paladin. Investors should consult the Company's ongoing quarterly filings, annual reports and Annual Information Form for additional information on risks and uncertainties relating to these forward-looking statements.

MANAGEMENT'S REPORT

The accompanying financial statements of **Paladin Labs Inc.** and all of the information in this Annual Report are the responsibility of management and have been approved by the Board of Directors.

The financial statements have been prepared in accordance with Canadian generally accepted accounting principles. The most significant of these accounting principles are described in Note 2 to the financial statements. The financial statements include some amounts that are based on estimates and judgments. Management has determined such amounts on a reasonable basis in order to ensure that the financial statements are presented fairly in all material respects. The Company's accounting procedures and related systems of internal control are designed to provide reasonable assurance that its assets are safeguarded and its financial records are reliable. The financial information elsewhere in this Annual Report is consistent with the information presented in the financial statements.

The Board of Directors has appointed an Audit Committee consisting of three outside directors. The committee meets periodically during the year to review with management and the external auditors any significant accounting, internal control and auditing matters. They review and finalize the annual financial statements of the Company along with the external auditors' report prior to the submission of the financial statements to the Board of Directors for final approval.

The Company's external auditors, Ernst & Young LLP, Chartered Accountants, conduct an independent audit on behalf of the shareholders, in accordance with Canadian generally accepted auditing standards, and express their opinion on the financial statements. Their report outlines the scope of their audit and their opinion on the financial statements of the Company. The external auditors have full access to management and the Audit Committee of the Board.

Montreal, Canada
January 17, 2003



Jonathan Ross Goodman,
B.A., LL.B., M.B.A.
President & CEO



Samira Sakhia, CA
Chief Financial Officer

AUDITORS' REPORT

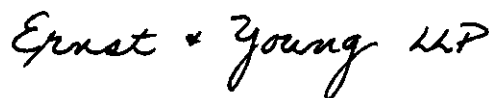
To the Shareholders of
Paladin Labs Inc.

We have audited the balance sheets of **Paladin Labs Inc.** as at December 31, 2002 and 2001 and the statements of income and retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatements. 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 financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2002 and 2001 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Montreal, Canada
January 17, 2003



Chartered Accountants

BALANCE SHEETS

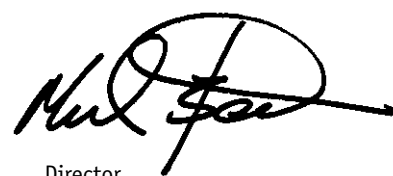
As at December 31 [In thousands of Canadian dollars]	2002 \$	2001 \$
ASSETS		
Current		
Cash and cash equivalents	2,020	1,978
Short-term marketable securities [note 4]	36,572	20,470
Accounts receivable and other assets [note 5]	2,586	2,067
Inventories	21	50
Investment tax credits receivable [note 15]	325	487
Future income tax assets [note 16]	1,221	2,275
Total current assets	42,745	27,327
Long-term marketable securities [note 6]	7,020	—
Property plant and equipment [note 7]	72	33
Intangible assets [note 8]	12,703	12,497
Deferred charges [note 9]	1,515	—
Investments, at cost [note 10]	2,771	2,771
Future investment tax credits recoverable [note 16]	470	347
Future income tax assets [note 16]	1,359	2,216
	68,655	45,191
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Accounts payable and accrued liabilities	3,658	3,924
Income taxes payable	109	181
Balance of sale payable [note 11]	597	—
Deferred credit [note 16]	1,113	1,638
Total current liabilities	5,477	5,743
Balance of sale payable [note 11]	—	544
Deferred credit [note 16]	—	935
Future income tax liability [note 16]	—	133
	5,477	7,355
Shareholders' equity		
Capital stock [note 12]	57,334	37,154
Contributed surplus	87	87
Other paid-in capital [note 12]	23	23
Retained earnings	5,734	572
Total shareholders' equity	63,178	37,836
	68,655	45,191

See accompanying notes

On behalf of the Board:



Director



Director

STATEMENTS OF INCOME AND RETAINED EARNINGS

Years ended December 31 [In thousands of Canadian dollars except for share and per share amounts]	2002 \$	2001 \$
Revenues <i>[note 14]</i>	23,355	17,795
Cost of sales <i>[note 14]</i>	6,387	5,788
Gross profit	16,968	12,007
Selling and administrative <i>[note 14]</i>	9,343	7,040
Research and development <i>[notes 14 and 15]</i>	1,084	994
Amortization of intangible assets and deferred charges	1,710	652
Interest income, net	(1,065)	(1,009)
Other income	(695)	—
Income before undernoted items	6,591	4,330
Write-downs of intellectual property and gain on disposition <i>[note 13]</i>	427	2,402
Income before income taxes	6,164	1,928
Provision for income taxes <i>[note 16]</i>		
Current	102	41
Future	900	402
	1,002	443
Net income	5,162	1,485
Retained earnings (deficit), beginning of year	572	(913)
Retained earnings, end of the year	5,734	572
Earnings per share		
Basic	0.37	0.12
Diluted	0.36	0.12
Weighted average number of shares outstanding <i>[note 17]</i>		
Basic	13,989,832	12,428,188
Diluted	14,160,630	12,496,356

See accompanying notes

STATEMENTS OF CASH FLOWS

Years ended December 31 [In thousands of Canadian dollars]	2002 \$	2001 \$
OPERATING ACTIVITIES		
Net income	5,162	1,485
Add items not affecting cash		
Amortization	1,733	661
Write-down of intellectual property	427	2,402
Future income taxes	195	242
Imputed interest on balance of sale	53	49
Expenses related to options issued to consultants	—	23
	7,570	4,862
Net change in non-cash balances relating to operations	1,064	292
Cash flows from operating activities	8,634	5,154
INVESTING ACTIVITIES		
Additions to pharmaceutical product licenses and rights, intellectual property and deferred charges	(4,496)	(9,627)
Accounts payable related to the acquisition of intellectual property and deferred charges	(1,731)	2,250
Acquisition of property plant and equipment	(62)	(16)
Purchases of short-term marketable securities	(46,350)	(22,655)
Maturities of short-term marketable securities	30,248	23,666
Purchases of long-term marketable securities	(7,020)	—
Proceeds from disposal of pharmaceutical license	639	—
Net increase in investment	—	(211)
Cash flows from investing activities	(28,772)	(6,593)
FINANCING ACTIVITIES		
Common shares issued for cash	219	539
Issuance of special warrants	20,952	—
Share issue costs, net of tax	(1,011)	—
Repayment of share purchase loan	20	20
Cash flows from financing activities	20,180	559
Net change in cash and cash equivalents during the year	42	(880)
Cash and cash equivalents, beginning of year	1,978	2,858
Cash and cash equivalents, end of year	2,020	1,978
Cash and cash equivalents consist of:		
Cash	1,162	1,978
Cash equivalents	858	—
Supplemental cash flow information		
Interest paid	2	2
Income taxes paid	114	31

See accompanying notes

NOTES TO FINANCIAL STATEMENTS

December 31, 2002

[In thousands of Canadian dollars except for share and per share amounts]

1. NATURE OF OPERATIONS

Paladin Labs Inc. [the "Company"] is a Canadian public company continued under the *Canada Business Corporations Act*. The Company's shares are traded on the Toronto Stock Exchange. The Company's business consists of in-licensing or acquiring, marketing, distributing and developing innovative pharmaceutical products in Canada.

2. BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

The financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles, the most significant of which are described below:

Use of estimates

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates and such differences could be material.

Cash and cash equivalents

Cash consists of bank deposits. Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of change in value, and consist primarily of bankers' acceptances with maturities of three months or less.

Inventories

Inventories are valued at the lower of cost, determined on a first-in, first-out basis, and net realizable value.

Short-term and long-term marketable securities

Short-term marketable securities are recorded at the lower of cost and market value on a portfolio basis. Long-term marketable securities are recorded at their cost and are written down to their market value when a decline in market value is other than temporary.

Investments

Investments in common shares of private and public companies, where the Company does not exercise significant influence, are accounted for by the cost method whereby earnings are recognized only to the extent that dividends are declared. Annually or whenever events or changes in circumstances indicate, the Company performs a review of its investments to determine if there has been other than temporary impairment in value. Any impairment in the value of the investment results in a write-down which is charged to income during the year.

Property plant and equipment

Property plant and equipment are recorded at cost. Amortization is provided on a basis and at rates assigned to amortize the cost of the assets over their estimated useful lives as follows:

Computer equipment and software: 30% declining balance

Intangible assets

In the normal course of business, the Company secures Canadian development, sales and marketing rights to innovative drug products. Intellectual property acquired is recorded at cost and consists primarily of process know-how covered by certain patented and non-patented information. Pharmaceutical product licenses, rights and intellectual property are amortized on a straight-line basis over the lesser of the term of the agreement, the life of the patent or twenty years. The terms generally range from 10 to 20 years. Management reviews the carrying value based on projected future results annually and whenever events or changes in circumstances indicate that the asset may be impaired. Any impairment in the carrying value results in a write-down of the pharmaceutical product license and right and intellectual property which is charged to income during the year.

Deferred charges

Under a number of operating agreements the Company has agreed to pay certain amounts over periods ranging from three to five years and has obtained the exclusive distribution rights to certain products for a period of ten years. The deferred charges are amortized over the term of the distribution right. Management reviews the carrying value based on projected future results annually and whenever events or changes in circumstances indicate that the asset may be impaired. Any impairment in the carrying value results in a write-down of the deferred charge which is charged to income during the year.

Revenue recognition

Revenue is recognized when the product is shipped to the Company's customers, provided the Company has not retained any significant risks of ownership or future obligations with respect to the product shipped. Revenue from product sales is recognized net of sales discounts and allowances. In certain circumstances, returns or exchange of products are allowed under the Company's policy and provisions are maintained accordingly.

Government assistance

Amounts received or receivable resulting from government assistance programs, including grants and investment tax credits for research and development, are reflected as reductions of the cost of the assets or expenses to which they relate at the time the eligible expenditures are incurred, provided there is reasonable assurance the benefits will be realized.

Research and development

Research costs are charged against income in the year of expenditure. Development costs are charged against income in the year of expenditure unless a development project meets the criteria under generally accepted accounting principles for deferral and amortization. The Company has not deferred any such development costs to date.

Interest income

Interest income is recognized as it accrues to the Company.

Income taxes

The Company provides for income taxes using the liability method. Under this method, future income tax assets and liabilities are determined based on the differences between the financial reporting and tax bases of assets and liabilities and are measured using substantively enacted tax rates and laws that are expected to be in effect in the period in which the future tax assets or liabilities are expected to be realized or settled. Future income tax assets are recognized to the extent that it is more likely than not that they will be realized.

Deferred credit

The deferred credit results from the acquisition of future income tax benefits arising from a business combination. The deferred credits are amortized to income tax expense, proportionately as these benefits are realized.

Stock-based compensation plans

The Company has a stock-based compensation plan, which is described in Note 12. No compensation expense is recognized for this plan when stock or stock options are issued to employees and directors. Any consideration paid by employees on exercise of stock options or purchase of stock is credited to share capital. If stock or stock options are repurchased from employees, the excess of the consideration paid over the carrying amount of the stock or stock options canceled is charged to retained earnings. Options issued to consultants are recognized as an expense in the period they are granted using the Black-Scholes option pricing model.

Earnings per share

Basic earnings per share are calculated using the weighted average number of shares outstanding during the year. Diluted earnings per share are calculated using the treasury stock method, giving effect to the exercise of all dilutive factors. The treasury stock method assumes that any proceeds that could be obtained upon the exercise of options would be used to purchase common shares at the average market price during the period.

Foreign currency translation

Transactions arising in foreign currencies are translated into Canadian dollars at the exchange rate prevailing at the transaction dates. At the balance sheet date, monetary assets and liabilities denominated in foreign currencies are translated at the year-end rates of exchange. Exchange gains and losses arising from the translation of foreign currency items are included in the determination of net income.

3. CHANGE IN ACCOUNTING POLICIES

i) Effective January 1, 2002, the Company prospectively adopted the new recommendation published by the Canadian Institute of Chartered Accountants relating to the method of valuation and the presentation and disclosure requirements for intangible assets. The new recommendations require recognized intangible assets to be

amortized over their useful life to an enterprise, unless the life is determined to be indefinite. When an intangible asset is determined to have an indefinite useful life, it should not be amortized until its life is determined to be no longer indefinite. The amortization method and estimate of the useful life of an intangible asset should be reviewed annually. Intangible assets, which are subject to amortization, are tested for impairment by comparing the net carrying amount with the net recoverable amount whereas for intangible assets not subject to amortization, the net carrying amount is compared to the asset's fair value. The impact of the adoption of the new recommendations will not result in any change to the recognized intangible assets of the Company because its intangible assets are not considered to have an indefinite life. However, the Company will have additional disclosure requirements relating to its intangible assets.

ii) Effective January 1, 2002, the Company prospectively adopted the new recommendation published by the Canadian Institute of Chartered Accountants relating to stock based compensation and other stock based payments. The Company has chosen to recognize no compensation when stock options are granted to employees and directors at the prevailing market price and where there are no cash settlement features. However, direct awards of stock to employees and stock options awards granted to non-employees will continue to be accounted for in accordance with the fair value method of accounting for stock based compensation.

4. SHORT-TERM MARKETABLE SECURITIES

	2002 \$	2001 \$
Corporate bonds, earning interest at rates ranging from 2.95% to 3.79% [3.86% to 5.40% in 2001] and maturing on various dates from February 2003 to December 2003 [February 2002 and September 2002 in 2001]	14,170	14,635
Government bonds, earning interest at rates ranging from 2.86% to 3.76% [1.90% to 2.30% in 2001] and maturing on various dates from May 2003 to September 2003 [September 2002 in 2001]	13,951	3,155
Discount notes, earning interest at rates ranging from 2.72% to 3.75% [2.00% in 2001] and maturing on various dates from February 2003 to April 2003 [April 2002 and June 2002 in 2001]	8,451	2,680
	36,572	20,470

Short-term marketable securities comprise five investments [three in 2001] in corporate bonds, five investments in government bonds [two in 2001] and three in discount notes [two in 2001] issued by unrelated corporations.

5. ACCOUNTS RECEIVABLE AND OTHER ASSETS

	2002	2001
	\$	\$
Receivable from an affiliated company [note 11]	1,697	1,213
Interest receivable	263	339
Other receivables	366	449
Other assets	260	66
	2,586	2,067

Other receivables consist primarily of commodity taxes of \$139 [2001 – \$105] and trade receivables of \$200 [2001 – \$317].

6. LONG-TERM MARKETABLE SECURITIES

	2002	2001
	\$	\$
Government bonds, earning interest at rates ranging from 3.83% to 4.39% and maturing on various dates from January 2004 to June 2004	7,020	—
	7,020	—

Long-term marketable securities comprise three investments in government bonds.

7. PROPERTY PLANT AND EQUIPMENT

	2002		2001	
	Cost	Accumulated amortization	Cost	Accumulated amortization
	\$	\$	\$	\$
Computer and software equipment	109	37	47	14
Total	109		47	14
Less: accumulated amortization	37		14	
Net carrying value	72		33	

8. INTANGIBLE ASSETS

	2002		2001	
	Cost	Accumulated amortization	Cost	Accumulated amortization
	\$	\$	\$	\$
Pharmaceutical product licenses and rights, and intellectual property	14,050	1,347	13,103	606
Total	14,050	1,347	13,103	606
Less: accumulated amortization	1,347		606	
Net carrying value	12,703		12,497	

During the year the Company purchased \$2,171 [2001 – \$9,627] of intangible assets and recorded amortization expense of \$900 [2001 – \$652].

9. DEFERRED CHARGES

	2002		2001	
	Cost	Accumulated amortization	Cost	Accumulated amortization
	\$	\$	\$	\$
Deferred charges	2,325	810	—	—
Total	2,325	810	—	—
Less: accumulated amortization	810			
Net carrying value	1,515			

10. INVESTMENTS

	2002	2001
	\$	\$
Investment in common shares of Connetics Corporation, a public corporation in the United States [US\$200] [market value – \$412 [2001 – \$414]]	304	304
Investment in shares of Anthra Pharmaceuticals, Inc. [“Anthra”], [US\$1,000] [market value – see note [i] below]	1,497	1,497
Investment in common shares of BioSante Pharmaceuticals, Inc., a public company in the United States [US\$636] [market value \$444 [2001 – \$1,136]]	970	970
	2,771	2,771

Management's review to determine if there has been other than a temporary decline in the market value of these investments below the carrying value may require the Company to recognize an impairment charge on the remaining value of its investments which could be material.

[i] Anthra is a private corporation based in the United States and it is not practicable within constraints of timeliness or cost to determine the fair value of the common shares. However, the Company's assessment of their carrying value of their investment in Anthra Pharmaceuticals, Inc. has indicated that there were a number of factors which could result in a near term impairment of the value of the Company's investment which could be material.

11. BALANCE OF SALE PAYABLE

In 1999, the Company acquired all of the outstanding common shares of NPI for a total consideration of \$750 consisting of \$100 cash and a \$650 non-interest bearing balance of sale due on December 21, 2003. NPI focuses on the discovery and development of novel therapeutics relating to dehydroepiandrosterone [DHEA]. Given the non-interest bearing nature of the \$650 balance of sale, the amount has been recorded in these financial statements at its discounted net present value of \$450 which will be accreted over the repayment term. As at December 31, 2002, the Company had recorded \$53 [\$49 in 2001] of interest expense and showed an accreted value of \$597 [\$544 in 2001], in balance of sale payable.

12. CAPITAL STOCK

Authorized

100,000,000 common shares without nominal or par value.

Issued and outstanding

	2002		2001	
	Number of shares	Amount \$	Number of shares	Amount \$
Balance, beginning of year	12,539,247	37,154	12,394,038	36,595
Issued during the year:				
Conversion of special warrants	2,205,500	20,952	—	—
Conversion of warrants	—	—	1,450	12
Exercise of stock options	30,041	183	143,412	525
Employee share purchase plan	5,417	36	347	2
Share issue costs, net of income taxes	—	(1,011)	—	—
Employee share purchase loan	—	20	—	20
Balance, end of year	14,780,205	57,334	12,539,247	37,154

Shareholder rights plan

On June 30, 1998, the Company adopted a Shareholders Rights ("Rights Plan"). Under the Rights Plan, holders of voting shares, including the Corporation's common shares, are entitled to one share purchase right ("Right") for each voting share held, if any person or group makes a take-over bid or acquires 20% or more of the Corporation's outstanding voting shares without complying with the Rights Plan. Each Right entitles the registered holder, other than the acquiring person and parties related to the acquirer, to purchase five (5) common shares from treasury at the current market price.

Employee share purchase plan

In 2000, \$100 was advanced to a key employee to purchase common shares. This loan is secured by a pledge of the common shares. During 2001, pursuant to the resignation of the above key employee, the Company entered into a repayment agreement requiring annual payments of \$20 commencing June 8, 2001. As at December 31, 2002, the amount of the Employee share purchase loan is \$60 [\$80 in 2001] pledged by 9,000 common shares [12,000 in 2001].

Stock option plan

The Company has a Stock Option Plan [the "Plan"] in place for the benefit of key employees, directors, officers and consultants of the Company to purchase an aggregate maximum of 900,000 common shares. On July 31, 2002, the Board amended the stock option plan to increase the number of shares reserved under the plan by 175,000 shares. As at December 31, 2002, 861,547 [2001 - 716,588] common shares remain available under the Plan. The number of common share options granted to a beneficiary and the vesting period will be determined at the discretion of the Board of Directors and is not to exceed 10% of the outstanding common shares.

The exercise price of any option granted under the Plan shall be fixed by the Board of Directors and will not be less than the average closing price per common share on the date of grant. The term of an option and vesting period was five years from the date of the grant. On December 6, 2001, the Board amended the stock option plan to extend the term to seven years and the vesting period to four years. All options granted on and after December 6, 2001 are subject to this amendment. On December 4, 2002, the Board amended option grants prior to December 6, 2001 to increase the option term from five to seven years.

The changes to the number of stock options granted by the Company, and their weighted average exercise price are as follows:

	2002		2001	
	#	Weighted average exercise price \$	#	Weighted average exercise price \$
Balance, beginning of year	694,833	5.71	484,344	4.90
Granted	144,258	8.16	399,233	5.94
Exercised	(30,041)	6.10	(143,412)	3.66
Forfeited	(102,526)	5.81	(45,332)	5.56
Balance, end of year	706,524	6.18	694,833	5.71
Options exercisable at end of year	294,129	5.66	235,500	4.98

Additional information concerning stock options outstanding as at December 31, 2002 is as follows:

Exercise price	Options outstanding		Options exercisable	
	Number	Weighted average months to expiry	Number	Weighted average share price
\$3.16 - \$4.50	147,149	42	134,188	4.30
\$5.00 - \$5.90	196,094	61	45,808	5.00
\$6.35 - \$7.00	282,459	65	88,993	6.84
\$9.60 - \$10.00	80,822	73	25,140	10.00
	706,524		294,129	

The fair value of option grants during 2002 was estimated at the date of grant using the following assumptions: weighted-average risk-free interest rate of 5.02%; dividend yield of nil; weighted-average volatility factor of the expected market price of the Company's common shares of 76%; and a weighted-average expected life of the options of 7 years. For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense on a straight-line basis over the option's vesting period. The weighted average fair value of stock options granted during the year ended December 31, 2002, under the Black-Scholes option pricing model, and above assumptions was \$6.05.

For options for which the option term was amended from five years to seven years, the fair value was estimated at the date of amendment using the following assumptions: weighted-average risk-free interest rate of 4.06%; dividend yield of nil; weighted-average volatility factor of the expected market price of the Company's common shares of 72%; and a weighted-average expected life of the options of 3.5 years. The weighted average fair value of stock options granted during the year ended December 31, 2002, under the Black-Scholes option pricing model, and above assumptions was \$4.06.

	2002 \$
Net income as reported	5,162
Less:	
Amortization of fair value related to option grants	323
Amortization of fair value related to option life amendment	43
Pro-forma net income	4,796
Basic earnings per share	
As reported	0.37
Pro forma	0.34
Diluted Earnings per share	
As reported	0.36
Pro forma	0.34

Stock purchase plan

The Company has a stock purchase plan with 200,000 common shares reserved for purchase by full-time employees at fair market value. During 2002, 5,417 [347 in 2001] shares were issued at fair market value under this plan.

Under this plan, the Company will contribute 25% of employees' contributions to a maximum of 6% of the employees' salary in the form of common shares. The Company will make its contribution if the employee remains employed by the Company and has held the original shares for two years from the original purchase date.

Other paid-in capital

During 2001, the Company granted 15,000 options to consultants at a price of \$7.00. These options have a five-year vesting period. Management has estimated the fair value of these options using Black-Scholes option pricing model using a volatility factor of 0.71 and a risk free rate of 2.65% to be approximately \$23. This amount of \$23 has been recorded as an expense and credit to other paid-in capital.

13. WRITE-DOWN OF INTELLECTUAL PROPERTY AND GAIN ON DISPOSITION

	2002 \$	2001 \$
Relaxin [i]	—	1,675
SYNSORB Cd® [ii]	—	85
DepoCyt™ [iii]	(47)	750
E2-NETA and E2 Patch [iv]	—	(108)
Rogitine® [v]	474	—
	427	2,402

The Company recorded write-downs and a gain associated with intellectual property as described below.

- [i] License agreement with Connetics Corporation ["Connetics"] for relaxin; the Company originally recorded licenses of \$1,875, of which \$200 had been amortized as at December 31, 2001.

On May 23, 2001, Connetics announced that it would no longer continue its relaxin program and would investigate other strategic alternatives. Connetics has been unable to conclude a satisfactory arrangement for the continuing development of relaxin and the Company wrote-off the unamortized balance of \$1,675 relating to this license on December 31, 2001.

- [ii] The Company entered into a License, Distribution, and Supply Agreement with Synsorb Biotech Inc. ["Synsorb"] for SYNORB Cd®. The Company's license cost was \$100, of which \$15 had been amortized. On December 10, 2001, Synsorb announced that it decided to terminate further development of SYNORB Cd® and the Company wrote-off the unamortized balance of \$85 relating to this license.

- [iii] The Company entered into a Marketing and Distribution agreement with SkyePharma, Inc. relating to DepoCyt™. The Company's license cost amounted to \$1,500, of which \$112 had been amortized.

During 2001, management reviewed the valuation of the license for DepoCyt™ and determined that there was an impairment in the carrying value of this license. Consequently, the Company recorded a write-down of \$750.

During 2002, the Company returned the rights to DepoCyt™ to SkyePharma, Inc. for net proceeds of \$639. The Company recorded a gain of \$47 representing the difference between the value of the consideration received and the net carrying value of the intellectual property related to DepoCyt™ of \$750 less the accumulated amortization of \$158.

- [iv] In 2001, the Company surrendered its right to the E2 Patch and BioSante withdrew E2-NETA and provided consideration of 173,611 shares of BioSante. The Company recorded a gain of \$108 representing the difference between the value of the consideration received and the write-off of the intellectual property related to these products of \$94 less the accumulated amortization of \$10.

- [v] The Company entered into a License and Trade-Mark License agreement with Novartis in November 2001 relating to Rogitine®. During 2002, management reviewed the projected future results of the license for Rogitine® and determined that there was an impairment in the carrying value of this license. Consequently, the Company recorded a write-down of \$474.

14. RELATED PARTY TRANSACTIONS

In June of 1998, the Company entered into a number of ten-year agreements each with five-year renewal options with an affiliated company. The affiliate provides manufacturing and logistics services including, customer service, warehousing and shipping on behalf of the Company. The affiliate also performs invoicing and collection services on behalf of the Company. The services rendered by the affiliate and the method of charging varies depending upon the agreement and products. The table below, reflects the transactions with the affiliate.

	2002 \$	2001 \$
Sales to affiliate	1,669	2,065
Purchases	5,259	4,873
Research and development expenses	483	819
Distribution fees	1,083	773
Selling and administrative expenses	274	290

During 2001, the Company sold a license for Amlexanox Paste to this affiliate. The Company originally obtained this license with a commitment to royalty and milestone payments based on future sales and through payments to obtain regulatory approval, which were previously expensed. Future royalty and milestone payments have been assigned to the affiliate for a cash consideration of \$250.

15. RESEARCH AND DEVELOPMENT AND GOVERNMENT ASSISTANCE

The Company incurred research and development expenditures which are eligible for investment tax credits. The investment tax credits recorded are based on management's estimates of amounts expected to be recovered and are subject to audit by taxation authorities. The amounts can be summarized as follows:

	2002 \$	2001 \$
Research and development expenditures	1,451	1,259
Investment tax credits	(367)	(265)
	1,084	994

16. INCOME TAXES

Future income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's future tax assets and liabilities are as follows:

	2002 \$	2001 \$
Future income tax assets		
Current		
Loss carryforwards	—	1,671
Tax basis of intangible and other assets in excess of carrying value	303	464
Scientific Research and Experimental Development expenditures not claimed for tax purposes	700	—
Tax benefit of share issue costs	218	140
	1,221	2,275
Long-term		
Tax basis of intangible assets in excess of carrying value	500	422
Scientific Research and Experimental Development expenditures not claimed for tax purposes	950	1,541
Tax benefit of share issue costs	409	253
	1,859	2,216
Total future income tax assets	3,080	4,491
Future income tax liabilities		
Long-term		
Tax basis of deferred charges less than carrying value	500	133
Total future income tax liabilities	500	133
Net future income tax assets	2,580	4,358

The Company's income tax expense consists of the following:

	2002 \$	2001 \$
Provision at Canadian statutory rates [35.16%] [2001 – 37.16%]	2,167	716
Decrease resulting from:		
Drawdown of deferred credit	(1,460)	(409)
Large corporation tax	102	41
Impact of change in expected tax rate	86	168
Other	107	(73)
	1,002	443

As at December 31, 2002, the Company has Scientific Research and Experimental Development expenditures available for Federal and Provincial income tax purposes, amounting to approximately \$6,203 and \$5,801, respectively, which may be applied against taxable income of future years. The Company also has Federal investment tax credits from Scientific Research and Experimental Development expenditures amounting \$470 which expire between 2010 and 2012. The benefit related to these items has been recognized in the financial statements.

The Company recorded a reduction of current tax expense reflecting the claiming of Federal and Provincial losses carryforward in the current year in the amount of \$1,460 [2001 – \$409]. There is measurement uncertainty with respect to these reductions and to the realization of \$1,113 [2001 – \$2,573] of the deferred credits relating to scientific research and experimental development expenditures and loss carryforwards previously recognized. Management believes it is more likely than not that these deferred credits will be realized. The amount of the deferred credits considered realizable, and the tax benefit claimed in the current and prior years, however, could be reduced by a material amount in the future.

17. EARNINGS PER SHARE

The following summarizes the reconciliation of the basic weighted average number of shares outstanding and the diluted weighted average number of shares outstanding used in the diluted earnings per share calculations:

	2002	2001
Basic weighted average number of shares outstanding	13,989,832	12,428,188
Dilutive effect of stock options	167,004	68,168
Dilutive effect of warrants	3,794	—
Diluted weighted average number of shares outstanding	14,160,630	12,496,356

There was no adjustment to net income for purposes of calculating diluted earnings per share.

18. COMMITMENTS

In the normal course of business, the Company secures Canadian sales and marketing rights to innovative drug products and has entered into various agreements which include contractual obligations extending beyond the current year. These obligations are classified into three major categories: revenue based, milestone based and purchase based commitments.

Revenue based commitments

Most pharmaceutical product license agreements require that the Company make royalty payments; ranging from 2.5% to 15% of sales, or require payments for products at rates ranging from 26% to 50% of the net selling price, or 60% of the net profit on sales.

In addition, the Company may have to pay up to \$4,817 [US\$3,050] if the Company achieves specific sales volumes on specific products in the future. Payments related to sales volume may be due over the next 10 years.

Milestone based commitments

The Company has also committed to fund certain research and development expenditures of third parties for \$237 [US\$150] over the next two years. In addition, specific payments are required under these agreements if milestones are met, such as regulatory approval in Canada. Based on the outcome of these milestones, the Company may have to pay up to \$2,736 including US\$1,668.

Purchase and service based commitments

The Company is committed to making minimum spending related to inventory purchases, regulatory, sales and marketing expenditures in the amount of \$14,285 in order to retain exclusive distribution agreements for certain products. These commitments end in 2011 and annual amounts are as follows:

	\$
2003	3,485
2004	3,295
2005	1,786
2006	1,792
2007	851
2008 – 2011	3,076

19. FINANCIAL INSTRUMENTS**[i] Fair values****Short-term financial assets and liabilities**

The carrying amounts of cash and cash equivalents, short-term marketable securities, accounts receivable and accounts payable are a reasonable estimate of their fair values because of the short maturity of these instruments.

The effective rate of return on cash equivalents, short-term and long-term marketable securities is approximately 2.7% [2001 – 4.7%].

Long-term financial liabilities

The carrying amount of the balance of sale is presented at fair value as it has been discounted using the estimated borrowing rate.

[ii] Concentration of credit risk

Investment tax credits recoverable and research and development tax credits receivable are due from the Federal and Provincial governments. Cash and cash equivalents, short-term marketable securities and long-term marketable securities consist of bonds or commercial paper in a number of large corporation and provincial and federal government. As at December 31, 2002, two term investments [two as at December 31, 2001] accounted for 29% of the term investments [80% in 2001].

20. ENTERPRISE WIDE DISCLOSURES

Substantially all of Company's revenues are generated from sales and distribution of pharmaceutical products in Canada and only one customer, an affiliated company [see note 14], accounts for 7% [2001 – 12%] of sales. All of the Company's assets are located in Canada.

21. COMPARATIVE FIGURES

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

DIRECTORS AND OFFICERS

Board of Directors

Ted Wise
Chairman
Co-founder of Pharmascience Inc.

Jonathan Ross Goodman
President & CEO
Paladin Labs Inc.

Mark Beaudet
Vice President, Marketing & Sales
Paladin Labs Inc.

Ger van Amersfoort*
Chairman of Sampling Technologies Inc.
Former President of
Novartis Pharmaceuticals Canada Inc.
& SmithKline Beecham Pharma Inc.

Robert Lande▲
Business Consultant
Former Chief Financial Officer
Telecom Américas Ltd.

Michael Tarnow*
Business Consultant
Former President of
Merck Frosst Canada & Co.

Dr. Brad Thompson*▲
President & CEO
Oncolytics Biotech Inc.

* member of the Audit Committee

▲ member of the Compensation Committee

Officers

Jonathan Ross Goodman, B.A., LL.B, M.B.A.
President & CEO

Mark Beaudet, B.Comm.
Vice President, Marketing & Sales

Samira Sakhia, B.Comm.,C.A., M.B.A.
Chief Financial Officer

Tom Koutsavlis, BSc, MD CM, LMCC, MSc,
CSPQ, FRCPC
Vice President, Scientific Affairs

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Annual General Meeting

May 1, 2003, 5 p.m.
6111 Royalmount Avenue
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Ce document est aussi disponible en français



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