

PALADIN LABS INC.
CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2006



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 consolidated results of operations, financial position and cash flows for Paladin Labs Inc. ("Paladin" or the "Company") and is current as at May 10, 2006. This discussion should be read in conjunction with the information contained in the Company's interim and annual consolidated financial statements and the related notes to the consolidated financial statements. As at May 10, 2006, 14,875,506 shares were issued and outstanding.

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 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. For additional information on risks and uncertainties relating to these forward-looking statements, investors should consult the Company's ongoing quarterly filings, annual reports and Annual Information Form and other filings found on SEDAR at www.sedar.com.

Overview

Paladin is a specialty pharmaceutical company focused on developing, acquiring, in-licensing, marketing, and distributing innovative pharmaceutical products. Through a national sales force, the Company markets its pharmaceutical products to Canadian physicians.

First quarter highlights:

- Revenues reached \$10,132, an increase of 58% over the same period last year
- Net income was \$1,150, an increase of 130% over the same period last year
- Cash flows from operations reached \$2,313, an 11% increase over the same period last year
- Acquired additional Canadian rights to Pennsaid[®] through a wholly-owned subsidiary, Squire Pharmaceuticals Inc.
- Announced a normal course issuer bid effective February 21, 2006
- Obtained Health Canada Approval of VANTAS[®] for the treatment of advanced prostate cancer

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 the timing and number of product launches. Each new product launch requires significant promotional investment during the first three to five years from launch. The level of patient and physician acceptance of Paladin's products, the acceptance of Provincial government reimbursement on such products, market access, 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 Estimates

Paladin's consolidated financial statements are prepared in accordance with Canadian generally accepted accounting principles, applied in a consistent basis. Paladin's critical accounting estimates include revenue recognition, the recording of research and development expenses, the fair value and useful lives of intangible assets, stock based compensation expense and future income tax asset recording. For a more detailed discussion of the Company's critical accounting, please refer to the Management Discussion & Analysis included in the Company's 2005 Annual Report. There have been no material changes to accounting estimates since December 31, 2005.

Results of Operations

Three-month period ended March 31, 2006 compared to three-month period ended March 31, 2005.

Revenues

Revenues increased \$3,704 or 58% to \$10,132 for the three-month period ended March 31, 2006 from \$6,428 for the three-month period ended March 31, 2005. These increases are due primarily to strong performance from the Company's key promoted products, including Estring[®], Oxytrol[®], Plan B[®] and Twinject[®] which increased by 148% for the three-month period ended March 31, 2006 compared to the three-month period ended March 31, 2005. Additionally, the Company's acquisition of Dimethaid Health Care Ltd., subsequently renamed Squire Pharmaceuticals Inc. ("Squire"), contributed \$1,403 to the Company's revenues for the period (see note 5).

Gross Profit

Total gross profit increased \$2,788 or 58% to \$7,567 for the three-month period ended March 31, 2006 from \$4,779 for the three-month period ended March 31, 2005. Gross profit, as a percentage of revenues, increased to 75% for the three-month period ended March 31, 2006 from 74% for the three-month period ended March 31, 2005. This increase in gross profit, as a percentage of sales, resulted primarily from the launch of new products yielding a higher gross profit margin and a change in the proportion of products sold for which the Company earns a distribution fee and consequently does not incur cost of sales related to these products.

Selling and Marketing Expense

Selling and marketing expense increased \$1,295 or 63% to \$3,338 for the three-month period ended March 31, 2006 from \$2,043 for the three-month period ended March 31, 2005. Selling and marketing expense, as percentage of revenues, increased to 33% for the three-month period ended March 31, 2006 from 32% for the three-month period ended March 31, 2005. This increase was primarily attributed to increased promotion activities relating to the launch of Twinject[®] and Oxytrol[®], the re-launch of Plan B[®] as a non-prescription product and the co-promotion expenses relating to Pennsaid[®].

General and Administrative Expense

General and administrative expense increased \$473 or 56% to \$1,314 for the three-month period ended March 31, 2006 from \$841 for the three-month period ended March 31, 2005. General and administrative expense, as percentage of revenues, remained steady at 13% for the three-month period ended March 31, 2006 and for the three-month period ended March 31, 2005.

Research and Development Expense

Research and development expense decreased \$19 or 6% to \$312 for the three-month period ended March 31, 2006 from \$331 for the three-month period ended March 31, 2005. During the three-month period ended March 31, 2006 and 2005, Paladin's research and development efforts have been to search and explore potential product opportunities for internal development. This decrease is primarily attributable to increased product submission fees related to certain product opportunities during the period ended March 31, 2005 which are currently awaiting regulatory response.

Amortization

Amortization expense increased \$791 or 73% to \$1,877 for the three-month period ended March 31, 2006 from \$1,086 for the three-month period ended March 31, 2005. This increase in amortization expense is the result of the amortization related to the Company's newly acquired pharmaceutical product licenses and rights, and deferred charges.

Net Interest Income

Net interest income decreased \$68 or 23% to \$234 for the three-month period ended March 31, 2006 from \$302 for the three-month period ended March 31, 2005. This decrease is as a result of certain interest payments the Company was required to disburse as well as lower average cash and marketable securities balances over the three-month period ended March 31, 2006 compared to the three-month period ended March 31, 2005.

Other Income

Other income was \$724 for the three-month period ended March 31, 2006 compared to \$ nil for the three-month period ended March 31, 2005. Other income relates to a stock dividend received during the period from one of the Company's portfolio investments.

Income Tax Expense

Income tax expense increased \$253 to \$534 for the three-month period ended March 31, 2006 from \$281 for the three-month period ended March 31, 2005. The effective tax rate was 32% for the three-month period ended March 31, 2006 compared to 36% for the three-month period ended March 31, 2005.

As at March 31, 2006, the Company had Scientific Research and Experimental Development expenditures available for federal and provincial income tax purposes, amounting to approximately \$10,973 and \$12,025, respectively, which may be applied against taxable income of future years. The Company has recognized a tax benefit of \$2,876 and \$3,927 for federal and provincial tax purposes respectively, for these expenditures. The Company also has Federal investment tax credits from Scientific Research and Experimental Development expenditures amounting to \$1,939 which expire between 2008 and 2014 of which only \$153 has been recognized in the consolidated financial statements.

The Company has capital losses carried forward totalling \$198 for federal purposes and \$891 for provincial purposes which have not been recognized in the consolidated financial statements.

The Company has non-capital tax losses which may be applied against taxable income for federal and provincial income tax purposes in the amount of \$19,002 and \$18,417, respectively, which expire between 2006 and 2012. The Company has recognized the tax benefit of these losses in the amount of \$13,919 for federal tax purposes and \$13,334 for provincial tax purposes.

Net Income

Due to the factors set forth above, net income increased \$651 to \$1,150 for the three-month period ended March 31, 2006 compared to net income of \$499 for the three-month period ended March 31, 2005.

Liquidity and Capital Resources

The Company believes that its existing cash and cash equivalents and short-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.

Paladin's cash and short-term and long-term marketable securities decreased \$1,035 to \$41,284 at March 31, 2006 from \$42,319 at December 31, 2005. This decrease is primarily due to investments in pharmaceutical product licenses, rights and intellectual property in the amount of \$3,452 and an investment in a portfolio company in the amount of \$500, offset by cash flows generated from operating activities in the amount of \$2,312 and cash flows generated through the issuance of common shares for \$642.

Working capital decreased \$588 to \$46,928 at March 31, 2006 from \$47,516 at December 31, 2005. This increase is primarily due to decreased cash and short-term and long-term marketable securities position due to investments described above.

Cash flows from operating activities increased 11% to \$2,313 from \$2,090 for the three-month period ended March 31, 2006 and 2005, respectively. Cash flows from operating activities represent the cash flows from net earnings, excluding revenues and expenses not affecting cash, principally amortization, future income taxes, stock based compensation expense and stock dividend income.

Cash flows from investing activities were \$3,411 for the three-month period ended March 31, 2006 compared to \$1,367 for the three-month period ended March 31, 2005. During the three month period ended March 31, 2006, the Company invested \$3,452 towards the acquisition of pharmaceutical product licenses and rights, and deferred charges, \$500 in the form of a portfolio investment and \$39 for the

acquisition of property, plant and equipment offset by cash generated through maturing marketable securities in the amount of \$7,402. For the three-month period ended March 31, 2005, the Company invested \$500 in long-term marketable securities and \$202 in acquisitions of pharmaceutical product licenses and rights, and deferred charges offset by cash generated from maturing marketable securities in the amount of \$2,076.

Cash flows from financing activities were \$642 for the three-month period ended March 31, 2006 compared to cash flows used in financing activities of \$351 for the three-month period ended March 31, 2005. During the three-month period ended March 31, 2006, \$642 was generated by the issuance of common shares for cash. For the three-month period ended March 31, 2005, accounts payable related to pharmaceutical product licenses decreased by \$364 offset by \$13 generated by the issuance of common shares for cash.

Related Party Transactions

JODDES Limited (“JODDES”), a private Canadian corporation, is a significant shareholder, holding approximately 45% of the outstanding shares of the Company, and one director of the Company, the Company’s President and CEO, is related to JODDES.

The Company engages this affiliate to provide logistics services, including customer service, warehousing and shipping, invoicing and collection services as well as to perform certain research and development services on a contractual pay-for-use basis. The Company also leases its office facilities from another wholly-owned subsidiary of JODDES. This lease is for a period of 3 years and includes annual minimum payments of \$159.

All transactions with affiliated companies are carried out in the normal course of operations, and are recorded at an agreed upon exchange amount.

The table below reflects all transactions and services with affiliates which include those referred to in the agreements described above as well as revenues from a wholly-owned subsidiary of JODDES:

	Three-month period ended	
	2006	March 31 2005
	\$	\$
Revenues	170	201
Purchases	2,113	1,142
Research and development expenses	24	48
Sales and marketing expenses	571	371
General and administrative expenses	91	70

Risk Factors

For a more detailed discussion of the risk factors that could materially affect the results of operations and the financial condition of the Company, please refer to the Company’s Annual Information Form.

Contractual Obligations and Commitments

In the normal course of business, Paladin secures development, sales, marketing and distribution rights to innovative drug products and has entered into various agreements which include contractual obligations extending beyond the current year. In addition, under certain agreements, Paladin may have to pay additional consideration should the Company achieve certain sales volumes or if certain milestones are met, such as regulatory approval in Canada. The Company has the following contractual obligations and commitments related to product license, trademark and distribution agreements:

	Contractual Obligations	Commitments	
	Purchase and service based commitments	Milestone based commitments	Revenue based commitments
	\$	\$	\$
April 1, 2006 – December 31, 2006	2,737	642	146
Fiscal 2007 – fiscal 2009	4,443	1,190	350
Fiscal 2010 – fiscal 2011	1,359	-	292
After fiscal 2012	-	2,183	10,604
Total	8,539	4,015	11,392

**NOTICE TO READER OF THE INTERIM
CONSOLIDATED FINANCIAL STATEMENTS**

The consolidated financial statements of Paladin Labs Inc. (the “**Company**”) and the accompanying interim consolidated balance sheet as at March 31, 2006 and the interim consolidated statements of income, retained earnings and cash flows for the three-month period then ended are the responsibility of the Company’s management. These consolidated financial statements have not been audited or reviewed on behalf of the shareholders by the independent external auditors, Ernst & Young LLP.

The interim consolidated financial statements have been prepared by management and include the selection of appropriate accounting principles, judgments and estimates necessary to prepare these consolidated financial statements in accordance with Canadian generally accepted accounting principles. Readers are cautioned that these interim consolidated statements may not be appropriate for their purposes.

Jonathan Ross Goodman, B.A., LL.B, M.B.A.
President and Chief Executive Officer
Montreal, Canada
May 10, 2006

Samira Sakhia C.A., M.B.A.
Chief Financial Officer
Montreal, Canada
May 10, 2006

CONSOLIDATED BALANCE SHEETS

[In thousands of Canadian dollars]

	March 31 2006 \$	December 31 2005 \$
	(unaudited)	
ASSETS		
Current		
Cash and cash equivalents	9,201	2,835
Marketable securities	32,083	39,484
Accounts receivable	7,130	8,128
Inventory	3,333	3,178
Other current assets	966	865
Investment tax credits receivable	827	827
Future income tax assets	2,944	3,158
Total current assets	56,484	58,475
Property, plant and equipment	118	96
Pharmaceutical product licenses and rights	10,819	9,135
Deferred charges	3,800	3,908
Investments	2,658	1,433
Future investment tax credits recoverable	153	153
Future income tax assets	4,549	4,479
	78,581	77,679
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Accounts payable and accrued liabilities	6,374	7,679
Accounts payable to related parties	1,300	1,044
Deferred revenue	725	903
Income taxes payable	232	408
Balance of license agreements payable	698	698
Balance of sale payable [note 5]	227	227
Total current liabilities	9,556	10,959
Long-term		
Balance of sale payable [note 5]	476	470
Future income tax liabilities	397	—
Total long-term liabilities	873	470
Shareholders' equity [note 3]		
Capital stock	58,020	57,378
Other paid-in capital	1,043	933
Retained earnings	9,089	7,939
Total shareholders' equity	68,152	66,250
	78,581	77,679

See accompanying notes

CONSOLIDATED STATEMENTS OF INCOME AND RETAINED EARNINGS

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

[unaudited]

	Three-month period ended March 31	
	2006	2005
	\$	\$
Revenues	10,132	6,428
Cost of sales	2,565	1,649
Gross profit	7,567	4,779
Selling and marketing	3,338	2,043
General and administrative	1,314	841
Research and development	312	331
Amortization of intangible assets and deferred charges	1,877	1,086
Interest income, net	(234)	(302)
Other income	(724)	—
Income before income taxes	1,684	780
Provision for income taxes		
Future	534	281
	534	281
Net income	1,150	499
Retained earnings, beginning of period	7,939	4,801
Retained earnings, end of period	9,089	5,300
Earnings per share		
Basic	0.08	0.03
Diluted	0.08	0.03
Weighted average number of shares outstanding [note 4]		
Basic	14,768,726	14,859,042
Diluted	14,944,974	14,872,337

See accompanying notes

CONSOLIDATED STATEMENTS OF CASH FLOWS

[In thousands of Canadian dollars]

[unaudited]

	Three-month period ended March 31	
	2006	2005
	\$	\$
Operating activities		
Net income	1,150	499
Add items not affecting cash		
Amortization	1,894	1,101
Stock based compensation expense <i>[note 3]</i>	112	67
Future income taxes	538	265
Unrealized foreign exchange loss (gain)	—	(17)
Stock dividend	(724)	—
	2,969	1,915
Net change in non-cash balances relating to operations	(657)	175
Cash flows from operating activities	2,313	2,090
Investing activities		
Additions to pharmaceutical product licenses and rights, and deferred charges	(3,452)	(202)
Purchases of short-term marketable securities	(2,578)	(1,196)
Maturities of short-term marketable securities	9,980	3,272
Purchases of long-term marketable securities	—	(500)
Acquisition of property, plant and equipment	(39)	(7)
Investment in portfolio company	(500)	—
Cash flows from investing activities	3,411	1,367
Financing activities		
Common shares issued for cash	642	13
Accounts payable related to the acquisition of intellectual property and deferred charges	—	(364)
Cash flows from (used in) financing activities	642	(351)
Effect of exchange rate change on cash and cash equivalents	—	(8)
Net change in cash and cash equivalents during the period	6,366	3,098
Cash and cash equivalents, beginning of period	2,835	1,507
Cash and cash equivalents, end of period	9,201	4,605
Cash and cash equivalents	9,201	4,605
Short-term marketable securities	32,083	38,541
Long-term marketable securities	—	500
	41,284	43,646

See accompanying notes

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

1. Basis of presentation

The consolidated financial statements of the Company have been prepared by management in accordance with Canadian generally accepted accounting principles (GAAP) and include the accounts of its wholly-owned subsidiary, Squire Pharmaceuticals Inc. Information with respect to the December 31, 2005 balance sheet is derived from the Company's complete audited consolidated financial statements. These unaudited interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto in the Company's Annual Report for the year ended December 31, 2005.

2. Accounting policies

The accounting policies underlying these interim consolidated financial statements are those set forth in note 2 of the audited consolidated financial statements for the year ended December 31, 2005.

3. Capital Stock

Authorized: 100,000,000 common shares without nominal or par value

Issued and outstanding:

	Number of shares	Amount
Balance at beginning of year	14,732,368	\$57,378
Issued upon exercise of stock options	140,856	628
Issued under employee share purchase plan	2,282	14
Balance at March 31, 2006	14,875,506	\$58,020

Stock option plan

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

	2006		2005	
	#	Weighted average exercise price \$	#	Weighted average exercise price \$
Balance at beginning of year	915,743	5.57	789,321	5.53
Granted	119,500	6.60	75,250	4.46
Exercised	(140,856)	4.30	—	—
Expired or forfeited	—	—	(2,400)	4.92
Balance at March 31	894,387	5.73	862,171	5.44
Options exercisable at March 31	521,619	5.88	541,593	5.59

During 2003, the Company adopted the fair value based method of accounting for employee stock compensation on a prospective basis. For options, which were granted or modified during fiscal 2002, the Company will continue to present pro-forma net income as if the fair value had been applied to those awards.

The Company recorded option compensation expense with a corresponding credit to other paid-in-capital and determined the fair value of stock under the Black-Scholes option-pricing model using the following assumptions:

	Three-month period ended March 31	
	2006	2005
Option compensation expense	132	64
Weighted average fair value of options	\$4.09	\$2.87
Weighted average risk-free interest rate	4.11%	3.88%
Dividend yield	Nil	nil
Weighted average volatility factor	58%	62%
Weighted average expected life	7 years	7 years

For purposes of pro forma disclosures, 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 fair value of the options granted prior to 2003 will continue to be disclosed as an expense on a straight-line basis over the option's vesting period for pro forma purposes. The weighted average fair value of stock options granted during 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 amended on December 4, 2002, under the Black-Scholes option-pricing model, and above assumptions was \$4.06.

	Three-month period ended	
	2006	2005
	\$	\$
Net income as reported	1,150	499
Less: Amortization of fair value related to options granted in fiscal 2002	(6)	(11)
Amortization of fair value related to option life amendment in fiscal 2002	(2)	(7)
Pro forma net income	1,142	481
Basic Earnings per share		
As reported	0.08	0.03
Pro forma	0.08	0.03
Diluted Earnings per share		
As reported	0.08	0.03
Pro forma	0.08	0.03

4. 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:

Earnings per share	Three-month period ended March 31	
	2006	2005
Basic weighted average number of shares outstanding	14,768,726	14,859,042
Dilutive effect of options	176,248	13,295
Diluted weighted average number of shares outstanding	14,944,974	14,872,337

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

5. Business acquisition

On August 16, 2005, Paladin acquired all the issued and outstanding shares of Dimethaid Health Care Ltd., subsequently renamed Squire Pharmaceuticals Inc. (“Squire”), a subsidiary of Nuvo Research Inc. (TSX: NRI), formerly Dimethaid Research Inc., for total consideration of \$8,445 consisting of \$5,748 in cash, \$2,000 for the assumption of a note payable in Squire, which was immediately repaid, and a \$827 non-interest bearing balance of sale payable of which \$227 is payable in the short term and \$600 is payable the earlier of meeting certain acquisition related conditions or December 31, 2010. Given the non-interest bearing nature of the \$827 balance of sale payable, the amount has been recorded in these financial statements at its discounted net present value of \$703 which will be accreted through charges to interest expense over the repayment term. Squire owns the Canadian license for Pennsaid[®], a lotion approved by Health Canada for the treatment of symptoms of knee osteoarthritis.

6. Related party transactions

JODDES Limited (“JODDES”), a private Canadian corporation, is a significant shareholder, holding approximately 45% of the outstanding shares of the Company, and one director of the Company, the Company’s President and CEO, is related to JODDES.

The Company engages this affiliate to provide logistics services, including customer service, warehousing and shipping, invoicing and collection services as well as to perform certain research and development services on a contractual pay-for-use basis. The Company also leases its office facilities from another wholly owned subsidiary of JODDES. This lease is for a period of 3 years and includes minimum annual payments of \$159.

All transactions with affiliated companies are carried out in the normal course of operations, and are recorded at an agreed upon exchange amount.

The table below reflects all transactions and services with affiliates which include those referred to in the agreements described above as well as revenues from a wholly-owned subsidiary of JODDES:

	Three-month period ended	
		March 31
	2006	2005
	\$	\$
Revenues	170	201
Purchases	2,113	1,142
Research and development expenses	24	48
Sales and marketing expenses	571	371
General and administrative expenses	91	70

7. Commitments

In the normal course of business, the Company secures development, sales, marketing and distribution 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 and services based commitments.

Revenue based commitments

Most pharmaceutical product license agreements require that the Company make royalty payments; ranging from 2.5% to 20% 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 \$11,292 [US\$9,675] and \$100 if the Company achieves specific sales volumes on specific products in the future over a maximum of 10 years.

Milestone based commitments

The Company has also committed to fund certain research and development expenditures of third parties for \$1,459 [US\$1,250] over the next five years. In addition, additional payments maybe 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 \$2,556, including US\$2,118, over a maximum period of 15 years.

Purchase and service based commitments

The Company is committed to making minimum purchases of inventory, and minimum expenditures for regulatory, selling and marketing services in the amount of \$8,539, to retain exclusive distribution agreements for certain products. These commitments end in 2011 and annual commitments are as follows:

	\$
April 1, 2006 - December 31, 2006	2,737
2007	2,349
2008	1,233
2009	861
2010	677
2011-2012	682

8. Comparative figures

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

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