

PALADIN LABS INC.
CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2007



Management Discussion and Analysis:

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

This management's discussion and analysis provides our overview of the Company's operations, performance and financial condition for the quarter ended June 30, 2007 and compares these unaudited quarterly results to those of the quarter ended June 30, 2006. It is intended to complement and supplement financial information included in the interim and annual consolidated financial statements, related notes, other financial information found elsewhere in our annual report and in our annual information form or other documents filed on SEDAR at www.sedar.com. As a result, it should be read in conjunction with such financial information. This management's discussion and analysis is current as at August 1, 2007 and 14,968,713 shares were issued and outstanding as at this date. Reference to "Paladin" or the "Company" includes Paladin Labs Inc. and all its subsidiaries.

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.

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.

Second quarter highlights:

- Revenues reached \$15,436, an increase of 37% over the same period last year
- Net income before extraordinary gain was \$1,037, a decrease of 15% over the same period last year
- Net income was \$5,911, an increase of \$4,697 over the same period last year.
- Cash flows from operations reached \$3,854, a 35% increase over the same period last year
- EBITDA¹ was \$5,094, an increase of 43% over the same period last year
- Approval by Health Canada of a new one-step dosing regimen for Plan B[®].
- Acquired all the outstanding shares of BioEnvelop Inc., a wholly owned subsidiary of BioEnvelop Technologies Inc. (TSX-V:BIE), having expertise in developing and manufacturing rapidly dissolving edible films for the nutraceutical and pharmaceutical markets.
- Entered into an agreement with Shire to acquire the rights to a total of eight products.
- Acquired Zincofax[®], one of Canada's leading diaper rash creams, from Johnson & Johnson, Inc.
- Subsequent to quarter end, Health Canada approved SEASONALE[™], the first and only extended-cycle oral contraceptive available in Canada.
- Subsequent to quarter end, the Company completed a licensing and distribution agreement under which Labopharm has granted Paladin the exclusive right to market and sell Labopharm's once-daily tramadol product in Canada.

Paladin's annual and quarterly operating results are primarily affected by the level of acceptance of Paladin's products by physicians and their patients, and the timing and number of product launches. 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. Each new product launch requires significant promotional investment during the first three to five years from launch.

¹ EBITDA – Non-GAAP financial measures

The term EBITDA (earnings before interest, taxes, depreciation and amortization) does not have any standardized meaning under Canadian Generally Accepted Accounting Principles ("GAAP") and therefore may not be comparable to similar measures presented by other companies. The Company defines EBITDA as earnings before interest expense, taxes, amortization, and unusual items; such as write-downs and gains (losses) on intellectual property and investments. EBITDA is calculated and presented consistently from period to period and agrees, on a consolidated basis, with the amount disclosed as earnings before under-noted items on the consolidated statement of income. The Company believes EBITDA to be an important measurement that allows it to assess the operating performance of its ongoing business on a consistent basis without the impact of depreciation and amortization expenses. The Company excludes depreciation and amortization expenses because their level depends substantially on non-operating factors such as the historical cost of capital assets. The Company's method for calculating EBITDA may differ from that used by other issuers and, accordingly, this measure may not be comparable to EBITDA used by other issuers.

Critical Accounting Estimates

Paladin's consolidated financial statements are prepared in accordance with Canadian GAAP, applied in a consistent basis. Paladin's critical accounting estimates include revenue recognition, inventory valuation, the recording of research and development expenses and related tax credits, the useful lives and fair value of intangible assets, stock based compensation expense and income taxes. For a more detailed discussion of the Company's critical accounting, please refer to the management's discussion & analysis included in the Company's 2006 Annual Report. There have been no material changes to accounting estimates since December 31, 2006.

Results of Operations

Three-month period ended June 30, 2007 compared to three-month period ended June 30, 2006, and six-month period ended June 30, 2007 compared to six-month period ended June 30, 2006.

Revenues

Revenues increased \$4,195 or 37% to \$15,436 for the three-month period ended June 30, 2007 from \$11,241 for the three-month period ended June 30, 2006. For the six-month period ended June 30, 2007, revenues increased \$6,956 or 33% to 28,329 from \$21,373 for the six-month period ended June 30, 2006. These increases are principally due to the strong sales performance of the Company's key products, including Twinject[®], Oxytrol[®], Plan B[®], Pennsaid[®], Metadol[®], Trelstar[®] and Testim[®] which increased by 63% for the three-month period ended June 30, 2007 compared to the three-month period ended June 30, 2006 and by 61% for the six-month period ended June 30, 2007 compared to the six-month period ended June 30, 2006.

Gross Profit

Total gross profit increased \$3,157 or 37% to \$11,702 for the three-month period ended June 30, 2007 from \$8,545 for the three-month period ended June 30, 2006. For the six-month period ended June 30, 2007, gross profit increased \$6,011 or 37% to \$22,123 from \$16,112 for the six-month period ended June 30, 2006. Gross profit, as a percentage of revenues, remains steady at 76% for the three-month period ended June 30, 2007 compared to the three-month period ended June 30, 2006. For the six-month period ended June 30, 2007, gross profit as a percentage of revenues increased to 78% from 75% for the same period ended June 30, 2006. This increase in gross profit as a percentage of revenues, resulted primarily from the launch of new products yielding a higher gross profit margin, the effect of terminating a co-promotion agreement which previously shared Pennsaid[®] revenues and the 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. It is expected that gross profit, as a percentage of revenues, will approximate 76% to 78% for the year ending December 31, 2007.

Selling and Marketing Expense

Selling and marketing expense increased \$1,015 or 27% to \$4,823 for the three-month period ended June 30, 2007 from \$3,808 for the three-month period ended June 30, 2006. For the six-month period ended June 30, 2007, selling and marketing increased \$2,025 or 28% to \$9,171 from \$7,146 for the six-month period ended June 30, 2006. Selling and marketing expense, as percentage of revenues, decreased to 31% for the three-month period ended June 30, 2007 from 34% for the same period last year. For the six-month period ended June 30, 2007, selling and marketing expense, as a percentage of revenues slightly decreased to 32% from 33% for the same period ended June 30, 2006. The slight decrease as a percentage of revenues relates to the timing of promotional expenditures expected in the second half of 2007. The promotional activities driving selling and marketing costs primarily relate to Paladin's launch of Pennsaid[®], Metadol[®], Trelstar[®], PravASA[®], and Testim[®] as well as the continued promotion activities for Twinject[®], Plan B[®], and Oxytrol[®].

General and Administrative Expense

General and administrative expense increased \$500 or 47% to \$1,557 for the three-month period ended June 30, 2007 from \$1,057 for the three-month period ended June 30, 2006. For the six-month period ended June 30, 2007, general and administrative expense increased \$291 or 12% to \$2,662 from \$2,371 for the six-month period ended June 30, 2006. General and administrative expense, as percentage of revenues, increased to 10% for the three-month period ended June 30, 2007 from 9% for the three-month period ended June 30, 2006. Similarly, general and administrative expense, as a percentage of revenues, decreased to 9% for the six-month period ended June 30, 2007 from 11% for the same period ended June 30, 2006. General and administrative expense, as a percentage of revenues, is expected to approximate 9% to 11% for the year ending December 31, 2007.

Research and Development Expense

Research and development expense increased \$108 or 23% to \$584 for the three-month period ended June 30, 2007 from \$476 for the three-month period ended June 30, 2006. For the six-month period ended June 30, 2007, research and development expense increased \$327 or 41% to \$1,115 from \$788 for the six-month period ended June 30, 2006. During the three and six-month periods ended June 30, 2007 and 2006, Paladin's research and development efforts have been to search and explore potential product opportunities for internal development. This increase is primarily attributable to an increased head-count, certain payments for contractual clinical studies and product submission fees related to product opportunities.

Amortization

Amortization expense increased \$1,540 or 89% to \$3,274 for the three-month period ended June 30, 2007 from \$1,734 for the three-month period ended June 30, 2006. For the six-month period ended June 30, 2007, amortization expense increased \$2,281 or 63% to \$5,892 from \$3,611 for the six-month period ended June 30, 2006. 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 \$10 or 3% to \$356 for the three-month period ended June 30, 2007 from \$366 for the three-month period ended June 30, 2006. This decrease is primarily the result of lower average cash and marketable securities balances partially offset by higher interest rates over the three-month period ended June 30, 2007 compared to the three-month period ended June 30, 2006. For the six-month period ended June 30, 2007, net interest income increased \$139 or 23% to \$739 from \$600 for the six-month period ended June 30, 2006. This increase is due to the netting of certain interest payments the Company was required to disburse to interest income in 2006. The Company did not incur such interest expense for the period ended June 30, 2007. In addition, upon adoption of Section 3855 - *Financial Instruments, Recognition and Measurement*, the Company has accreted interest income on the allocated loan portion of a secured convertible term note investment in a portfolio company, in the amount of \$37.

Net Unrealized Loss on Derivative Instruments

Upon adoption of Section 3855, as described above, the Company using the Black-Scholes option pricing model determined the fair value of the conversion option on the secured convertible term note investment in a portfolio company as at January 1, 2007, and subsequently re-measured it as at June 30, 2007. The Company recognized an unrealized loss for the conversion option on the note for \$101 and \$311 for the three and six-month periods ended June 30, 2007, respectively. In addition, for the three month periods ended June 30, 2007, the Company recognized an unrealized gain on a contingent stock right received from a portfolio investment in the amount of \$67. The net effect is an unrealized loss of \$34 and \$244 for the three and six-month periods ended June 30, 2007, respectively

Gain on Disposal of Investment

During the six-month period ended June 30, 2007, the Company exercised its right to convert \$158 of a secured convertible term note in one of the Company's portfolio investments into common shares and subsequently sold such shares in the public market for \$232, representing a gain of \$74.

Other Income

Other income was nil for the three-month period ended June 30, 2007 and 2006. For the six-month period ended June 30, 2007, other income was nil compared to \$724 for the same period last year which related to a stock dividend received during the period from one of the Company's portfolio investments.

Income Tax Expense

Income tax expense increased \$127 to \$749 for the three-month period ended June 30, 2007 from \$622 for the three-month period ended June 30, 2006. For the six-month period ended June 30, 2007, income tax expense increased \$395 or 34% to \$1,551 from \$1,156 for the six-month period ended June 30, 2006. For the three and six-month periods ended June 30, 2007, the effective tax rate was 42% and 40%, respectively, compared to 34% and 33% for the three and six-month period ended June 30, 2006. The Company has the following tax pools detailed below which may be applied against taxable income:

	Available \$	Recognized \$	Expires in
Non-capital tax losses			
Federal	23,107	20,468	2009-2026
Provincial	19,674	17,512	2009-2026
Scientific Research and Experimental Development expenditures			
Federal	11,894	—	N/A
Provincial	13,565	—	N/A
Capital losses			
Federal	198	—	N/A
Provincial	891	—	N/A
Investment tax credits			
Federal	3,233	762	2008-2015

Net Income before Extraordinary Gain

Due to the factors set forth above, net income before extraordinary gain decreased \$177 to \$1,037 for the three-month period ended June 30, 2007 compared to net income of \$1,214 for the three-month period ended June 30, 2006. For the six-month period ended June 30, 2007, net income before extraordinary gain decreased \$63 to \$2,301 from \$2,364 for the six-month period ended June 30, 2006.

Extraordinary Gain (net of \$nil taxes)

On April 30, 2007, the Company acquired all of the issued and outstanding shares of BioEnvelop Inc. ("BioEnvelop"), a subsidiary of BioEnvelop Technologies Inc. (TSX VENTURE: BIE), for a total consideration of \$1,993 consisting of the assumption of a note payable in BioEnvelop which was immediately repaid. The total purchase price of \$1,993 was preliminarily allocated to the fair value of the net assets acquired in the amount of \$7,077, representing negative goodwill in the amount of the excess of \$5,084. The Company, as per applicable accounting standards, eliminated the value previously assigned to certain prescribed assets in the amount of \$210 against the excess of the amounts assigned to assets acquired and liabilities assumed over the cost of the purchase above. The remaining excess is presented as an extraordinary gain in the amount of \$4,874 (see note 7).

Net Income

Due to the factors set forth above, net income increased \$4,697 to \$5,911 for the three-month period ended June 30, 2007 compared to net income of \$1,214 for the three-month period ended June 30, 2006. For the six-month period ended June 30, 2007, net income increased \$4,811 to \$7,175 from \$2,364 for the six-month period ended June 30, 2006.

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.

Paladin's cash, cash equivalents and marketable securities decreased \$3,513 to \$32,561 at June 30, 2007 from \$36,074 at December 31, 2006. This decrease is primarily as a result of the Company's acquisition of pharmaceutical product licenses and rights, and deferred charges in the amount of \$11,758 offset by cash flows generated from operating activities in the amount of \$8,357. The Company's Investment Policy regulates the investment activities relating to cash resources. An Investment Committee composed of representatives from management and the Board of Directors monitors compliance with said policy. The Company invests strictly in liquid, high-grade investment securities with varying terms to maturity, selected with regard to the expected timing of investments and expenditures for continuing operations and prevailing interest rates. Working capital (current assets less current liabilities) increased \$772 to \$44,444 at June 30, 2007 from \$43,672 at December 31, 2006 primarily due to the increase in future income tax assets recognized.

Cash flows from operating activities increased 35% or \$1,000 to \$3,854 for the three-month period ended June 30, 2007 from \$2,854 for the three-month period ended June 30, 2006. Cash flows from operating activities for the six-month period ended June 30, 2007 were \$8,357 compared to \$5,191 for the six-month period ended June 30, 2006. 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, gains (losses) on investments and stock dividend income.

Cash flows used in investing activities were \$3,148 compared to \$7,259 for the three-month period ended June 30, 2007 and 2006, respectively. During the three-month period ended June 30, 2007, the Company invested \$11,758 towards the acquisition of pharmaceutical product licenses and rights, and deferred charges, \$650 for the acquisition of BioEnvelop Inc. further described in note 7, \$32 for the acquisition of property, plant and equipment, partially offset by proceeds from maturing marketable securities in the amount of \$9,292. For the three-month period ended June 30, 2006, the Company invested \$202 towards the acquisition of pharmaceutical product licenses and rights, and deferred charges, \$27,133 towards the purchase of short-term marketable securities offset by cash generated by maturing marketable securities in the amount of \$20,076.

Cash flows used in investing activities were \$7,549 compared to \$3,850 for the six-month period ended June 30, 2007 and 2006, respectively. During the six-month period ended June 30, 2007, the Company invested \$11,758 towards the acquisition of pharmaceutical product licenses and rights, and deferred charges, \$650 for the acquisition of BioEnvelop Inc. further described in note 7, and \$71 towards the acquisition of property plant and equipment, partially offset by cash generated by maturing marketable securities in the amount of \$4,698 and proceeds from the disposal of an investment in a portfolio company in the amount of \$232. For the six-month period ended June 30, 2006, the Company invested \$3,654 in acquisitions of pharmaceutical product licenses and rights, and deferred charges, \$500 in the form of an investment in a portfolio company, \$39 towards the acquisition of property plant and equipment, partially offset by cash flows generated from maturing marketable securities in the amount of \$343.

Cash flows from financing activities were \$552 compared to cash flows used in financing activities of \$7 for the three-month period ended June 30, 2007 and 2006, respectively. During the three-month period ended June 30, 2007, an amount of \$552 was generated from stock option exercises and the issuance of common shares under the stock purchase plan for cash. For the three-month period ended June 30, 2006, \$227 was generated from common stock option exercises and the issuance of common shares under the stock purchase plan offset by a payment related to the acquisition of intellectual property in the amount of \$234.

Cash flows from financing activities were \$276 compared to \$613 for the six-month period ended June 30, 2007 and 2006, respectively. During the six-month period ended June 30, 2007, \$880 was generated from common stock option exercises and the issuance of common shares under the stock purchase plan, offset by an amount of \$373 used by the Company to repurchase 37,800 of its own shares under the terms of the normal course issuer bid and a payment related to the acquisition of intellectual property in the amount of \$231. For the six-month period ended June 30, 2006, \$847 was generated from common stock option exercises and the issuance of common shares under the stock purchase plan offset by a payment related to the acquisition of intellectual property in the amount of \$234.

Subsequent to June 30, 2007, under the terms of the normal course issuer bid, the Company repurchased an additional 207,500 shares which are in the process of being cancelled.

Related Party Transactions

Joddes Limited ["Joddes"], a private Canadian corporation, is a significant shareholder holding approximately 43% 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 a wholly-owned subsidiary of Joddes to provide logistics services including: customer service, warehousing, shipping, invoicing, collection services and certain manufacturing services on behalf of the Company. The Company also engages this affiliate 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 10 years, ending in 2013 and includes minimum annual payments of \$136.

Effective November 1, 2006, the Company acquired the Canadian distribution rights to Metadol[®] from a wholly-owned subsidiary of Joddes for cash consideration of \$15,000. Under the terms of the agreement, the Company can purchase the Canadian license for Metadol[®] on the fourth anniversary of the agreement for \$1 and can receive a reimbursement of up to \$3,750 subject to certain acquisition related conditions.

All transactions with related parties are carried out in the normal course of operations, and are recorded at an agreed upon exchange amount. The accounts payable to related parties is on normal commercial terms and conditions and is non-interest bearing.

The table below reflects all transactions and services with related parties 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 June 30		Six-month period ended June 30	
	2007 \$	2006 \$	2007 \$	2006 \$
Revenues	153	162	293	332
Purchases	4,030	3,034	5,957	5147
Research and development expenses	76	52	141	76
Sales and marketing expenses	801	663	1,588	1,234
General and administrative expenses	84	68	150	159

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, 2007 – December 31, 2007	4,353	1,392	—
Fiscal 2008 – fiscal 2010	20,994	2,112	972
Fiscal 2011 – fiscal 2012	2,518	720	1,282
After fiscal 2013	1,681	957	14,105
Total	29,546	5,181	16,359

New Accounting Standards

On January 1, 2007, the Company retroactively adopted, without restatement of prior periods, the recommendations of the following Sections of the Canadian Institute of Chartered Accountants Handbook: Section 1530, *Comprehensive Income*, Section 3251, *Equity*, Section 3855, *Financial Instruments – Recognition and Measurement*, and Section 3865, *Hedges*. These standards set out, among other things, at what point a financial instrument must be recognized in the balance sheet and in what amount, sometimes using fair value and other times using cost-based measures, in addition to specifying the basis of presentation for the gains and losses on the financial instruments. Based on their classification on the balance sheet, the gains and losses on the financial instruments are recognized in the statement of income or in the newly introduced financial statement, the statement of comprehensive income.

The impact of the adoption of these new standards, as at January 1, 2007, translated into a \$692 increase in accumulated other comprehensive income, a \$162 increase in marketable securities, a \$684 increase in investments in other companies, including the recognition through bifurcation of certain embedded derivatives in investments in secured convertible notes in a portfolio company in the amount of \$526, a \$19 increase in the opening balance of retained earnings, and a \$135 reduction in future income tax assets. Further, the adoption of these new standards has no impact on the Company's cash flows.

The Company refers the reader to note 3 of the Consolidated Interim Financial Statements for the second quarter ended June 30, 2007, for further details regarding the adoption of these standards.

Controls and procedures

In compliance with the Canadian Securities Administrators Multilateral Instrument 52-109, the Company has filed certificates signed by the President and Chief Executive Officer and the Chief Financial Officer that, among other things, report on the design of disclosure controls and procedures and the design of internal control over financial reporting.

Internal control over financial reporting ("ICFR") is designed to provide reasonable assurance regarding the reliability of the Company's financial reporting and its compliance with Canadian Generally Accepted Accounting Principles in its financial statements. The President and Chief Executive Officer and the Chief Financial Officer of the Company have evaluated whether there were changes to its ICFR during the six-month period ended June 30, 2007 that have materially affected, or are reasonably likely to materially affect, the ICFR. No such significant changes were identified through their evaluation.

**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 June 30, 2007 and the interim consolidated statements of income, other comprehensive 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 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
August 1, 2007

Samira Sakhia C.A., M.B.A.
Chief Financial Officer
Montreal, Canada
August 1, 2007

CONSOLIDATED BALANCE SHEETS

[In thousands of Canadian dollars]

	June 30 2007 \$	December 31 2006 \$
	(unaudited)	
ASSETS		
Current		
Cash and cash equivalents	3,853	2,769
Marketable securities <i>[notes 3 and 4]</i>	28,708	33,305
Accounts receivable	10,283	9,495
Inventory	4,581	3,635
Other current assets	2,410	1,306
Investment tax credits receivable	831	831
Future income tax asset	4,940	2,550
Total current assets	55,606	53,891
Property, plant and equipment	181	151
Pharmaceutical product licenses and rights	28,340	21,482
Deferred charges	2,525	3,476
Investments <i>[notes 3 and 4]</i>	3,371	3,217
Future income tax asset	6,218	3,634
Total assets	96,241	85,851
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Accounts payable and accrued liabilities	7,871	8,208
Accounts payable to related parties	1,962	1,274
Income taxes payable	953	279
Balance of license agreements payable	—	231
Balance of sale payable	376	227
Total current liabilities	11,162	10,219
Long-term		
Balance of sale payable	506	494
Future income tax liability	927	1,397
Total liabilities	12,595	12,110
Shareholders' equity <i>[note 5]</i>		
Capital stock	60,860	58,807
Other paid-in capital	1,602	1,223
Retained earnings	20,678	13,711
Accumulated other comprehensive income <i>[notes 3 and 4]</i>	506	—
Total shareholders' equity	83,646	73,741
Total liabilities and shareholders' equity	96,241	85,851

See accompanying notes

CONSOLIDATED STATEMENTS OF INCOME

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

[unaudited]

	Three-month period ended June 30		Six-month period ended June 30	
	2007	2006	2007	2006
	\$	\$	\$	\$
Revenues	15,436	11,241	28,329	21,373
Cost of sales	3,734	2,696	6,206	5,261
Gross profit	11,702	8,545	22,123	16,112
Expenses (income)				
Selling and marketing	4,823	3,808	9,171	7,146
General and administrative	1,557	1,057	2,662	2,371
Research and development	584	476	1,115	788
Interest income, net	(356)	(366)	(739)	(600)
Earnings before under-noted items	5,094	3,570	9,914	6,407
Amortization of intangible assets and deferred charges	3,274	1,734	5,892	3,611
Net unrealized loss on derivative instruments <i>[note 4]</i>	34	—	244	—
Gain on disposal of investment	—	—	(74)	—
Other income	—	—	—	(724)
Income before income taxes	1,786	1,836	3,852	3,520
Provision for income taxes				
Current	520	—	674	—
Future	229	622	877	1,156
	749	622	1,551	1,156
Net income before extraordinary gain	1,037	1,214	2,301	2,364
Extraordinary gain (net of \$nil taxes) <i>[note 7]</i>	4,874	—	4,874	—
Net income for the period	5,911	1,214	7,175	2,364
Earnings per share before extraordinary gain				
Basic	0.07	0.08	0.15	0.16
Diluted	0.07	0.08	0.15	0.16
Earnings per share				
Basic	0.39	0.08	0.48	0.16
Diluted	0.38	0.08	0.47	0.16
Weighted average number of shares outstanding <i>[note 6]</i>				
Basic	15,100,003	14,891,946	15,052,122	14,830,676
Diluted	15,437,995	15,112,323	15,382,160	15,026,206

See accompanying notes

CONSOLIDATED STATEMENTS OF CASH FLOWS

[In thousands of Canadian dollars]

[unaudited]

	Three-month period ended June 30		Six-month period ended June 30	
	2007	2006	2007	2006
	\$	\$	\$	\$
Operating activities				
Net income	5,911	1,214	7,175	2,364
Add items not affecting cash				
Amortization	3,292	1,750	5,930	3,644
Stock based compensation expense [note 5]	391	212	520	346
Future income taxes	(5,541)	620	(4,893)	1,166
Unrealized foreign exchange gain	(2)	(3)	(2)	(3)
Stock dividends	—	—	—	(724)
Gain on disposal of investment	—	—	(74)	—
Net unrealized loss on derivative instruments [note 4]	34	—	244	—
Accreted interest	(13)	—	(24)	—
	4,072	3,793	8,876	6,793
Net change in non-cash balances relating to operations	(218)	(939)	(519)	(1,602)
Cash flows from operating activities	3,854	2,854	8,357	5,191
Investing activities				
Additions to pharmaceutical product licenses and rights, and deferred charges	(11,758)	(202)	(11,758)	(3,654)
Purchases of short-term marketable securities	—	(27,133)	(25,986)	(29,712)
Maturities of short-term marketable securities	9,292	20,076	41,062	30,055
Purchases of long-term marketable securities	—	—	(10,378)	—
Proceeds from the disposal of investment	—	—	232	—
Investment in portfolio company	—	—	—	(500)
Business acquisition	(650)	—	(650)	—
Acquisition of property, plant and equipment	(32)	—	(71)	(39)
Cash flows (used in) investing activities	(3,148)	(7,259)	(7,549)	(3,850)
Financing activities				
Common shares issued for cash	552	227	880	847
Accounts payable related to the acquisition of intellectual property and deferred charges	—	(234)	(231)	(234)
Repurchase of shares	—	—	(373)	—
Cash flows from (used in) from financing activities	552	(7)	276	613
Net change in cash and cash equivalents during the period	1,258	(4,412)	1,084	(1,954)
Cash and cash equivalents, beginning of period	2,595	9,201	2,769	2,835
Cash and cash equivalents, end of period	3,853	4,789	3,853	4,789
Cash and cash equivalents	3,853	4,789		
Short-term marketable securities	28,708	39,141		
	32,561	43,930		

See accompanying notes

CONSOLIDATED STATEMENTS OF OTHER COMPREHENSIVE INCOME AND RETAINED EARNINGS

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

[unaudited]

	Three-month period ended June 30		Six-month period ended June 30	
	2007	2006	2007	2006
	\$	\$	\$	\$
Net income for the period	5,911	1,214	7,175	2,364
Other comprehensive income:				
Change in fair value of available-for-sale financial instruments [net of income taxes of (\$24) for the three-month period and (\$10) for the six-month period]	(124)	—	(52)	—
Reclassification adjustment for losses (gains) on available-for-sale financial instruments included in net income in the current period [net of income taxes of \$1 for the three-month period and (\$25) for the six-month period]	4	—	(134)	—
	(120)	—	(186)	—
Comprehensive income for the period	5,791	1,214	6,989	2,364
Retained earnings, beginning of period	14,767	9,089	13,711	7,939
Net income for the period	5,911	1,214	7,175	2,364
Purchase of common shares	—	—	(227)	—
Cumulative impact of accounting changes relating to financial instruments (net of income taxes of \$3) [Note 3]	—	—	19	—
Retained earnings, end of period	20,678	10,303	20,678	10,303

See accompanying notes

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

1. Governing Statute and Nature of Operations

Paladin Labs Inc. is a specialty pharmaceutical public company continued under the Canada Business Corporations Act, focusing on developing, acquiring, marketing and distributing innovative pharmaceutical products. Paladin Labs Inc., together with its subsidiaries, is hereinafter referred to as the “Company”.

2. Basis of Presentation and Accounting policies

The unaudited interim consolidated financial statements have been prepared by the Company in accordance with Canadian generally accepted accounting principles (“GAAP”) applicable to interim financial statements and include the accounts of all its subsidiaries. Accordingly, they do not include all the information and disclosures required according to GAAP for annual financial statements and should be read in conjunction with the Company’s audited consolidated financial statements and notes thereto in the Company’s Annual Report for the year ended December 31, 2006.

Information with respect to the December 31, 2006 balance sheet is derived from the Company’s complete audited consolidated financial statements. The accounting policies underlying these interim financial statements are those set forth in note 2 of the audited financial statements for the year ended December 31, 2006 and those mentioned in note 3 to the interim financial statements.

3. Change in Accounting Policy

Effective January 1, 2007, the Company retroactively adopted, without restatement of prior periods, the recommendations included in the following sections of the Canadian Institute of Chartered Accountants (“CICA”) Handbook: Section 1530, *Comprehensive Income*, Section 3251, *Equity*, Section 3855, *Financial Instruments – Recognition and Measurement*, and Section 3865, *Hedges*.

Section 1530, *Comprehensive Income*, along with Section 3251, *Equity*, which amends Section 3250, *Surplus*, requires the presentation of comprehensive income and its components in a new financial statement. Further, they require companies to separately present changes in equity during the period as well as components of equity at the end of the period, including comprehensive income. Comprehensive income is the change in the net assets of a company arising from transactions, events and circumstances not related to shareholders. The impact of the adoption of this standard has been to incorporate other comprehensive income disclosures within the financial statements.

Section 3855, *Financial Instruments – Recognition and Measurement* sets out the standards for the recognition and measurement of financial assets, financial liabilities and derivatives. This standard prescribes when to recognize a financial instrument in the balance sheet and at what amount. Depending on their balance sheet classification, fair value or cost-based measures are used. This standard also prescribes the basis of presentation for gains and losses on financial instruments. Based on financial instrument classification, gains and losses on financial instruments are recognized in net income or other comprehensive income.

3. Change in Accounting Policy (cont'd)

The following is a summary of the classifications the Company has elected to apply to each of its significant categories of financial instruments outstanding as of January 1, 2007:

- Marketable Securities are classified principally as “Assets held to maturity” with certain identified investments classified as “Available for sale”. The Marketable Securities classified as “Assets held to maturity” are initially recognized at their fair values, with any resulting premium or discount from the face value being amortized to income or expense using the effective interest method. After their initial fair value measurement, they are measured at amortized cost using the effective interest rate method. The Marketable Securities classified as “Available for sale” are initially recognized at their fair values, with any resulting changes in the fair value being charged or credited to other comprehensive income and when ultimately sold to net income. Fair values for marketable securities are obtained using quoted active market prices for such securities;
- Accounts receivable and other assets and Investment tax credits receivable are classified as “Loans and receivables”. They are recorded at cost, which upon their initial measurement is equal to their fair value. Subsequent measurements are recorded at amortized cost using the effective interest rate method;
- Investments in other companies are classified as “Available for Sale” except for the allocated conversion option of a secured convertible term note in a portfolio company, which is classified as a “Derivative” and the allocated loan portion on the same convertible term note which is classified as “Loans and receivables”. Derivatives are carried at fair value with changes in the fair value being charged or credited to the statement of income for the relevant period. Investments in other companies, consist of strategic investments in the form of equity in partner companies. The investments classified as “Available for Sale” are carried at fair value with changes in the fair value being charged or credited to other comprehensive income. In compliance with Section 3855, investments in private companies are carried at cost unless evidence of an other than temporary impairment exists in which case they are written down to their net recoverable amount. Fair values for investments in other companies classified as “Available for sale” are obtained using quoted prices in active markets for public companies, if such are available. Fair value for the allocated conversion option of a secured convertible term note in a portfolio company classified as a Derivative was obtained using the Black-Scholes option pricing valuation model; and,
- Accounts payable and accrued liabilities, Accounts payable to related parties and Balance of sale payable are classified as “Other financial liabilities”. They are initially measured at their fair value. Subsequent measurements are recorded at amortized cost using the effective interest rate method.

The impact of the adoption of these new standards translated into the following changes as at January 1, 2007: a \$692 increase in accumulated other comprehensive income; a \$162 increase in marketable securities; a \$684 increase in investments in other companies, including the recognition through bifurcation of certain embedded derivatives in investments (secured convertible notes in a portfolio company) in the amount of \$527; a \$19 increase in the opening balance of retained earnings; and, a \$135 reduction in future income tax assets. Further, the adoption of these new standards has no impact on the Company’s cash flows.

3. Change in Accounting Policy (cont'd)

The impact of the adoption of this standard on the statement of income for the six-month period ended June 30, 2007 has been to record an unrealized loss on the allocated conversion option of a secured convertible term note in a portfolio company recognized as a derivative instrument, in the amount of \$310 (\$101 for the three-month period ended June 30, 2007), which will subsequently be re-measured at each reporting period until ultimate settlement. In addition, accretive interest income on the allocated loan portion of the same convertible term note in the amount of \$37 (\$19 for the three-month period ended June 30, 2007) was recorded. During the three and six-month period ended June 30, 2007, the Company also recorded an unrealized gain of \$67 on a contingent stock right from Indevus.

Section 3865, “*Hedges*” allows optional treatment providing that hedges be designated as either fair value hedges, cash flow hedges or hedges of a self-sustaining foreign operation. Since the Company does not currently have any hedging programs in place, the adoption of this section did not have any impact on the Company’s financial statements.

4. Financial Instruments and Accumulated Other Comprehensive Income

	Carrying Value \$	Fair Value \$
Marketable Securities		
<i>Available for Sale</i>	8,992	8,992
<i>Held to Maturity</i>	19,716	19,624
Investments		
Investment in 8% Secured Convertible Term Notes in Nuvo Research Inc. [“Nuvo”], a public company listed on the Toronto Stock Exchange (Face Value \$500)		
• <i>Loans and receivables allocated amount</i>	182	457
• <i>Embedded derivative</i>	66	66
Investment in common shares of Indevus Pharmaceuticals, Inc. [“Indevus”], a public company in the United States		
• <i>Common Shares</i>	2,420	2,420¹
• <i>Contingent Stock Right</i>	301	301
Investment in Series A 8% non-cumulative, convertible Preferred Shares of Verus Pharmaceuticals, Inc. [“Verus”], a private company in the United States	393	393²
Investment in common shares of BioSante Pharmaceuticals, Inc. [“BioSante”], a public company in the United States	9	9

¹ On April 18, 2007, Indevus acquired Valera Pharmaceuticals Inc. [“Valera”], consequently, the Company’s original common stock investment in Valera was exchanged for 1.1337 Indevus shares and three contingent stock rights for each Valera share. Contingent stock rights are convertible into Indevus common shares upon reaching certain milestones.

² In compliance with Section 3855, the Company’s investment in Verus, a private company, is carried at cost as there are no quoted market prices in an active market for such an equity instrument. Fair value has not been disclosed because fair value cannot be measured reliably.

4. Financial Instruments and Accumulated Other Comprehensive Income (cont'd)

The accumulated other comprehensive income as at June 30, 2007, and the net change in unrealized gains on available-for-sale investments are detailed as follows:

	Three-month period ended June 30, 2007	Six-month period ended June 30, 2007
	\$	\$
Balance, beginning of period	626	—
Cumulative impact of accounting changes relating to financial instruments [Note 3]	—	692
Adjusted balance, beginning of period	626	692
Other comprehensive income for the period	(120)	(186)
Balance, end of period	506	506

5. 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	14,980,131	\$58,807
Issued upon exercise of stock options	131,545	966
Issued under employee share purchase plan	3,882	39
Purchase of shares	(37,800)	(147)
Issued in connection with the acquisition of BioEnvelop Inc. [note 7]	98,455	1,029
Common shares to be issued in connection with the acquisition of BioEnvelop Inc. [note 7]	—	166
Balance at June 30, 2007	15,176,213	\$60,860

During the six-month period ended June 30, 2007, under the terms of the normal course issuer bid, the Company repurchased and cancelled 37,800 shares.

Subsequent to June 30, 2007, under the terms of the normal course issuer bid, the Company repurchased an additional 207,500 shares which are in the process of being cancelled.

5. Capital Stock (cont'd)

Stock option plan

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

	2007		2006	
	#	Weighted average exercise price \$	#	Weighted average exercise price \$
Balance at beginning of year	819,915	6.07	915,743	5.57
Granted	317,822	11.18	145,500	6.87
Exercised	(131,545)	6.40	(184,779)	4.43
Expired or forfeited	(20,486)	9.08	(6,336)	5.29
Balance at June 30	985,706	7.61	870,128	5.84
Options exercisable at June 30	445,526	5.83	508,519	6.04

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 June 30		Six-month period ended June 30	
	2007	2006	2007	2006
Option compensation expense	377	210	504	342
Weighted average fair value of options	\$6.70	\$5.02	\$6.69	\$4.26
Weighted average risk-free interest rate	4.22%	4.34%	4.18%	4.15%
Dividend yield	Nil	Nil	Nil	Nil
Weighted average volatility factor	55%	58%	55%	58%
Weighted average expected life	7 years	7 years	7 years	7 years

6. 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 June 30		Six-month period ended June 30	
	2007	2006	2007	2006
Basic weighted average number of shares outstanding	15,100,003	14,891,946	15,052,122	14,830,676
Dilutive effect of options	337,992	220,377	330,038	195,530
Diluted weighted average number of shares outstanding	15,437,995	15,112,323	15,382,160	15,026,206

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

7. Business acquisition

On April 30, 2007, the Company acquired all of the issued and outstanding shares of BioEnvelop Inc. ("BioEnvelop"), a subsidiary of BioEnvelop Technologies Inc. (TSX VENTURE: BIE), for a total consideration of \$1,993 consisting of the assumption of a note payable in BioEnvelop which was immediately repaid. The consideration was paid as follows: \$650 in cash, \$1,029 in common stock issued on the closing of the transaction representing 98,455 common shares and a \$315 non-interest bearing balance of sale payable 180 days after the closing date, subject to certain acquisition related conditions. The non-interest bearing balance of sale payable consists of a short term balance of sale payable in the amount of \$149 and \$166 payable in a pre-determined number of common shares to be issued using a value of \$10.45 per share, determined based on the weighted average trading price of the Company's common shares on the TSX for the ten trading days immediately prior to the closing date. The Company also incurred transaction costs in the amount of \$179, included in cash above, in connection with the acquisition. BioEnvelop has expertise in developing and manufacturing rapidly dissolving edible films for the nutraceutical and pharmaceutical markets.

The acquisition was accounted for using the purchase method. The results of BioEnvelop operations have been included in the Company's results since April 30, 2007, the date of acquisition. The total purchase price of \$1,993 was preliminarily allocated to the fair value of the net assets acquired in the amount of \$7,077, representing negative goodwill in the amount of the excess of \$5,084. The Company, as per applicable accounting standards, eliminated the value previously assigned to certain prescribed assets in the amount of \$210 against the excess of the amounts assigned to assets acquired and liabilities assumed over the cost of the purchase above. The remaining excess is presented as an extraordinary gain in the amount of \$4,874. The purchase price was preliminarily allocated as follows:

Purchase price allocation	\$
Current assets	448
Future income tax asset	5,919
Government assistance benefits receivable	500
	<hr/> 6,867
Consideration represented by:	
Assumption and simultaneous payment of debt	1,993
	<hr/>
Extraordinary gain (net of \$nil taxes)	4,874

The Company is in the process of finalizing the purchase price allocation and will be completed during 2007.

8. Related party transactions

Joddes Limited [“Joddes”], a private Canadian corporation, is a significant shareholder holding approximately 43% 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 a wholly-owned subsidiary of Joddes to provide logistics services including: customer service, warehousing, shipping, invoicing, collection services and certain manufacturing services on behalf of the Company. The Company also engages this affiliate 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 10 years, ending in 2013 and includes minimum annual payments of \$136.

Effective November 1, 2006, the Company acquired the Canadian distribution rights to Metadol[®] from a wholly-owned subsidiary of Joddes for cash consideration of \$15,000. Under the terms of the agreement, the Company can purchase the Canadian license for Metadol[®] on the fourth anniversary of the agreement for \$1 and can receive a reimbursement of up to \$3,750 subject to certain acquisition related conditions.

All transactions with related parties are carried out in the normal course of operations, and are recorded at an agreed upon exchange amount. The accounts payable to related parties is on normal commercial terms and conditions and is non-interest bearing.

The table below reflects all transactions and services with related parties 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 June 30		Six-month period ended June 30	
	2007	2006	2007	2006
	\$	\$	\$	\$
Revenues	153	162	293	332
Purchases	4,030	3,034	5,957	5,147
Research and development expenses	76	52	141	76
Sales and marketing expenses	801	663	1,588	1,234
General and administrative expenses	84	68	150	159

9. 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 3% to 20% of sales, or require payments for products at rates ranging from 20% to 40% of the net selling price.

A certain pharmaceutical product license agreement requires that the Company make royalty payments ranging from 75% to 90% of the excess of a defined contribution amount above certain established minimums and requires payments of 50% of the excess of certain established internal rates of return for a product.

In addition, the Company may have to pay up to \$15,859, including US\$14,819 if it achieves specific sales volumes on certain 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 \$4,680, including US\$1,150 over the next six years. In addition, certain 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 \$437 (US\$411), 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 \$15,504, including US\$6,792 and €1,750, to retain exclusive distribution agreements for certain products. These commitments end in 2014 and annual commitments are as follows:

	\$
April 1, 2007 - December 31, 2007	2,561
2008	3,849
2009	2,613
2010	2,282
2011	1,599
2012-2014	2,600

10. Comparative figures

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

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