

PALADIN LABS INC.
CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2008



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, 2008 and compares these unaudited quarterly results to those of the quarter ended June 30, 2007. 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, 2008 and 14,875,453 shares and 1,110,914 options 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.

Second quarter highlights:

- Revenues reached \$20,668, an increase of 34% over the same period last year
- Net income before extraordinary gain was \$2,588, an increase of 150% over the same period last year
- Net income was \$2,588, a decrease of 56% over the same period last year
- EBITDA¹ reached \$6,997, a 37% increase over the same period last year
- Plan B[®] granted over-the-counter status by the National Association of Pharmacy Regulatory Authorities (NAPRA)
- Licensed to Nuvo Research Inc. (TSX: NRI) the exclusive rights to develop and commercialize a novel pain formulation
- Entered into a Canadian co-promotion agreement for Seasonale[™] with Procter & Gamble (P&G) Pharmaceuticals Canada Inc. – Canada's first and only extended-cycle oral contraceptive available in Canada

Subsequent to quarter end, Paladin announced:

- Modified the existing licensing arrangements with Nuvo Research Inc. for Pennsaid[®] and its follow-on product, Pennsaid[®] Plus
- Acquired the Canadian, Australian and New Zealandian rights to Unisom[™] and the Canadian rights to Kaopectate[®] from Johnson & Johnson Inc. (NYSE: JNJ).
- Acquired the worldwide rights to Antizol[®] and Antizol-Vet[®] from Jazz Pharmaceuticals, Inc. (NASDAQ: JAZZ).

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 amortization expenses. The Company excludes amortization expenses because their level depends substantially on non-operating factors such as the historical cost of intangible and 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 estimates, please refer to the management's discussion & analysis included in the Company's 2007 Annual Report. There have been no material changes to accounting estimates since December 31, 2007.

Results of Operations

Three-month period ended June 30, 2008 compared to three-month period ended June 30, 2007, and six-month period ended June 30, 2008 compared to six-month period ended June 30, 2007.

Revenues

Revenues increased \$5,232 or 34% to \$20,668 for the three-month period ended June 30, 2008 from \$15,436 for the three-month period ended June 30, 2007. For the six-month period ended June 30, 2008, revenues increased \$9,173 or 32% to \$37,502 from \$28,329 for the six-month period ended June 30, 2007. Revenue from products acquired during 2008 contributed \$905 to the quarter ended June 30, 2008 and \$1,040 for the six-month period ended June 30, 2008.

The increase in revenues for the three and six-month periods ended June 30, 2008 is primarily attributable to the sales growth of certain significant promoted products, including Tridural[™], Twinject[®], Seasonale[™], Plan B[®], Pennsaid[®], Metadol[®], Trelstar[®], and Testim[®] which combined increased by 43% and 36% for the three and six-month periods ended June 30, 2008, respectively, compared to 63% and 61% for the same periods last year.

Product revenue highlights for the Company's most significant promoted products using IMS Canada data² for the three-month and six-month period ended June 30, 2008 are as follows:

² The Company has chosen not to disclose detailed product revenue information for competitive reasons, however, does include detailed IMS Canada sales data, essentially end-user pharmacy purchase volume data, to allow the reader to better understand revenue changes from period to period on certain significant products. It is important that readers of this sales data note that IMS Canada sales data may not necessarily correspond to the Company's recording of revenue in accordance with GAAP.

Promoted Products	Three-month periods ended June 30		Six-month periods ended June 30	
	Revenue per IMS Canada in 2008 \$	% change vs. 2007	Revenue per IMS Canada in 2008 \$	% change vs. 2007
Plan B [®]	1,887	32%	3,613	30%
Twinject [®]	2,023	29%	3,095	18%
Pennsaid [®]	2,868	6%	5,464	6%
Metadol [®]	1,649	31%	3,113	30%
Trelstar [®]	355	128%	640	196%
Seasonale [™]	186	N/A	285	N/A
Testim [®]	327	N/A	638	N/A
Tridural [™]	879	N/A	1,421	N/A

During the quarter, the Company entered into a Canadian co-promotion agreement for Seasonale[™] with Procter and Gamble Pharmaceuticals Canada Inc. In connection with this agreement the Company will not be recording revenue from product sales effective June 27, 2008 and instead will be recording earned co-promotion and royalty revenue in accordance with the co-promotion agreement.

Gross Profit

Total gross profit increased \$3,514 or 30% to \$15,216 for the three-month period ended June 30, 2008 from \$11,702 for the three-month period ended June 30, 2007. For the six-month period ended June 30, 2008, gross profit increased \$5,983 or 27% to \$28,106 from \$22,123 for the same period last year. Gross profit, as a percentage of revenues, decreased to 74% from 76% for the quarter ended June 30, 2008 compared to the same quarter ended June 30 last year. For the six-month period ended June 30, 2008, gross profit as a percentage of revenues decreased to 75% from 78% for the same period ended last year. This decrease in gross profit as a percentage of revenues, is mainly a result of the impact of lower margins from the BioEnvelop[™] edible film business and reduced margins on certain newly launched products. It is expected that gross profit, as a percentage of revenues, will approximate 75% to 77% for the year ending December 31, 2008.

Selling and Marketing Expense

Selling and marketing expense increased \$659 or 13% to \$5,569 for the three-month period ended June 30, 2008 from \$4,910 for the three-month period ended June 30, 2007. For the six-month period ended June 30, 2008, selling and marketing increased \$1,771 or 19% to \$11,102 from \$9,331 for the six-month period ended June 30, 2007.

Selling and marketing expense, as percentage of revenues, decreased to 27% for the three-month period ended June 30, 2008 from 32% for the same period last year. For the six-month period ended June 30, 2008, selling and marketing expense, as a percentage of revenues decreased to 30% from 33% for the same period last year. The decrease in selling and marketing expenses as a percentage of revenues is primarily the result of the timing of certain promotional efforts by the Company. Furthermore, during the quarter, the Company received a \$1,000 reimbursement for certain marketing related expenses related to the launch of Seasonale[™] in connection with the Canadian co-promotion agreement for Seasonale[™] with Procter and Gamble Pharmaceuticals Canada Inc. This amount was credited to selling and marketing expenses for the quarter ending June 30, 2008. The promotional activities driving selling and marketing costs primarily relate to Paladin's launch of Seasonale[™], Tridural[™], Testim[®] and Trelstar[®] as well as the continued promotional activities for Twinject[®], Plan B[®], Pennsaid[®] and Metadol[®]. It is expected that selling and marketing expense, as a percentage of revenues, will approximate 30% to 40% for the year ending December 31, 2008.

General and Administrative Expense

General and administrative expense increased \$511 or 35% to \$1,955 for the three-month period ended June 30, 2008 from \$1,444 for the three-month period ended June 30, 2007. For the six-month period ended June 30, 2008, general and administrative expense increased \$908 or 37% to \$3,369 from \$2,461 for the six-month period ended June 30, 2007. General and administrative expense, as percentage of revenues, remained consistent at 9% for the quarters ended June 30, 2008 and 2007. Similarly, general and administrative expense, as a percentage of revenues, remained consistent at 9% for the six-month period ended June 30, 2008 and for the same period last year. General and administrative expense, as a percentage of revenues, is expected to approximate 8% to 10% for the year ending December 31, 2008.

Research and Development Expense

Research and development expense increased \$469 or 77% to \$1,079 for the three-month period ended June 30, 2008 from \$610 for the three-month period ended June 30, 2007. For the six-month period ended June 30, 2008, research and development expense increased \$966 or 84% to \$2,122 from \$1,156 for the six-month period ended June 30, 2007. Research and development expense as a percentage of revenues, increased to 5% for the quarter ended June 30, 2008 compared to 4% for the same period last year. For the six-month period ended June 30, 2008, research and development expense as a percentage of revenues increased to 6% from 4% for the same period last year. During the three and six-month periods ended June 30, 2008 and 2007, Paladin's research and development efforts have been to manage development projects with licensors and preparing new drug submissions to strengthen the Company's pipeline as well as to search and explore potential product opportunities for internal development. It is expected that research and development expense, as a percentage of revenues, will approximate 5% to 7% for the year ending December 31, 2008 primarily as a result of BioEnvelop's advancement in its research and development activities.

Net Interest Income

Net interest income increased \$28 or 8% to \$384 for the three-month period ended June 30, 2008 from \$356 for the three-month period ended June 30, 2007. For the six-month period ended June 30, 2008, net interest income increased \$164 or 22% to \$903 from \$739 for the six-month period ended June 30, 2007. This increase is primarily the result of higher average cash and marketable securities balances partially offset by lower interest rates over the three and six-month periods ended June 30, 2008 compared to the three and six-month periods 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 \$26 for the three-month period ended June 30, 2008 [2007 - \$19], and \$50 [2007 - \$36] for the six-month period ended June 30, 2008.

Amortization of Intangible Assets and Deferred Charges

Amortization expense decreased \$151 or 5% to \$3,123 for the three-month period ended June 30, 2008 from \$3,274 for the three-month period ended June 30, 2007. This decrease in amortization expense relates to the full amortization of certain older pharmaceutical product licenses and rights, and deferred charges. For the six-month period ended June 30, 2008, amortization expense increased \$168 or 3% to \$6,060 from \$5,892 for the same period last year. 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.

Unrealized (Income) Loss on Derivative Instruments

In accordance with Section 3855, the Company used the Black-Scholes option pricing model to re-measure the fair value of the conversion option on a the secured convertible term note investment in a portfolio company recognizing an unrealized gain for the conversion option on the note in the amount of \$12 [2007 - loss of \$101] and \$10 [2007 - loss of \$311] for the three and six-month periods ended June 30, 2008, respectively. In addition, for the three-month periods ended June 30, 2008, the Company recognized an unrealized gain on warrants in a portfolio company in the amount of \$54. For the same three-month period last year, 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 gain of \$66 [2007 - loss of \$34] and \$64 [2007 - loss of \$244] for the three and six-month periods ended June 30, 2008, respectively.

Gain on Disposal of Investment

During the three and six-month periods ended June 30, 2008, the Company did not dispose of any investments. 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 \$127 and \$130 for the three and six-month periods ended June 30, 2008, respectively, compared to \$nil for the same periods last year. During the quarter, the Company received common shares in a portfolio company having a fair value of \$125 in exchange for out-licensing the exclusive rights to a novel topical pain formulation. In addition, during the six-month period ended June 30, 2008, the Company received \$75 as a termination payment for certain costs disbursed as part of a previously licensed pharmaceutical product and paid \$72 to settle a disputed client relationship.

Income Tax Expense

Income tax expense increased \$730 or 97% to \$1,479 for the three-month period ended June 30, 2008 from \$749 for the three-month period ended June 30, 2007. For the six-month period ended June 30, 2008, income tax expense increased \$934 or 60% to \$2,485 from \$1,551 for the six-month period ended June 30, 2007. For the three and six-month periods ended June 30, 2008, the effective tax rate was 36% and 38%, respectively, compared to 42% and 40% for the three and six-month period ended June 30, 2007. 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	13,143	12,348	2024-2028
Provincial	9,995	9,200	2024-2028
Scientific Research and Experimental Development expenditures			
Federal	11,831	3,555	N/A
Provincial	5,588	1,961	N/A
Investment tax credits			
Federal	2,422	773	2010-2027

Net Income before Extraordinary Gain

Due to the factors set forth above, net income before extraordinary gain increased \$1,551 to \$2,588 for the three-month period ended June 30, 2008 compared to net income of \$1,037 for the three-month period ended June 30, 2007. For the six-month period ended June 30, 2008, net income before extraordinary gain increased \$1,764 to \$4,065 from \$2,301 for the six-month period ended June 30, 2007.

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-V: 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 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 5).

Net Income

Due to the factors set forth above, net income decreased \$3,323 to \$2,588 for the three-month period ended June 30, 2008 compared to net income of \$5,911 for the three-month period ended June 30, 2007. For the six-month period ended June 30, 2008, net income decreased \$3,110 to \$4,065 from \$7,175 for the six-month period ended June 30, 2007.

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 other than those described in Note 11 to the interim financial statements.

Paladin's cash, cash equivalents and marketable securities increased \$330 to \$36,546 at June 30, 2008 from \$36,216 at December 31, 2007. This increase is a result of cash flows generated from operating activities in the amount of \$11,416 partially offset by the Company's acquisition of pharmaceutical product licenses and rights, and deferred charges in the amount of \$8,867 and the repurchase of shares under the terms of the normal course issuer bid in the amount of \$1,806. 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 \$2,781 to \$44,746 at June 30, 2008 from \$41,965 at December 31, 2007 primarily due to an increase in the Company's operating activities.

Cash flows from operating activities increased 5% or \$188 to \$4,042 for the three-month period ended June 30, 2008 from \$3,854 for the three-month period ended June 30, 2007. Cash flows from operating activities for the six-month period ended June 30, 2008 were \$11,416 compared to \$8,126 for the six-month period ended June 30, 2007. 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 \$2,769 compared to \$3,148 for the three-month period ended June 30, 2008 and 2007, respectively. During the three-month period ended June 30, 2008, the Company invested a net amount of \$1,714 towards marketable securities, \$1,000 for an investment in a portfolio company and \$55 towards the acquisition of property, plant and equipment. 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.

Cash flows used in investing activities were \$9,134 compared to \$7,549 for the six-month period ended June 30, 2008 and 2007, respectively. During the six-month period ended June 30, 2008, the Company invested \$8,867 towards the acquisition of pharmaceutical product licenses and rights, and deferred charges, \$1,000 for an investment in a portfolio company, and \$310 towards the acquisition of property plant and equipment partially offset by cash generated by maturing marketable securities in the amount of \$1,043. 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.

Cash flows from financing activities were \$304 compared to \$552 for the three-month period ended June 30, 2008 and 2007, respectively. During the three-month period ended June 30, 2008, an amount of \$304 was generated from stock option exercises and the issuance of common shares under the stock purchase plan for cash. 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.

Off-Balance Sheet Arrangements and Guarantees

The Company's off balance sheet arrangements consist of contractual obligations and agreements for development, sales, marketing and distribution rights to innovative drug products for the Canadian market. The effect of terminating these arrangements under normal operating circumstances consists of an effective transition of the remaining responsibilities and obligations to the licensor under agreed upon time frames and conditions. Please refer to this section below or note 7 of the Company's interim consolidated financial statements for additional details. Other than these contractual obligations and commitments, the Company does not have any off-balance sheet arrangements that have, or are reasonably likely to have, a current or future effect on the Company's financial condition, changes in revenues or expenses, results of operations, liquidity, capital expenditures, or capital resources that are material to investors.

The Company does not issue guarantees contemplated by the applicable CICA Guidelines.

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
	\$	\$	\$
July 1, 2008 – December 31, 2008	6,583	360	262
Fiscal 2009 – fiscal 2011	29,211	2,018	1,275
Fiscal 2012 – fiscal 2013	1,779	1,561	162
After fiscal 2014	728	509	13,464
Total	38,301	4,448	15,163

Quarterly Information (unaudited)

(In thousands of Canadian dollars except per share information)

	Q2	Q1	Q4	Q3	Q2	Q1	Q4	Q3
	F2008	F2008	F2007	F2007	F2007	F2007	F2006	F2006
Revenues	20,668	16,834	17,697	16,915	15,436	12,893	14,282	12,702
EBITDA ¹	6,997	5,419	4,925	5,074	5,094	4,820	4,271	4,742
Earnings before income taxes	4,067	2,483	2,500	1,606	1,786	2,066	2,365	3,139
Net Income before extraordinary gain	2,588	1,477	1,030	828	1,037	1,264	1,534	1,908
Net Income	2,588	1,477	1,030	828	5,911	1,264	1,534	1,908
Earnings per share before extraordinary gain	\$0.17	\$0.10	\$0.07	\$0.06	\$0.07	\$0.08	\$0.10	\$0.13
Earnings per share	\$0.17	\$0.10	\$0.07	\$0.06	\$0.39	\$0.08	\$0.10	\$0.13
Diluted earnings per share before extraordinary gain	\$0.17	\$0.10	\$0.07	\$0.05	\$0.07	\$0.08	\$0.10	\$0.13
Diluted earnings per share	\$0.17	\$0.10	\$0.07	\$0.05	\$0.38	\$0.08	\$0.10	\$0.13

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.

Events occurring subsequent to the Quarter

On July 7, 2008, the Company acquired the Canadian, Australian and New Zealandian rights to Unisom[®] and the Canadian rights to Kaopectate[®] from Johnson & Johnson Inc.

On July 8, 2008, the Company amended its existing licensing arrangements for Pennsaid and its follow-on product, Pennsaid Plus with Nuvo Research Inc. ("Nuvo" - TSX: NRI). The Company paid \$1,014 in lieu of future payments relating to the Canadian sales of Pennsaid accruing prior to January 1, 2011 and \$1,486 for amounts accrued as at June 30, 2008 for a total of \$2,500. The Company will pay Nuvo a royalty on future Canadian sales of Pennsaid occurring after January 1, 2011. In addition, the Company invested \$2,000 in Nuvo by way of a two-year convertible debenture and received \$500 to settle an outstanding convertible debenture in the same amount. The new debenture bears interest at 8% per annum and is convertible into Nuvo common shares at a price of \$0.1380. The conversion price is based on Nuvo's volume weighted average trading price on the TSX for the five-day trading period ending July 4, 2008.

On July 28, 2008, the Company received notices of re-assessment from the Canada Revenue Agency ("CRA") relating to the taxation years ending August 16, 2005 and July 31, 2006 containing adjustments relating to the use of certain non-capital losses acquired as part of the Dimethaid Health Care Ltd. (subsequently renamed Squire Pharmaceuticals Inc. "Squire") acquisition from Nuvo Research Inc. ("Nuvo"). The notices of re-assessment, if they stood, would amount to additional Canadian federal tax due of approximately \$2,600 plus interest and penalties of approximately \$1,100. It is likely that the CRA will propose similar adjustments for future years. In addition, it is likely that the Quebec and Ontario provincial tax authorities will propose similar adjustments as a result of the CRA reassessments. As such the Company estimates the total tax liability exposure to the federal and relevant provincial governments as a result of the CRA's position to be approximately \$13,900 including interest and penalties. The Company disagrees with the position taken by the CRA and believes it is without merit. The Company intends to file Notices of Objection through the CRA appeals process and the courts if necessary.

Under the terms of the Share Purchase Agreement ("SPA") for Squire, Nuvo provided representations and warranties with respect to the status of the Squire tax accounts and certain tax asset values whereby, if the amounts represented are incorrect then Nuvo is required to indemnify the Company. The Company also holds indemnities from Nuvo relating to all costs relating to reassessment including advisory fees, interest and penalties, as applicable. The Company intends to claim at least \$9,650 from Nuvo under the SPA.

Although the final resolution of the proposed adjustments is uncertain, based on currently available information, the Company has not provided for any amounts relating to this reassessment.

In connection with the appeals process, in the notice of reassessment, the Company is required to post a deposit of up to one half of the tax and interest assessed. As a result, the Company may have to deposit an amount of \$1,858 to the CRA and will make a claim from Nuvo under the SPA. It is likely that the CRA will propose similar adjustments for 2007 and for any tax attributes in dispute claimed in the 2008 fiscal year of Squire and as such the Company may have to pay additional amounts in connection with the appeals process. If the Company is successful in its appeal of the reassessment these amounts will be refunded to the Company with accrued interest.

Management currently believes that the resolution of this matter will not have a material effect on the Company's results of operations, financial position or liquidity. However, an unfavourable resolution with the CRA combined with a failure of Nuvo to satisfy their obligations under the SPA, could have a material impact on the Company's results of operations, financial position and cash flows in the quarter in which an adjustment is recorded or the tax is due or paid.

Effective August 1, 2008 Paladin acquired the worldwide rights to Antizol[®] and Antizol-Vet[®] from JPI Commercial, LLC and Jazz Pharmaceuticals, Inc. Antizol[®] is indicated as an antidote for ethylene glycol (such as antifreeze) or methanol poisoning, or for use in suspected ethylene or methanol ingestion. Antizol-Vet[®] is indicated as an antidote for ethylene glycol (antifreeze) poisoning in dogs that have ingested or are suspected of having ingested ethylene glycol.

New Accounting Standards and Disclosure Changes

Effective January 1, 2008, the Company adopted the following recently introduced Canadian Institute of Chartered Accountants (“CICA”) Handbook Sections:

Section 1535, “Capital Disclosures”, establishes standards for disclosing information about an entity’s capital and how it is managed. These standards require an entity to disclose the following:

- its objectives, policies and processes for managing capital;
- summary quantitative data about what the Company views as capital
- whether during the period, it complied with any externally imposed capital requirements to which it is subject;
- when the entity has not complied with such requirements, the consequences of such non-compliance.

Section 3862, “Financial Instruments – Disclosures”, modifies the disclosures requirements for financial instruments that were included in Section 3861 “Financial Instruments – Disclosure and Presentation”. The new standard requires entities to provide disclosures in their financial statements that enable users to evaluate:

- the significance of financial instruments for the entity’s financial position and performance;
- the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the balance sheet date, and how the entity manages those risks.

Section 3863, “Financial Instruments – Presentation”, carries forward unchanged the presentation requirements of the old Section 3861 “Financial Instruments – Disclosure and Presentation”.

The impact of these changes is outlined in notes 8 and 9 to these interim financial statements.

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, 2008 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, 2008 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.

(signed) Jonathan Ross Goodman

Jonathan Ross Goodman, B.A., LL.B, M.B.A.
President and Chief Executive Officer
Montreal, Canada
August 6, 2008

(signed) Samira Sakhia

Samira Sakhia C.A., M.B.A.
Chief Financial Officer
Montreal, Canada
August 6, 2008

CONSOLIDATED BALANCE SHEETS

[In thousands of Canadian dollars]

	June 30 2008 \$	December 31 2007 \$
	(unaudited)	
ASSETS		
Current		
Cash and cash equivalents	7,324	6,074
Marketable securities	29,222	26,041
Accounts receivable	16,405	11,920
Inventory	5,578	6,781
Other current assets	1,566	2,943
Investment tax credits receivable	—	244
Future income tax asset	2,414	2,992
Total current assets	62,509	56,995
Long-term marketable securities	—	4,101
Investment tax credits recoverable	776	773
Capital assets	526	300
Pharmaceutical product licences and rights	28,071	24,366
Deferred charges	550	1,455
Investments	3,365	4,041
Future income tax assets	7,119	6,874
Total assets	102,916	98,905
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Accounts payable and accrued liabilities	11,674	11,582
Accounts payable to related parties	1,307	1,032
Deferred revenue	—	271
Income taxes payable	4,251	2,056
Balance of sale payable <i>[note 5]</i>	531	89
Total current liabilities	17,763	15,030
Long-term		
Future income tax liability	885	1,357
Balance of sale payable	—	518
Total liabilities	18,648	16,905
Shareholders' equity		
Capital stock <i>[note 3]</i>	59,996	59,797
Other paid-in capital	2,567	2,019
Accumulated other comprehensive loss	(1,796)	(324)
Retained earnings	23,501	20,508
Total shareholders' equity	84,268	82,000
Total liabilities and shareholders' equity	102,916	98,905

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	
	2008	2007	2008	2007
	\$	\$	\$	\$
Revenues	20,668	15,436	37,502	28,329
Cost of sales	5,452	3,734	9,396	6,206
Gross profit	15,216	11,702	28,106	22,123
Expenses (income)				
Selling and marketing	5,569	4,910	11,102	9,331
General and administrative	1,955	1,444	3,369	2,461
Research and development	1,079	610	2,122	1,156
Interest income, net	(384)	(356)	(903)	(739)
Earnings before under-noted items	6,997	5,094	12,416	9,914
Amortization of intangible assets and deferred charges	3,123	3,274	6,060	5,892
Unrealized (income) loss on derivative instruments	(66)	34	(64)	244
Gain on disposal of investment	—	—	—	(74)
Other income	(127)	—	(130)	—
Income before income taxes	4,067	1,786	6,550	3,852
Provision for income taxes				
Current	1,444	520	2,293	674
Future	35	229	192	877
	1,479	749	2,485	1,551
Net income before extraordinary gain	2,588	1,037	4,065	2,301
Extraordinary gain (net of \$nil taxes) [note 5]	—	4,874	—	4,874
Net income for the period	2,588	5,911	4,065	7,175
Earnings per share before extraordinary gain				
Basic	0.17	0.07	0.27	0.15
Diluted	0.17	0.07	0.27	0.15
Earnings per share				
Basic	0.17	0.39	0.27	0.48
Diluted	0.17	0.38	0.27	0.47
Weighted average number of shares outstanding [note 4]				
Basic	14,829,218	15,100,003	14,829,889	15,052,122
Diluted	15,066,153	15,437,995	15,075,385	15,382,160

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	
	2008	2007	2008	2007
	\$	\$	\$	\$
Operating activities				
Net income	2,588	5,911	4,065	7,175
Add items not affecting cash				
Amortization	3,147	3,292	6,106	5,930
Future income taxes	35	(5,541)	192	(4,893)
Stock based compensation expense [note 3]	466	391	709	520
Unrealized net (gain) loss on derivative instruments	(66)	34	(64)	244
Accreted interest	(26)	(19)	(50)	(36)
Gain on disposal of investments	—	—	—	(74)
Imputed interest on balance of sale	6	6	12	12
	6,150	4,074	10,970	8,878
Net change in non-cash balances relating to operations	(2,108)	(220)	446	(752)
Cash flows from operating activities	4,042	3,854	11,416	8,126
Investing activities				
Additions to pharmaceutical product licenses and rights, and deferred charges	—	(11,758)	(8,867)	(11,758)
Investment in portfolio company	(1,000)	—	(1,000)	—
Acquisition of property, plant and equipment	(55)	(32)	(310)	(71)
Purchases of short-term marketable securities	(13,363)	—	(25,128)	(25,986)
Maturities of short-term marketable securities	11,649	9,292	26,171	41,062
Purchases of long-term marketable securities	—	—	—	(10,378)
Proceeds from the disposal of investment	—	—	—	232
Business acquisition	—	(650)	—	(650)
Cash flows used in investing activities	(2,769)	(3,148)	(9,134)	(7,549)
Financing activities				
Common shares issued for cash	304	552	774	880
Repurchase of shares	—	—	(1,806)	(373)
Cash flows from (used in) from financing activities	304	552	(1,032)	507
Net change in cash and cash equivalents during the period	1,577	1,258	1,250	1,084
Cash and cash equivalents, beginning of period	5,747	2,595	6,074	2,769
Cash and cash equivalents, end of period	7,324	3,853	7,324	3,853
Cash and cash equivalents	7,324	3,853		
Short-term marketable securities	29,222	28,708		
	36,546	32,561		

See accompanying notes

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME, ACCUMULATED OTHER COMPREHENSIVE (LOSS) 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	
	2008	2007	2008	2007
	\$	\$	\$	\$
Net income for the period	2,588	5,911	4,065	7,175
Other comprehensive (loss) income:				
Change in fair value of available-for-sale financial instruments [net of taxes of (\$204) for the three-month period [2007 – (\$24)] and (\$313) for the six-month period [2007 – (\$10)]]	(969)	(124)	(1,435)	(52)
Reclassification adjustment for (gains) losses on available-for-sale financial instruments included in net income in the current period [net of taxes of (\$6) for the three-month period [2007 – \$1] and (\$8) for the six-month period [2007 – (\$25)]]	(26)	4	(37)	(134)
Other comprehensive loss for the period	(995)	(120)	(1,472)	(186)
Comprehensive income for the period	1,593	5,791	2,593	6,989
Accumulated other comprehensive (loss) income, beginning of period	(801)	626	(324)	—
Cumulative impact of accounting changes upon adoption of new financial instruments accounting standards on January 1, 2007	—	—	—	692
Adjusted balance, beginning of period	(801)	626	(324)	692
Other comprehensive loss for the period	(995)	(120)	(1,472)	(186)
Accumulated other comprehensive (loss) income, end of period	(1,796)	506	(1,796)	506
Retained earnings, beginning of period	20,913	14,767	20,508	13,711
Net income for the period	2,588	5,911	4,065	7,175
Excess of purchase price over stated capital of common shares cancelled	—	—	(1,072)	(227)
Adjustment to retained earnings upon adoption of new financial instruments accounting standards on January 1, 2007 (net of \$3 taxes)	—	—	—	19
Retained earnings, end of period	23,501	20,678	23,501	20,678

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, 2007.

Information with respect to the December 31, 2007 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, 2007.

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	14,902,784	\$59,797
Issued upon exercise of stock options	130,209	879
Issued under employee share purchase plan	5,054	54
Purchase of shares	(182,725)	(734)
Balance at June 30, 2008	14,855,322	\$59,996

During the three-month period ended June 30, 2008, the Company did not repurchase any shares. During the six-month period ended June 30, 2008, under the terms of the normal course issuer bid, the Company repurchased and cancelled 182,725 shares.

3. 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:

	2008		2007	
	#	Weighted average exercise price \$	#	Weighted average exercise price \$
Balance at beginning of year	1,002,844	7.73	819,915	6.07
Granted	313,435	10.86	317,822	11.18
Exercised	(130,209)	5.58	(131,545)	6.40
Expired or forfeited	(54,525)	9.84	(20,486)	9.08
Balance at June 30	1,131,545	8.74	985,706	7.61
Options exercisable at June 30	473,020	6.60	445,526	5.83

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	
	2008	2007	2008	2007
Option compensation expense	\$472	\$377	\$699	\$504
Weighted average fair value of options	\$5.75	\$6.70	\$5.77	\$6.69
Weighted average risk-free interest rate	3.28%	4.22%	3.30%	4.18%
Dividend yield	Nil	Nil	Nil	Nil
Weighted average volatility factor	46%	55%	48%	55%
Weighted average expected life	7 years	7 years	7 years	7 years

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 June 30		Six-month period ended June 30	
	2008	2007	2008	2007
Basic weighted average number of shares outstanding	14,829,218	15,100,003	14,829,889	15,052,122
Dilutive effect of options	236,935	337,992	245,497	330,038
Diluted weighted average number of shares outstanding	15,066,153	15,437,995	15,075,386	15,382,160

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

5. 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-V: 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 \$314 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 \$148 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. As at June 30, 2008, the Company has fully repaid this non-interest bearing balance of sale payable. 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 pharmaceutical and nutraceutical 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 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 allocated as follows:

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

6. Related party transactions

Joddes Limited [“Joddes”], a private Canadian corporation, is a significant shareholder holding approximately 42% 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 for a total remaining committed amount of \$853 as at June 30, 2008 and is included in the purchase and service based commitments in note 7.

During 2006, the Company acquired the Canadian distribution rights to Metadol[®] from a wholly-owned subsidiary of Joddes. 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. As at June 30, 2008, the Company has not received or earned any reimbursement.

All transactions with related parties, except for the Metadol[®] transaction described above, 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	
	2008 \$	2007 \$	2008 \$	2007 \$
Revenues	1,044	153	1,777	293
Purchases	4,692	4,030	7,541	5,957
Research and development expenses	104	76	226	141
Sales and marketing expenses	1,165	801	2,078	1,588
General and administrative expenses	110	84	201	150

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 1.5% 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 \$15,163, including US\$14,707 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 \$3,013, including US\$150 and €1,500 over the next six years. In addition, certain additional payments may be 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 \$1,435, including US\$411 and GBP£500, 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 \$39,901 including US\$5,731, to retain exclusive distribution agreements for certain products. These commitments end in 2015 and annual commitments remaining are as follows:

	\$
2008	7,183
2009	11,561
2010	13,225
2011	5,425
2012	888
2013-2015	1,619

8. Financial Instruments

The classification of the Company's financial instruments under the new accounting standards as of June 30, 2008 and December 31, 2007 and their respective carrying values and fair values were as follows:

As at June 30, 2008	Available -for-sale	Held-to- maturity	Loans and receivables	Other financial liabilities	Derivatives	Carrying value	Fair value
	\$	\$	\$	\$	\$	\$	\$
Cash and cash equivalents	7,324					7,324	7,324
Marketable securities	29,222					29,222	29,222
Accounts receivable			16,405			16,405	16,405
Other current assets			1,566			1,566	1,566
Investments	3,020		270		75	3,365 ³	3,538
Accounts payable and accrued liabilities				11,696		11,696	11,696
Accounts payable to related parties				1,307		1,307	1,307
Income taxes payable				2,777		2,777	2,777
Balance of sale payable				531		531	531
Total	39,566	—	18,241	16,311	75	74,193	74,366

As at December 31, 2007	Available -for-sale	Held-to- maturity	Loans and receivables	Other financial liabilities	Derivatives	Carrying value	Fair value
	\$	\$	\$	\$	\$	\$	\$
Cash and cash equivalents	6,074					6,074	6,074
Marketable securities	16,375	9,666				26,041	26,019
Accounts receivable			11,920			11,920	11,920
Other current assets			2,943			2,943	2,943
Investment tax credits receivable			244			244	244
Long-term marketable securities	4,101					4,101	4,101
Investments	3,809		220		12	4,041 ³	4,176
Accounts payable and accrued liabilities				11,582		11,582	11,582
Accounts payable to related parties				1,032		1,032	1,032
Income taxes payable				2,056		2,056	2,056
Balance of sale payable				607		607	607
Total	30,359	9,666	15,327	15,277	12	70,641	70,754

³ In accordance with Section 3855, the Company's investments in Verus and Glide, both of which are private companies and included in the balance above, are carried at cost as there are no quoted market prices in an active market for such equity instruments. Fair value has not been disclosed because fair value cannot be measured reliably.

8. Financial Instruments (cont'd)

Fair Value

Fair value is the amount of consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act. The Company uses the following methods and assumptions to establish the fair value for each class of financial instruments for which their carrying amounts are included in the interim balance sheet as follows:

- Cash & cash equivalents are classified as "Available-for-sale" due to their short-term nature and the fact that they must be readily available to finance the Company's operations;
- Marketable securities are classified as "Held to maturity" and "Available for sale". The marketable securities classified as "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 current 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. The carrying amount is a reasonable approximation of fair value due to the short-term nature of the accounts;
- Investments in other companies are classified as "Available for sale" except for the bifurcated conversion option of a secured convertible term note in a portfolio company and certain warrants in a portfolio company, which are classified as a "Derivatives" 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 consist of strategic investments in portfolio 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 accordance 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 classified as "Available for sale" are obtained using quoted prices in active markets for public companies, if such are available. Fair values for the bifurcated conversion option of a secured convertible term note in a portfolio company classified as a derivative and certain warrants in a portfolio company were obtained using the Black-Scholes option pricing valuation model. The allocated loan portion described above classified as "Loans and receivables" is being discounted using an 11% discount rate, such approximating market value; and,
- Accounts payable and accrued liabilities, accounts payable to related parties, income taxes payable, 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 carrying amounts included on the balance sheet are measured at amortized cost which approximates fair value due to the short-term nature of these financial liabilities. The long-term balance of sale payable has been recorded at its discounted value, using a discount rate of 5%, and approximates its market value.

8. Financial Instruments (cont'd)

These estimates are affected by assumptions the Company makes about the amount and timing of estimated future cash flows and discount rates, all of which reflect varying degrees of risk. Income taxes and other expenses that would be incurred on disposition of these financial instruments are not reflected in the fair values. As a result, the fair values are not necessarily the net amounts that would be realized if these instruments were settled.

Risk arising from financial instruments

The Company does not use derivative financial instruments for speculative or trading purposes. Since the Company does not trade actively in derivative instruments it is not exposed to any significant liquidity risks relating to them.

Credit risk

Our cash equivalents and short-term investments are held through various institutions. Cash equivalents are mainly investments in Canadian banker's acceptances that are readily convertible into a known amount of cash, they are subject to minimal risk of changes in value and have an original maturity of three months or less from the date of purchase. Marketable securities are mainly investments in liquid, high-grade investment securities, they are subject to minimal risk of changes in value and have an original maturity from three months to a eighteen months from the date of purchase. Marketable securities are all invested with large Canadian financial institutions.

The Company is exposed to credit risk from our customers and continually monitors its customers' credit. It establishes the provision for doubtful accounts based upon the credit risk applicable to each customer. For the three-month period ended June 30, 2008, two customers, a major wholesale distributor and a major retail chain, represented 29% and 17% of revenues, respectively [2007 - 32% and 17%]. For the six-month period ended June 30, 2008, two customers, a major wholesale distributor and a major retail chain, represented 29% and 17% of revenues, respectively [2007 - 32% and 17%]. As at June 30, 2008, two customers, a major wholesale distributor and a major retail chain, represented 47% and 15% of trade accounts receivable, respectively [2007 - 43% and 14%].

Liquidity risk and market risk

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 in strategic investments in the form of equity or 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. As at June 30, 2008, there were no restrictions on the flow of these funds nor have any of these funds been committed in any way, except as set out in note 7 and note 11.

8. Financial Instruments (cont'd)

The Company principally operates nationally, however, a portion of the Company's expenses, mainly inventory purchases, are incurred in United States (US) dollars. This results in financial risk due to fluctuations in the value of the US dollar relative to the Canadian dollar. The Company does not use derivative financial instruments to reduce its foreign exchange exposure. Fluctuations in foreign exchange rates could cause unanticipated fluctuations in the Company's operating results, financial position or cash flows.

The Company is subject to interest rate risk on its cash, cash equivalents and marketable securities. The Company does not believe that the results of operations or cash flows would be materially affected to any significant degree by a sudden change in market interest rates relative to interest rates on the investments, owing to the relative short-term nature of the marketable securities.

9. Management of Capital

The Company's objectives when managing capital are:

- to safeguard the Company's ability to continue as a going concern in order to provide returns for shareholders;
- to maintain a flexible capital structure which optimizes the cost of capital at acceptable risk.

In the management of capital, the Company includes shareholders' equity alone in the definition of capital. The Company manages the capital structure and makes adjustments to it in the light of changes in economic conditions and the risk characteristics of the underlying assets. To maintain or adjust the capital structure, the Company may attempt to issue new shares, issue new debt, acquire or dispose of assets or adjust the amount of cash and short-term investments balances.

The Company expects that its current capital resources will be sufficient to carry on its operations for the foreseeable future and is not subject to any capital requirements imposed by a regulator or third parties.

10. Comparative figures

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

11. Subsequent Events

On July 7, 2008, the Company acquired the Canadian, Australian and New Zealandian rights to Unisom[®] and the Canadian rights Kaopectate[®] from Johnson & Johnson Inc.

11. Subsequent Events (cont'd)

On July 8, 2008, the Company amended its existing licensing arrangements for Pennsaid and its follow-on product, Pennsaid Plus with Nuvo Research Inc. ("Nuvo" - TSX: NRI). The Company paid \$1,014 in lieu of future payments relating to the Canadian sales of Pennsaid accruing prior to January 1, 2011 and \$1,486 for amounts accrued as at June 30, 2008 for a total of \$2,500. The Company will pay Nuvo a royalty on future Canadian sales of Pennsaid occurring after January 1, 2011. In addition, the Company invested \$2,000 in Nuvo by way of a two-year convertible debenture and received \$500 to settle an outstanding convertible debenture in the same amount. The new debenture bears interest at 8% per annum and is convertible into Nuvo common shares at a price of \$0.1380. The conversion price is based on Nuvo's volume weighted average trading price on the TSX for the five-day trading period ending July 4, 2008.

On July 28, 2008, the Company received notices of re-assessment from the Canada Revenue Agency ("CRA") relating to the taxation years ending August 16, 2005 and July 31, 2006 containing adjustments relating to the use of certain non-capital losses acquired as part of the Dimethaid Health Care Ltd. (subsequently renamed Squire Pharmaceuticals Inc. "Squire") acquisition from Nuvo Research Inc. ("Nuvo"). The notices of re-assessment, if they stood, would amount to additional Canadian federal tax due of approximately \$2,600 plus interest and penalties of approximately \$1,100. It is likely that the CRA will propose similar adjustments for future years. In addition, it is likely that the Quebec and Ontario provincial tax authorities will propose similar adjustments as a result of the CRA reassessments. As such the Company estimates the total tax liability exposure to the federal and relevant provincial governments as a result of the CRA's position to be approximately \$13,900 including interest and penalties. The Company disagrees with the position taken by the CRA and believes it is without merit. The Company intends to file Notices of Objection through the CRA appeals process and the courts if necessary.

Under the terms of the Share Purchase Agreement ("SPA") for Squire, Nuvo provided representations and warranties with respect to the status of the Squire tax accounts and certain tax asset values whereby, if the amounts represented are incorrect then Nuvo is required to indemnify the Company. The Company also holds indemnities from Nuvo relating to all costs relating to reassessment including advisory fees, interest and penalties, as applicable. The Company intends to claim at least \$9,650 from Nuvo under the SPA.

Although the final resolution of the proposed adjustments is uncertain, based on currently available information, the Company has not provided for any amounts relating to this reassessment.

In connection with the appeals process, in the notice of reassessment, the Company is required to post a deposit of up to one half of the tax and interest assessed. As a result, the Company may have to deposit an amount of \$1,858 to the CRA and will make a claim from Nuvo under the SPA. It is likely that the CRA will propose similar adjustments for 2007 and for any tax attributes in dispute claimed in the 2008 fiscal year of Squire and as such the Company may have to pay additional amounts in connection with the appeals process. If the Company is successful in its appeal of the reassessment these amounts will be refunded to the Company with accrued interest.

Management currently believes that the resolution of this matter will not have a material effect on the Company's results of operations, financial position or liquidity. However, an unfavourable resolution with the CRA combined with a failure of Nuvo to satisfy their obligations under the SPA, could have a material impact on the Company's results of operations, financial position and cash flows in the quarter in which an adjustment is recorded or the tax is due or paid.

Effective August 1, 2008 Paladin acquired the worldwide rights to Antizol[®] and Antizol-Vet[®] from JPI Commercial, LLC and Jazz Pharmaceuticals, Inc. Antizol[®] is indicated as an antidote for ethylene glycol (such as antifreeze) or methanol poisoning, or for use in suspected ethylene or methanol ingestion. Antizol-Vet[®] is indicated as an antidote for ethylene glycol (antifreeze) poisoning in dogs that have ingested or are suspected of having ingested ethylene glycol.

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