

**PALADIN LABS INC.**  
**CONSOLIDATED FINANCIAL STATEMENTS**  
**June 30, 2009**



# 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 consolidated operations, performance and financial condition for the quarter ended June 30, 2009 and compares these unaudited quarterly results to those of the quarter ended June 30, 2008. 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](http://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 10, 2009 and as at this date 18,495,238 shares and 1,315,042 options were issued and outstanding. Reference to "Paladin" or the "Company" includes Paladin Labs Inc. and all its subsidiaries, including the acquisition of Isotechnika Inc. as of June 18, 2009 and Virexx Medical Corp. as of December 23, 2008, the effective dates of these acquisitions, respectively, further described in note 4 to these unaudited interim consolidated financial statements.

## Forward-Looking Statements

This document contains forward-looking statements for the Company and its subsidiaries. These forward looking statements, by their nature, necessarily involve risks and uncertainties that could cause actual results to differ materially from those contemplated by the forward-looking statements. The Company considers the assumptions on which these forward-looking statements are based to be reasonable at the time they were prepared, but cautions the reader that these assumptions regarding future events, many of which are beyond the control of the Company and its subsidiaries, may ultimately prove to be incorrect. Factors and risks, which could cause actual results to differ materially from current expectations, are discussed in the Company's Annual Report as well as in the Company's Annual Information Form for the year ended December 31, 2008. The Company disclaims any intention or obligation to update or revise any forward-looking statements whether as a result of new information, future events, except as required by law. For additional information on risks and uncertainties relating to these forward-looking statements, investors should consult the Company's ongoing quarterly filings, Annual Report and Annual Information Form and other filings found on SEDAR at [www.sedar.com](http://www.sedar.com).

## Overview

Paladin is a specialty pharmaceutical company focused on developing, acquiring, in-licensing, marketing, and distributing innovative pharmaceutical products.

## Second quarter highlights:

- Revenues reached \$26,225, an increase of 27% over the same period last year
- Net income before extraordinary gain was \$1,771, a decrease of 32% over the same period last year
- Cash flows from operations reached \$11,280, a 179% increase over the same period last year
- EBITDA<sup>1</sup> was \$8,410, an increase of 20% over the same period last year
- Entered into an agreement with Sylphar N.V. to develop and market an oral dissolving teeth whitening film strip in Europe
- Announced the Canadian launch of Twinject<sup>®</sup> Twinpack<sup>™</sup>, in a package that includes two Twinject<sup>®</sup> epinephrine auto-injectors
- Announced the launch of GELICIOUS<sup>™</sup> and GELMEG3<sup>™</sup>, the first and only Omega 3 supplements in a tasty gel format
- Closed a bought deal offering of 3,450,000 common shares issued at a price of \$17.00 per common share for total gross proceeds of approximately \$58.7 million
- Acquired all the outstanding shares of Isotechnika Inc., Isodiagnostica Inc. (together "Isotechnika") and 19% of the outstanding shares of Isotechnika Pharma Inc. (TSX:ISA). Entered into a partnership for the commercialization of voclosporin including committed research and development funding of \$4.35 million to Isotechnika Pharma Inc. over the next 12 months to further the development of voclosporin. Isotechnika is a biopharmaceutical company focused on the discovery and development of novel immunosuppressive therapeutics and the commercialization of diagnostic products

- Entered into an agreement with Wyeth to acquire a bundle of products currently marketed in Canada by Wyeth that includes Anacin<sup>®</sup> (acetylsalicylic acid) and Anbesol<sup>®</sup> (benzocaine)
- Announced that its biotechnology division, ViRexx, has received a contribution from the National Research Council of Canada Industrial Research Assistance Program (NRC-IRAP) for its Chimigen<sup>®</sup> Platform

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.

### <sup>1</sup> **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, income taxes and the determination of fair value of financial instruments. 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 2008 Annual Report. There have been no material changes to accounting estimates since December 31, 2008.

### **New Accounting Standards and Disclosure Changes**

Effective January 1, 2009, the Company has adopted the following recently introduced Canadian Institute of Chartered Accountants ("CICA") Handbook Section:

Section 3064 – *Goodwill and Intangible Assets*, reinforces the approach under which assets are recorded only if they meet the definition and the recognition criteria of an asset. It also clarifies the application of the concept of matching costs with revenues. These changes, including the related disclosure requirements, did not have a significant effect on the Company's consolidated financial statements.

Section 1400 – *General Standards of Financial Statement Presentation*. This section includes requirements to assess and disclose the Company's ability to continue as a going concern. These changes did not have a significant impact on the Company's consolidated financial statements.

### **IFRS Changeover Plan**

In February 2008 the Canadian Accounting Standards Board (AcSB) confirmed that the use of International Financial Reporting Standards ("IFRS") would be required for Canadian publicly accountable enterprises for years beginning on or after January 1, 2011. The Company will implement these standards as at January 1, 2011. The AcSB also stated that, during the transition period, enterprises will be required to

provide comparative figures in accordance with IFRS. Under IFRS, there is significantly more disclosure required. Further, while IFRS uses a conceptual framework similar to Canadian GAAP, there are significant differences in accounting policy that must be addressed. The Company is currently further evaluating the impact of adopting IFRS on the consolidated financial statements. While the Company has put in place an implementation program and has begun training and analyzing the possible impact of this change on the Company's consolidated financial statements, the final impact of the transition to IFRS cannot be reasonably estimated at this time.

## Results of Operations

Three-month period ended June 30, 2009 compared to three-month period ended June 30, 2008, and six-month period ended June 30, 2009 compared to six-month period ended June 30, 2008.

### Revenues

Revenues increased \$5,557 or 27% to \$26,225 for the three-month period ended June 30, 2009 from \$20,668 for the three-month period ended June 30, 2008. For the six-month period ended June 30, 2009, revenues increased \$14,538 or 39% to \$52,040 from \$37,502 for the six-month period ended June 30, 2008. Revenues generated by the acquisition of Dexedrine<sup>®</sup>, effective December 24, 2008, contributed \$3,380 for the quarter ended June 30, 2009 and \$6,993 for the six-month period ended June 30, 2009.

The increase in revenues for the three and six-month periods ended June 30, 2009 is also attributable to the sales growth of certain significant promoted products, including Tridural<sup>®</sup>, Twinject<sup>®</sup>, Plan B<sup>®</sup>, Pennsaid<sup>®</sup>, Metadol<sup>®</sup>, Testim<sup>®</sup> and Trelstar<sup>®</sup> which combined increased by 7% and 10% for the quarter and six-month period ended June 30, 2009, respectively.

Product revenues highlights for the Company's most significant promoted products using IMS Canada data<sup>2</sup> for the three-month and six-month period ended June 30, 2009 are as follows

Promoted Products	Three-month period ended June 30		Six-month period ended June 30	
	Revenue per IMS Canada in 2009 \$	% change vs. 2008	Revenue per IMS Canada in 2009 \$	% change vs. 2008
Plan B <sup>®</sup>	2,168	14%	4,111	13%
Twinject <sup>®</sup>	1,659	(18%)	2,759	(11%)
Pennsaid <sup>®</sup>	2,823	(2%)	5,595	2%
Metadol <sup>®</sup>	1,919	16%	3,770	21%
Trelstar <sup>®</sup>	770	117%	1,285	101%
Seasonale <sup>™</sup>	880	147%	1,577	185%
Testim <sup>®</sup>	521	60%	960	51%
Tridural <sup>®</sup>	2,360	168%	4,372	208%
	13,100	26%	24,429	32%

### Gross Profit

Total gross profit increased \$3,656 or 24% to \$18,872 for the three-month period ended June 30, 2009 from \$15,216 for the three-month period ended June 30, 2008. For the six-month period ended June 30, 2009, gross profit increased \$10,211 or 36% to \$38,317 from \$28,106 for the same period last year. Gross profit, as a percentage of revenues, decreased to 72% from 74% for the quarter ended June 30, 2009 compared to the same quarter ended June 30 last year. For the six-month period ended June 30, 2009, gross profit as a percentage of revenues slightly decreased to 74% from 75% for the same period ended last year. The decrease in gross profit as a percentage of revenues, is mainly a result of the impact of lower margins from the BioEnvelop<sup>®</sup> edible film business and reduced margins on the Company's product mix as a result of growth in certain promoted products.

<sup>2</sup> The Company has chosen not to disclose detailed product revenues 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 note that IMS Canada sales data may not necessarily correspond to the Company's recording of revenues in accordance with GAAP.

### **Selling and Marketing Expense**

Selling and marketing expense increased \$1,315 or 24% to \$6,884 for the three-month period ended June 30, 2009 from \$5,569 for the three-month period ended June 30, 2008. For the six-month period ended June 30, 2009, selling and marketing increased \$1,294 or 12% to \$12,396 from \$11,102 for the six-month period ended June 30, 2008. Selling and marketing expense, as percentage of revenues, slightly decreased to 26% for the quarter ended June 30, 2009 from 27% for the same quarter last year. For the six-month period ended June 30, 2009, selling and marketing expense, as a percentage of revenues decreased to 24% from 30% for the same period last year. The decrease in selling and marketing expenses as a percentage of revenues is primarily the result of the Company's growth in non-promoted product revenue for the quarter and six-month period ended June 30, 2009, driving selling and marketing expense as a percentage of revenues downward for the quarter and six-months ended June 30, 2009. Furthermore, during the first six months of 2008, the Company was in the first year of promotional market launch activities for Tridural<sup>®</sup> and Seasonale<sup>™</sup>, requiring significant marketing expense outlays. The promotional activities driving selling and marketing costs primarily relate to Paladin's continued promotional activities for Tridural<sup>®</sup>, Trelstar<sup>®</sup>, Twinject<sup>®</sup>, Plan B<sup>®</sup>, Metadol<sup>®</sup> and Testim<sup>®</sup>.

### **General and Administrative Expense**

General and administrative expense increased \$489 or 25% to \$2,413 for the three-month period ended June 30, 2009 from \$1,924 for the three-month period ended June 30, 2008. For the six-month period ended June 30, 2009, general and administrative expense increased \$965 or 29% to \$4,331 from \$3,366 for the six-month period ended June 30, 2008. General and administrative expense, as percentage of revenues, remained consistent at 9% for the quarters ended June 30, 2009 and 2008. For the six-month period ended June 30, 2009, general and administrative expense, as a percentage of revenues slightly decreased to 8% from 9% for the same period last year. The increase in dollar terms for the quarter and six-month period end June 30, 2009, is the result of an increase in headcount, an increase in stock-based compensation expense and business development activities supporting the Company's growth.

### **Research and Development Expense**

Research and development expense increased \$179 or 17% to \$1,258 for the three-month period ended June 30, 2009 from \$1,079 for the three-month period ended June 30, 2008. For the six-month period ended June 30, 2009, research and development expense increased \$399 or 19% to \$2,521 from \$2,122 for the six-month period ended June 30, 2008. Research and development expense as a percentage of revenues, remained consistent at 5% for the quarters ended June 30, 2009 and 2008. For the six-month period ended June 30, 2009, research and development expense as a percentage of revenues slightly decreased to 5% from 6% for the same period last year. The increase in dollar terms for the quarter and six-month period ended June 30, 2009, primarily relates to on-going research and development efforts at Virexx<sup>®</sup> (see note 4 to the unaudited interim consolidated financial statements) and research activities related to BioEnvelop<sup>®</sup> and the Impavido<sup>®</sup> business. During the quarters and six-month periods ended June 30, 2009 and 2008, 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.

### **Net Interest Income**

Net interest income decreased \$291 or 76% to \$93 for the three-month period ended June 30, 2009 from \$384 for the three-month period ended June 30, 2008. For the six-month period ended June 30, 2009, net interest income decreased \$611 or 68% to \$292 from \$903 for the six-month period ended June 30, 2008. This decrease for the quarter and six-month period ended June 30, 2009 is primarily the result of lower interest rates, the reduction of effective non-cash interest on a convertible debenture sold during the quarter ended June 30, 2009, partially offset by slightly higher average daily cash and marketable securities balances over the three and six-month periods ended June 30, 2009 compared to the three and six-month periods ended June 30, 2008.

### **Amortization of Pharmaceutical Product Licenses, Rights and Deferred Charges**

Amortization expense increased \$2,849 or 91% to \$5,972 for the three-month period ended June 30, 2009 from \$3,123 for the same period last year. For the six-month period ended June 30, 2009, amortization expense increased \$6,004 or 99% to \$12,064 from \$6,060 for the same period last year. The increase in amortization expense for both the three-month and the six-month period ended June 30, 2009 is the result

of the amortization related to the Company's recently acquired pharmaceutical product licenses and rights, including: Dexedrine<sup>®</sup>, Antizol<sup>®</sup>, Impavido<sup>®</sup>, Unisom<sup>®</sup> and Kaopectate<sup>®</sup>.

#### **Unrealized Gain on Derivative Financial 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 secured convertible term note investment in a portfolio company recognizing an unrealized gain on the conversion option of \$nil [2008 – gain of \$12] and \$344 [2008 – gain of \$10] for the three and six-month periods ended June 30, 2009, respectively. In addition, the Company recognized an unrealized gain on warrants in a portfolio company of \$nil [2008 – gain of \$54] and \$14 [2008 – gain of \$54] for the three and six-month periods ended June 30, 2009, respectively.

#### **Net Gain on Investments**

During the three-month period ended June 30, 2009, the Company disposed of certain shares held in a portfolio company for proceeds of \$772, representing a gain of \$153. The Company also exercised its right to convert a convertible term note in this same portfolio investment into common shares subsequently selling such shares in the public market for \$3,168 and realizing a gain of \$1,000. Furthermore, during the quarter, the Company also exercised its right to convert warrants in the portfolio investment discussed above into common shares and subsequently disposed such shares for proceeds of \$304, representing a gain of \$133. During the same period, the Company as part of its on-going assessment of investment carrying values determined the investment in a private company, to be permanently impaired and recorded a write-down in the amount of \$801, resulting in a net gain on investments in the amount of \$485 for the quarter ended June 30, 2009.

During the six-month period ended June 30, 2009, in addition to the above, the Company disposed of shares held in a portfolio company for proceeds of \$568, representing a gain of \$62. In addition, during the six-month period ended June 30, 2009, Endo Pharmaceuticals Inc. ("Endo") acquired Indevus Pharmaceuticals Inc. ("Indevus") for \$4.50 per Indevus share in cash and up to an additional \$3.00 per share in cash upon achievement of certain regulatory and sales milestones. The Company received proceeds in the amount of \$2,167 (US\$1,720) for the investment it held in 382,253 common shares of Indevus, resulting in a realized loss on disposal in the amount of \$414. Furthermore, the Company recorded a \$416 contingent right receivable in relation to the achievement of certain regulatory and sales milestones, determined to represent the fair value upon receipt and measured based upon the average incremental Indevus common stock trading price over the \$4.50 cash payment received over a 31 day trading period on NASDAQ.

During the three-month and the six-month period ended June 30, 2008, the Company did not dispose of any investments.

#### **Foreign Exchange Loss (Gain)**

During the three-month and six-month period ended June 30, 2009, the Company recorded a foreign exchange gain of \$18 [2008 – loss of \$31] and a foreign exchange loss of \$4 [2008 – loss of \$3], respectively, mainly as a result of the fluctuations of the Canadian dollar relative to the US dollar and Euro.

#### **Other Income**

Other income was \$110 for the three and six-month periods ended June 30, 2009, compared to \$127 and \$130 for the same periods last year. During the quarter and the six-month period ended June 30, 2009, the Company disposed of certain legacy pharmaceutical product licenses and rights for proceeds of \$110, representing a net gain of \$110. During the quarter ended June 30, 2008, 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 decreased \$199 or 13% to \$1,280 for the three-month period ended June 30, 2009 from \$1,479 for the three-month period ended June 30, 2008. For the six-month period ended June 30, 2009, income tax expense increased \$587 or 24% to \$3,072 from \$2,485 for the six-month period ended

June 30, 2008. For the three and six-month periods ended June 30, 2009, the effective tax rate was 42% and 39%, respectively, compared to 36% and 38% for the three and six-month period ended June 30, 2008. These increases in effective tax rates relate to certain permanent differences during the three and six month period ended June 30, 2009. The Company has the following tax pools detailed below which may be applied against taxable income:

	Available \$	Recognized \$	Expires in
<b>Non-capital tax losses</b>			
Federal	47,180	27,925	2013-2028
Provincial	44,184	24,299	2013-2028
<b>Scientific Research and Experimental Development expenditures</b>			
Federal	86,470	68,863	N/A
Provincial	84,446	68,863	N/A
<b>Investment tax credits</b>			
Federal	23,505	15,776	2016-2029

The amount of the tax benefit claimed in the current and prior years, is subject to audit by the taxation authorities and could be reduced by a material amount in the future.

#### **Net Income before Extraordinary Gain**

Due to the factors set forth above, net income before extraordinary gain decreased \$817 to \$1,771 for the three-month period ended June 30, 2009 compared to net income of \$2,588 for the three-month period ended June 30, 2008. For the six-month period ended June 30, 2009, net income before extraordinary gain increased \$758 to \$4,823 from \$4,065 for the six-month period ended June 30, 2008.

#### **Extraordinary Gain (net of \$nil taxes)**

On June 18, 2009, the Company acquired all the issued and outstanding shares of Isotechnika Inc. ("Isotechnika")(TSX:ISA) in accordance with a court supervised Plan of Arrangement whereby the Company paid \$7,594 in cash, and Isotechnika entered into a research and development agreement with Isotechnika Pharma Inc. ("IsoPharma") in exchange for supporting research and development services for the commercialization of voclosporin, Isotechnika's next-generation calcineurin inhibitor, in Canada, Mexico, Central & South America, Israel and South Africa ("Paladin-acquired territories"). The total purchase price of \$14,147 was allocated to the fair value of the net assets acquired in the amount of \$47,204, representing negative goodwill in the amount of the excess of \$33,057. The Company, as per applicable accounting standards, eliminated the value previously assigned to certain prescribed assets in the amount of \$7,098 against the excess of the amounts assigned to assets acquired and undiscounted liabilities assumed over the cost of the purchase above. The remaining excess is presented as an extraordinary gain in the amount of \$25,959. The Company refers the reader to note 4 of the interim unaudited consolidated financial statements, for further details regarding the acquisition.

#### **Net Income**

Due to the factors set forth above, net income increased \$25,142 to \$27,730 for the three-month period ended June 30, 2009 compared to net income of \$2,588 for the three-month period ended June 30, 2008. For the six-month period ended June 30, 2009, net income increased \$26,717 to \$30,782 from \$4,065 for the six-month period ended June 30, 2008.

#### **Liquidity and Capital Resources**

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. As at June 30, 2009, 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 6 and note 10 to the unaudited interim consolidated financial statements.

The Company believes that its existing cash, cash equivalents and short-term marketable securities, as well as cash generated from operations, are sufficient to finance its current operations, 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.

	Three-month period ended		Six-month period ended	
	2009	June 30 2008	2009	June 30 2008
	\$	\$	\$	\$
Cash flows from operating activities	<b>11,280</b>	4,042	<b>19,546</b>	11,416
Cash flows used in investing activities	<b>(48,926)</b>	(2,769)	<b>(49,586)</b>	(9,134)
Cash flows from (used) in financing activities	<b>56,561</b>	304	<b>56,749</b>	(1,032)
Increase in cash position	<b>18,915</b>	1,577	<b>26,709</b>	1,250
Cash and cash equivalents, beginning of period	<b>12,439</b>	5,747	<b>4,645</b>	6,074
Cash and cash equivalents, end of period	<b>31,354</b>	7,324	<b>31,354</b>	7,324
Short and long-term marketable securities, end of period	<b>59,925</b>	29,222	<b>59,925</b>	29,222
Cash, cash equivalents and marketable securities, end of period	<b>91,279</b>	36,546	<b>91,279</b>	36,546

Paladin's cash, cash equivalents and marketable securities increased \$69,937 to \$91,279 at June 30, 2009 from \$21,342 at December 31, 2008. This increase is primarily a result of the Company's cash flows from financing activities whereby the Company issued common 3,450,000 common shares in the form of a bought deal share offering at a price of \$17.00 per common share generating total net proceeds of \$55,824. Furthermore, the Company generated \$6,979 from the disposal of investments in portfolio companies and cash flows generated from operating activities in the amount of \$11,280, partially offset by the acquisition of Isotechnika Inc. in the amount of \$7,594. Working capital (current assets less current liabilities) increased \$57,772 to \$83,191 at June 30, 2009 from \$25,419 at December 31, 2008 primarily due to an increase in the Company's financing activities described above.

Cash flows from operating activities increased 179% or \$7,238 to \$11,280 for the three-month period ended June 30, 2009 from \$4,042 for the three-month period ended June 30, 2008. Cash flows from operating activities for the six-month period ended June 30, 2009 were \$19,546 compared to \$11,416 for the six-month period ended June 30, 2008. 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 derivative instruments, accreted interest and extraordinary gains.

Cash flows used in investing activities were \$48,926 compared to \$2,769 for the three-month period ended June 30, 2009 and 2008, respectively. During the quarter ended June 30, 2009, the Company invested \$39,889 towards the acquisition of short and long-term marketable securities net of cash flows generated by maturing marketable securities, \$5,475 towards the acquisition of pharmaceutical product licenses and rights and \$7,594 for the business acquisition of Isotechnika Inc. further described in note 4 to the unaudited interim consolidated financial statements, partially offset by proceeds from disposal of investments in portfolio companies in the amount of \$4,244. During the quarter ended June 30, 2008, the Company invested a net amount of \$1,714 towards the acquisition of short-term marketable securities net of cash flows generated by maturing marketable securities, \$1,000 for an investment in a portfolio company and \$55 towards the acquisition of property, plant and equipment.

Cash flows used in investing activities were \$49,586 compared to \$9,134 for the six-month period ended June 30, 2009 and 2008, respectively. During the six-month period ended June 30, 2009, the Company invested \$43,255 towards the acquisition of short and long-term marketable securities net of cash flows generated by maturing marketable securities, \$5,476 for the acquisition of pharmaceutical product licenses

and rights and \$7,594 for the business acquisition of Isotechnika Inc. further described in note 4 to the unaudited interim consolidated financial statements, partially offset by proceeds from disposal of investments in portfolio companies in the amount of \$6,979. 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.

Cash flows from financing activities were \$56,561 compared to \$304 for the three-month period ended June 30, 2009 and 2008, respectively. During the quarter ended June 30, 2009, the Company issued 3,450,000 common shares in the form of a bought deal share offering at a price of \$17.00 per common share for total gross proceeds to the Company in the amount of \$58,650. In conjunction with the offering the Company incurred share issue costs of approximately \$2,826 for total net proceeds amounting to \$55,824. In addition, an amount of \$737 was generated from stock option exercises and the issuance of common shares under the stock purchase plan for cash. During the quarter 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.

Cash flows from financing activities were \$56,749 compared to cash flows used in financing activities in the amount of \$1,032 for the six-month period ended June 30, 2009 and 2008, respectively. During the six-month period ended June 30, 2009, the Company issued 3,450,000 common shares in the form of a bought deal share offering at a price of \$17.00 per common share for total gross proceeds to the Company in the amount of \$58,650. In conjunction with the offering the Company incurred share issue costs of approximately \$2,826 for total net proceeds amounting to \$55,824. In addition, an amount of \$925 was generated from stock option exercises and the issuance of common shares under the stock purchase plan for cash. During the six-month period ended June 30, 2008, the Company repurchased 182,725 of its own common shares under the terms of the normal course issuer bid for an amount of \$1,806 offset by cash generated from stock option exercises and the issuance of common shares under the stock purchase plan in the amount of \$774.

#### **Acquisition of Isotechnika Inc.**

On June 18, 2009, the Company acquired all the issued and outstanding shares of Isotechnika Inc. ("Isotechnika")(TSX:ISA) in accordance with a court supervised Plan of Arrangement whereby the Company paid \$7,594 in cash, and Isotechnika entered into a research and development agreement with Isotechnika Pharma Inc. ("IsoPharma") in exchange for supporting research and development services for the commercialization of voclosporin, Isotechnika's next-generation calcineurin inhibitor, in Canada, Mexico, Central & South America, Israel and South Africa ("Paladin-acquired territories"). The research and development services extend for a period of seven years and include an amount of \$4,350 committed to by the Company to IsoPharma over the next 12 months. Furthermore, the research and development agreement in conjunction with the Company's licencing agreement for voclosporin in the Paladin acquired territories, contains certain other voclosporin research, development and commercialization payment arrangements including possible licensing and royalty revenue payments over the remaining period.

As part of the acquisition, the Company received the international rights to a portfolio of products under development and a commercialized diagnostic product portfolio and has also assumed an obligation to pay out certain amounts of future contractually pre-defined amounts over a period of seven years currently estimated to amount to approximately \$5,950. While the Company believes based on historical sales of the product, current expenditure levels and market conditions that it will make payments estimated to total \$5,950 over the seven year period pursuant to its Research and Development Agreement, it is reasonably possible, based on existing knowledge, that changes in future conditions could require a material change in the recognized amount. Furthermore, as part of the purchase price, the Company received 24,921,312 common shares, representing a 19 percent interest in IsoPharma as at the date of acquisition, with an approximate value of \$4,348 using the weighted average trading price of the common shares on the TSX for the 20 trading days pre and post acquisition. In connection with the acquisition, the Company has incurred transaction costs in the amount of \$530 included in the purchase price below. Isotechnika Inc. is an international biopharmaceutical company dedicated to the discovery, development and commercialization of novel immunosuppressive therapeutics for the treatment of autoimmune diseases and

for use in the prevention of organ rejection in transplantation. In addition to the Company's drug pipeline, Isotechnika also has commercialized diagnostic products.

The results of Isotechnika's operations have been included in the Company's results since June 18, 2009, the effective date of acquisition. The Company refers the reader to note 4 to the interim unaudited consolidated financial statements, for further details regarding the acquisition.

#### **Acquisition of Virexx Medical Corp.**

On December 23, 2008, the Company acquired all the issued and outstanding shares of Virexx Medical Corp. ("Virexx")(TSX:VIR) (AMEX:REX) in accordance with an Order for Reorganization led by Virexx's appointed Trustee, whereby the Company paid \$1,446 in cash. In addition, the Company has agreed to a contractual right of payment of an amount of up to \$2,500 in the aggregate to former Virexx shareholders, if certain conditions are met, including the Company receiving at least \$4,000 in connection with certain Virexx assets, prior to December 31, 2009. The Company has not received funds with respect to this contractual right which would generate a contractual amounts payable as at June 30, 2009. The Company has also incurred transaction costs in the amount of \$196, included in the cash payment above, in connection with the acquisition. Virexx, a Canadian-based biotech company focused on developing innovative-targeted therapeutic products, was subsequently wound-up into Paladin Labs Inc. The results of Virexx operations have been included in the Company's results since December 23, 2008, the date of acquisition. The Company refers the reader to note 4 of the interim unaudited consolidated financial statements, for further details regarding the acquisition.

#### **Related Party Transactions**

Joddes Limited ["Joddes"], a private Canadian corporation, is a significant shareholder holding approximately 38% 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 owns a 19% shareholder interest in Isotechnika Pharma Inc. ["IsoPharma"], as further described in note 4 to the interim unaudited consolidated financial statements and considers this investment a related party.

The Company engages a wholly-owned subsidiary of Joddes to provide logistics services including: customer service, warehousing, shipping, invoicing, collection services and certain manufacturing and selling 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 for a total remaining committed amount of \$791 as at June 30, 2009 and is included in the purchase and service based commitments amount as set out in the "Contractual Obligations and Commitments" section below.

The Company has also entered into contractual royalty agreements with a wholly-owned subsidiary of Joddes for certain legacy and over-the-counter products. The terms of these arrangements vary whereby the Company may earn a royalty fee based on certain established terms relating to the net sales of the respective products such as through a percentage of net sales, certain guaranteed minimum annual payments, or as a percentage of a defined product contribution.

Effective November 1, 2006, the Company acquired the Canadian distribution rights to Metadol<sup>®</sup> from a wholly-owned subsidiary of Joddes. Under the terms of the agreement, the Company can purchase the Canadian license for Metadol<sup>®</sup> 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, 2009, the Company has not received or earned any reimbursement. The acquisition of the Canadian distribution rights to Metadol<sup>®</sup> was not in the normal course of operations and was recorded at an agreed upon exchange amount in accordance with the requirements of accounting standard CICA 3840.

All transactions with related parties except for the Metadol<sup>®</sup> 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		Six-month period	
	ended June 30		ended June 30	
	2009	2008	2009	2008
	\$	\$	\$	\$
Revenues	992	1,044	1,881	1,777
Purchases	1,683	4,692	3,254	7,541
Sales and marketing expenses	1,433	1,165	2,672	2,078
Research and development expenses	131	104	264	226
General and administrative expenses	164	110	285	201

### Quarterly Information (unaudited)

(In thousands of Canadian dollars except per share information)

	Q2	Q1	Q4	Q3	Q2	Q1	Q4	Q3
	F2009	F2009	F2008	F2008	F2008	F2008	F2007	F2007
Revenues	26,255	25,815	23,051	22,191	20,668	16,834	17,697	16,915
EBITDA <sup>1</sup>	8,410	10,955	7,415	9,189	6,997	5,419	4,925	5,074
Earnings before income taxes	3,051	4,844	3,512	5,975	4,067	2,483	2,500	1,606
Net Income before extraordinary gain	1,771	3,052	2,044	3,617	2,588	1,477	1,030	828
Net Income	27,730	3,052	6,116	3,617	2,588	1,477	1,030	828
Earnings per share before extraordinary gain	\$0.11	\$0.20	\$0.14	\$0.24	\$0.17	\$0.10	\$0.07	\$0.06
Earnings per share	\$1.77	\$0.20	\$0.41	\$0.24	\$0.17	\$0.10	\$0.07	\$0.06
Diluted earnings per share before extraordinary gain	\$0.11	\$0.20	\$0.14	\$0.24	\$0.17	\$0.10	\$0.07	\$0.05
Diluted earnings per share	\$1.71	\$0.20	\$0.41	\$0.24	\$0.17	\$0.10	\$0.07	\$0.05

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.

### Off-Balance Sheet Arrangements

The Company's off balance sheet arrangements consist of contractual obligations and agreements for development, sales, marketing and distribution rights to innovative drug products. 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 6 of the Company's unaudited 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.

## **Concentration of Credit Risk and Major Customers**

The Company's cash and cash equivalents, short-term and long-term investments are held through various institutions. 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 four months to twenty-one months from the date of purchase. Marketable securities are substantially 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, 2009, two customers, a major wholesale distributor and a major retail chain, represented 30% and 15% of revenues, respectively [2008 – 29% and 17%]. For the six-month period ended June 30, 2009, two customers, a major wholesale distributor and a major retail chain, represented 29% and 15% of revenues, respectively [2008 – 29% and 17%]. As at June 30, 2009, two customers, a major wholesale distributor and a major retail chain, represented 42% and 12% of trade accounts receivable, respectively [2008 – 47% and 15%]. For a more detailed analysis and disclosure of credit risk please refer to note 7 to the quarterly unaudited consolidated financial statements.

## **Liquidity risk**

The Company generates sufficient cash from operating activities to fund its operations and fulfill its obligations as they become due. The Company has sufficient funds available through its cash, cash equivalents and marketable securities, should its cash requirements exceed cash generated from operations to cover all financial liability obligations. As at June 30, 2009, 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 the "Contractual Obligations and Commitments" section below and note 10 to the unaudited interim consolidated financial statements.

## **Foreign exchange risk**

The Company principally operates within Canada, however, a portion of the Company's revenues, expenses, and current assets and liabilities, are denominated in United States dollars ("USD") and EURO. This results in financial risk due to fluctuations in the value of the USD and EURO relative to the Canadian dollar ("CAD"). The Company currently does not use derivative financial instruments to reduce its foreign exchange exposure. Based on the net exposure described in note 7 to the unaudited interim consolidated financial, and assuming that all other variables remain constant, a ten-point increase or decrease in the CAD/USD and CAD/EURO exchange rates would have an effect of \$250 on net earnings.

## **Interest rate risk**

The Company is subject to interest rate risk on its cash 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.

## **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.

## **Internal Control Over Financial Reporting**

No changes were made in our internal control over financial reporting during the quarter ended June 30, 2009 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## **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. The Company is committed to making minimum purchases of inventory, and minimum expenditures for regulatory, selling and marketing services in the amount of

\$26,503, including €4,438, to retain exclusive distribution agreements for certain products. These commitments end in 2015 and annual commitments are as follows:

<b>Contractual Obligations</b>	<b>Total</b>	<b>Less than 1 year</b>	<b>1-3 years</b>	<b>4-5 years</b>	<b>After 5 years</b>
Purchase and service based commitments (\$)	<b>26,503</b>	3,439	19,581	2,380	1,103

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 may have to pay up to \$21,652 including US\$8,497, €1,207 and GBP£500 over a maximum period of 15 years if it achieves certain product, regulatory or sales milestones on specific products in the future. The Company has the following commitments related to product license, trademark and distribution agreements:

<b>Commitments</b>	<b>Total</b>	<b>Less than 1 year</b>	<b>1-3 years</b>	<b>4-5 years</b>	<b>After 5 years</b>
Milestone based commitments (\$)	<b>13,241</b>	6,383	5,620	1,125	113
Revenues based commitments (\$)	<b>8,411</b>	—	1,332	153	6,926

### **Contingencies**

On July 25, 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”). In addition, on August 11, 2008, the Company received a notice of assessment from CRA for the taxation year ending July 31, 2007. The notices of assessment and re-assessment, if they stood, amount to additional Canadian federal tax due of approximately \$5,558 plus interest and penalties of approximately \$1,733. On October 30, 2008, the Company received a Notice of Reassessment from the Ontario Minister of Finance for the taxation year ended August 16, 2005 for additional taxes, due of \$747 plus interest and penalties of \$378. It is likely that the Quebec provincial tax authorities will propose similar adjustments as a result of the CRA re-assessments. 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 \$11,057 including interest and penalties. The Company disagrees with the position taken by the CRA and believes it is without merit. On October 23, 2008, the Company filed a Notice of Objection through the CRA appeals process and intends to pursue further through the courts, if necessary. The Ontario Minister of Finance has agreed to be bound by the decision of the CRA appeals process.

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. In the event of an unfavorable ruling, the Company intends to claim at least \$7,142 from Nuvo under the SPA. Nuvo has issued a Letter Agreement providing security over the indemnity obligations by entitling the Company to the benefit of security over certain assets and product revenue streams of Nuvo and certain of its subsidiaries.

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 re-assessment, the Company is required to post a deposit of up to one half of the tax and interest assessed. To that effect the Company deposited \$3,755 to the CRA and \$500 to the Ontario Minister of Finance during the year ended December 31, 2008, and may make a claim from Nuvo under the SPA.

If the Company is successful in its appeal of the re-assessment 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 and the relevant provincial authorities 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 year in which an adjustment is recorded or the tax is due or paid.

## **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, 2009 and the interim consolidated statements of income, cash flows, comprehensive income, accumulated other comprehensive income (loss) and retained earnings 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. Management has determined such amounts on a reasonable basis in order to ensure that the consolidated financial statements are presented fairly in all material respects. The Company’s accounting procedures and related systems of internal controls are designed to provide a reasonable assurance that its assets are safeguarded and its financial records are reliable. 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 10, 2009

*(signed) Samira Sakhia*  
\_\_\_\_\_  
Samira Sakhia C.A., M.B.A.  
Chief Financial Officer

Montreal, Canada  
August 10, 2009

## CONSOLIDATED BALANCE SHEETS

[In thousands of Canadian dollars]

	June 30 2009 (unaudited)	December 31 2008 (audited <sup>3</sup> )
<b>ASSETS</b>		
<b>Current</b>		
Cash and cash equivalents	31,354	4,646
Marketable securities	48,722	14,753
Accounts receivable [note 7]	17,696	17,889
Inventory	12,335	8,643
Other current assets	2,836	2,531
Income taxes receivable [note 10]	4,376	4,209
Investment tax credits receivable	58	36
Future income tax asset	5,122	9,120
<b>Total current assets</b>	<b>122,499</b>	<b>61,870</b>
Long-term marketable securities	11,203	1,943
Capital assets	579	594
Pharmaceutical product licences and rights	51,566	58,152
Investments	420	4,792
Investment tax credits recoverable	11,938	43
Future income tax assets	32,941	4,789
<b>Total assets</b>	<b>231,146</b>	<b>132,140</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Current</b>		
Accounts payable and accrued liabilities	21,835	16,464
Accounts payable to related parties	1,439	1,384
Deferred revenue	—	1,693
Income taxes payable	4,622	6,391
Balance of sale payable	11,050	10,429
Future income tax liabilities	362	90
<b>Total current liabilities</b>	<b>39,308</b>	<b>36,451</b>
<b>Long-term</b>		
Future income tax liabilities	—	341
Balance of sale payable	5,525	—
<b>Total liabilities</b>	<b>44,833</b>	<b>36,451</b>
<b>Shareholders' equity</b>		
Capital stock [note 3]	118,684	60,664
Other paid-in capital	3,794	3,155
Accumulated other comprehensive income (loss)	104	(1,420)
Retained earnings	63,731	32,949
<b>Total shareholders' equity</b>	<b>186,313</b>	<b>95,348</b>
<b>Total liabilities and shareholders' equity</b>	<b>231,146</b>	<b>131,799</b>

See accompanying notes

<sup>3</sup> Derived from the audited annual financial statements filed on SEDAR at www.sedar.com

## 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	
	2009	2008	2009	2008
Revenues	26,225	20,668	52,040	37,502
Cost of sales	7,353	5,452	13,723	9,396
<b>Gross profit</b>	<b>18,872</b>	<b>15,216</b>	<b>38,317</b>	<b>28,106</b>
<b>Expenses (income)</b>				
Selling and marketing	6,884	5,569	12,396	11,102
General and administrative	2,413	1,924	4,331	3,366
Research and development	1,258	1,079	2,521	2,122
Interest income, net	(93)	(384)	(292)	(903)
<b>Earnings before under-noted items</b>	<b>8,410</b>	<b>7,028</b>	<b>19,361</b>	<b>12,419</b>
Amortization of pharmaceutical product licenses, rights and deferred charges	5,972	3,123	12,064	6,060
Unrealized gain on derivative financial instruments	—	(66)	(358)	(64)
Net gain on investments	(485)	—	(134)	—
Foreign exchange (gain) loss	(18)	31	4	3
Other income	(110)	(127)	(110)	(130)
<b>Income before income taxes</b>	<b>3,051</b>	<b>4,067</b>	<b>7,895</b>	<b>6,550</b>
<b>Provision for income taxes</b>				
Current	(2,228)	1,444	(2,034)	2,293
Future	3,508	35	5,106	192
	<b>1,280</b>	<b>1,479</b>	<b>3,072</b>	<b>2,485</b>
<b>Net income before extraordinary gain</b>	<b>1,771</b>	<b>2,588</b>	<b>4,823</b>	<b>4,065</b>
Extraordinary gain (net of \$nil taxes) <i>[note 4]</i>	25,959	—	25,959	—
<b>Net income for the period</b>	<b>27,730</b>	<b>2,588</b>	<b>30,782</b>	<b>4,065</b>
<b>Earnings per share before extraordinary gain</b>				
Basic	0.11	0.17	0.31	0.27
Diluted	0.11	0.17	0.30	0.27
<b>Earnings per share</b>				
Basic	1.77	0.17	1.96	0.27
Diluted	1.71	0.17	1.89	0.27
<b>Weighted average number of shares outstanding</b>				
Basic	15,706,245	14,829,218	15,320,105	14,829,889
Diluted	16,251,887	15,066,153	15,741,757	15,075,385

*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	
	2009	2008	2009	2008
<b>Operating activities</b>				
Net income	27,730	2,588	30,782	4,065
Add items not affecting cash				
Extraordinary gain [note 4]	(25,959)	—	(25,959)	—
Amortization	6,038	3,147	12,187	6,106
Future income taxes	3,508	35	5,106	192
Stock based compensation expense [note 3]	687	466	1,089	709
Unrealized gain on derivative instruments	—	(66)	(359)	(64)
Net gain on investments	(485)	—	(134)	—
Net accreted interest	24	(20)	(1)	(38)
	11,543	6,150	22,711	10,970
Net change in non-cash balances relating to operations	(263)	(2,108)	(3,165)	446
<b>Cash flows from operating activities</b>	<b>11,280</b>	<b>4,042</b>	<b>19,546</b>	<b>11,416</b>
<b>Investing activities</b>				
Additions to pharmaceutical product licenses and rights, and deferred charges	(5,475)	—	(5,476)	(8,867)
Investments in portfolio company	(130)	(1,000)	(130)	(1,000)
Acquisition of property, plant and equipment	(81)	(55)	(109)	(310)
Purchases of short-term marketable securities	(32,988)	(13,363)	(43,350)	(25,128)
Maturities of short-term marketable securities	2,333	11,649	11,298	26,171
Purchases of long-term marketable securities	(9,235)	—	(11,204)	—
Proceeds from the disposal of investments	4,244	—	6,979	—
Business acquisition [note 4]	(7,594)	—	(7,594)	—
<b>Cash flows used in investing activities</b>	<b>(48,926)</b>	<b>(2,769)</b>	<b>(49,586)</b>	<b>(9,134)</b>
<b>Financing activities</b>				
Net proceeds on issuance of common shares	56,561	304	56,749	774
Repurchase of shares	—	—	—	(1,806)
<b>Cash flows from (used in) financing activities</b>	<b>56,561</b>	<b>304</b>	<b>56,749</b>	<b>(1,032)</b>
<b>Net change in cash and cash equivalents during the period</b>	<b>18,915</b>	<b>1,577</b>	<b>26,709</b>	<b>1,250</b>
Cash and cash equivalents, beginning of period	12,439	5,747	4,645	6,074
<b>Cash and cash equivalents, end of period</b>	<b>31,354</b>	<b>7,324</b>	<b>31,354</b>	<b>7,324</b>
Cash and cash equivalents	31,354	7,324		
Short-term marketable securities	48,722	29,222		
Long-term marketable securities	11,203	—		
	91,279	36,546		

See accompanying notes

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME,  
ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS),  
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	
	2009	2008	2009	2008
<b>Net income for the period</b>	<b>27,730</b>	2,588	<b>30,782</b>	4,065
<b>Other comprehensive (loss) income:</b>				
Change in fair value of available-for-sale financial instruments [net of taxes of (\$nil) for the three-month period [2008 – (\$204)] and (\$29) for the six-month period [2008 – (\$313)]]	(2)	(969)	183	(1,435)
Reclassification adjustment for (losses) gains on available-for-sale financial instruments included in net income in the current period [net of taxes of \$3 for the three-month period [2008 – (\$6)] and (\$216) for the six-month period [2008 – (\$8)]]	(58)	(26)	1,341	(37)
<b>Other comprehensive (loss) income for the period</b>	<b>(60)</b>	(995)	<b>1,524</b>	(1,472)
<b>Comprehensive income for the period</b>	<b>27,670</b>	1,593	<b>32,306</b>	2,593
<b>Accumulated other comprehensive income (loss), beginning of period</b>	<b>164</b>	(801)	<b>(1,420)</b>	(324)
Other comprehensive (loss) income for the period	(60)	(995)	1,524	(1,472)
<b>Accumulated other comprehensive income (loss), end of period</b>	<b>104</b>	(1,796)	<b>104</b>	(1,796)
<b>Retained earnings, beginning of period</b>	<b>36,001</b>	20,913	<b>32,949</b>	20,508
Net income for the period	27,730	2,588	30,782	4,065
Excess of purchase price over stated capital of common shares cancelled	—	—	—	(1,072)
<b>Retained earnings, end of period</b>	<b>63,731</b>	23,501	<b>63,731</b>	23,501

*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, 2008.

Information with respect to the December 31, 2008 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 consolidated financial statements for the year ended December 31, 2008.

### Changes in accounting policies

Effective January 1, 2009, the Company has adopted the following recently introduced Canadian Institute of Chartered Accountants (“CICA”) Handbook Sections:

Section 3064 – Goodwill and Intangible Assets, reinforces the approach under which assets are recorded only if they meet the definition and the recognition criteria of an asset. It also clarifies the application of the concept of matching costs with revenues. These changes, including the related disclosure requirements, did not have a significant effect on the Company’s consolidated financial statements.

Section 1400 – General Standards of Financial Statement Presentation. This section includes requirements to assess and disclose the Company’s ability to continue as a going concern. These changes did not have a significant impact on the Company’s consolidated financial statements.

### 3. Capital Stock

#### Authorized

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

#### Issued and outstanding

	Number of shares	Amount
<b>Balance at beginning of year</b>	<b>14,921,446</b>	<b>\$60,664</b>
Issued upon exercise of stock options	117,084	1,292
Issued under employee share purchase plan	6,694	96
Issued upon common share offering <sup>4</sup>	3,450,000	56,632
<b>Balance at June 30, 2009</b>	<b>18,495,224</b>	<b>\$118,684</b>

#### Stock option plan

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

	2009		2008	
	#	Weighted average exercise price \$	#	Weighted average exercise price \$
<b>Balance at beginning of year</b>	<b>1,067,948</b>	<b>9.03</b>	1,002,844	7.73
Granted	<b>394,000</b>	<b>12.80</b>	313,435	10.86
Exercised	<b>(117,084)</b>	<b>7.18</b>	(130,209)	5.58
Expired or forfeited	<b>(17,175)</b>	<b>12.20</b>	(54,525)	9.84
<b>Balance at June 30</b>	<b>1,327,689</b>	<b>10.27</b>	1,131,545	8.74
<b>Options exercisable at June 30</b>	<b>381,593</b>	<b>7.60</b>	473,020	6.60

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	
	2009	2008	2009	2008
Option compensation expense	<b>\$687</b>	\$472	<b>\$1,089</b>	\$699
Weighted average fair value of options	<b>\$7.96</b>	\$5.75	<b>\$6.03</b>	\$5.77
Weighted average risk-free interest rate	<b>2.44%</b>	3.28%	<b>2.44%</b>	3.30%
Dividend yield	<b>Nil</b>	Nil	<b>Nil</b>	Nil
Weighted average volatility factor	<b>42%</b>	46%	<b>42%</b>	48%
Weighted average expected life	<b>7 years</b>	7 years	<b>7 years</b>	7 years

<sup>4</sup> During the quarter ended June 30, 2009, the Company issued 3,450,000 common shares including an amount of 450,000 comprising of the underwriters' over-allotment option in the form of a bought deal share offering of at a price of \$17.00 per common share for total gross proceeds to the Company in the amount of \$58,650. In conjunction with the offering, the Company incurred share issue costs of approximately \$2,018, net of taxes, and as per accounting standards recorded these as a reduction of capital stock.

Volatility is determined based on the seven year share price history.

#### **4. Business acquisition**

##### ***Isotechnika Inc. acquisition***

On June 18, 2009, the Company acquired all the issued and outstanding shares of Isotechnika Inc. ("Isotechnika")(TSX:ISA) in accordance with a court supervised Plan of Arrangement whereby the Company paid \$7,594 in cash, and Isotechnika entered into a collaborative research and development agreement with Isotechnika Pharma Inc. ("IsoPharma") in exchange for supporting research and development services for the commercialization of voclosporin, Isotechnika's next-generation calcineurin inhibitor, in Canada, Mexico, Central & South America, Israel and South Africa ("Paladin-acquired territories"). The research and development services extend for a period of seven years and include an amount of \$4,350 payable by the Company to IsoPharma over the next 12 months. Furthermore, the Research and Development Agreement in conjunction with the Company's Licence Agreement for voclosporin in the Paladin acquired territories, contains certain other voclosporin research, development and commercialization payment arrangements including possible licensing and royalty revenue payments over the remaining period.

As part of the acquisition, the Company received the international rights to a portfolio of products under development and a commercialized diagnostic product portfolio and has also assumed an obligation to pay out certain amounts of future contractually pre-defined amounts over a period of seven years currently estimated to amount to approximately \$5,950. While the Company believes based on historical sales of the product, current expenditure levels and market conditions that it will make payments estimated to total \$5,950 over the seven year period pursuant to its Research and Development Agreement, it is reasonably possible, based on existing knowledge, that changes in future conditions could require a material change in the recognized amount. Furthermore, as part of the purchase price, the Company received 24,921,312 common shares, representing a 19 percent interest in IsoPharma as at the date of acquisition, with an approximate value of \$4,348 using the weighted average trading price of the common shares on the TSX for the 20 trading days pre and post acquisition. In connection with the acquisition, the Company has incurred transaction costs in the amount of \$530 included in the purchase price below. Isotechnika Inc. is an international biopharmaceutical company dedicated to the discovery, development and commercialization of novel immunosuppressive therapeutics for the treatment of autoimmune diseases and for use in the prevention of organ rejection in transplantation. In addition to the Company's drug pipeline, Isotechnika also has commercialized diagnostic products.

The acquisition was accounted for using the purchase method. The results of Isotechnika's operations have been included in the Company's results since June 18, 2009, the effective date of acquisition. The total purchase price of \$14,147 was allocated to the fair value of the net assets acquired in the amount of \$47,204, representing negative goodwill in the amount of the excess of \$33,057. The Company, as per applicable accounting standards, eliminated the value previously assigned to certain prescribed assets in the amount of \$7,098 against the excess of the amounts assigned to assets acquired and undiscounted liabilities assumed over the cost of the purchase above. The remaining excess is presented as an extraordinary gain in the amount of \$25,959. The purchase price was preliminarily allocated as follows:

#### 4. Business acquisition (cont'd)

<b>Purchase price allocation</b>	<b>\$</b>
Cash	1,565
Current assets	627
Future income tax asset	39,440
Current liabilities	(1,526)
	<u>40,106</u>
<b>Consideration represented by:</b>	
Cash paid	7,594
Balance of sale payable	6,023
Acquisition costs	530
	<u>25,959</u>
<b>Extraordinary gain (net of \$nil taxes)</b>	<b>25,959</b>

The Company is in the process of finalizing the purchase price allocation and will be completed during 2009.

#### *Virexx Medical Corp. acquisition*

On December 23, 2008, the Company acquired all the issued and outstanding shares of Virexx Medical Corp. ("Virexx")(TSX:VIR) (AMEX:REX) in accordance with an Order for Reorganization led by Virexx's appointed Trustee, whereby the Company paid \$1,446 in cash. In addition, the Company has agreed to a contractual right of payment of an amount up to \$2,500 in the aggregate to former Virexx shareholders, if certain conditions are met, including the Company receiving at least \$4,000 in connection with certain Virexx assets, prior to December 31, 2009. The Company has not received funds with respect to this contractual right which would generate a contractual amount payable as at June 30, 2009. The Company has also incurred transaction costs in the amount of \$196, included in the cash payment above, in connection with the acquisition. Virexx is a Canadian-based biotech company focused on developing innovative-targeted therapeutic products and was subsequently wound up into the Company on December 23, 2008.

The acquisition was accounted for using the purchase method. The results of Virexx operations have been included in the Company's results since December 23, 2008, the date of acquisition. The Company, using information currently available has estimated the fair value of the contingent consideration described above to be \$nil. The total purchase price of \$1,446 was allocated to the fair value of the net assets acquired in the amount of \$7,951, representing negative goodwill in the amount of the excess of \$6,505. The Company, as per applicable accounting standards, eliminated the value previously assigned to certain prescribed assets in the amount of \$2,433 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 \$4,072. The purchase price was preliminarily allocated as follows:

#### 4. Business acquisition (cont'd)

<b>Purchase price allocation</b>	\$
Cash	27
Future income tax asset	6,056
Current liabilities	(565)
	<u>5,518</u>
<b>Consideration represented by:</b>	
Cash paid	<u>1,446</u>
<b>Extraordinary gain (net of \$nil taxes)</b>	<b><u>4,072</u></b>

The Company is in the process of finalizing the purchase price allocation and will be completed during 2009.

#### 5. Related party transactions

Joddes Limited [“Joddes”], a private Canadian corporation, is a significant shareholder holding approximately 38% 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 owns a 19% shareholder interest in Isotechnika Pharma Inc. [“IsoPharma”], as further described in note 4 and considers this investment a related party.

The Company engages a wholly-owned subsidiary of Joddes to provide logistics services including: customer service, warehousing, shipping, invoicing, collection services and certain manufacturing and selling 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 for a total remaining committed amount of \$791 as at June 30, 2009 and is included in the purchase and service based commitments in Note 6.

The Company has also entered into contractual royalty agreements with a wholly-owned subsidiary of Joddes for certain legacy and over-the-counter products. The terms of these arrangements vary whereby the Company may earn a royalty fee based on certain established terms relating to the net sales of the respective products such as through a percentage of net sales, certain guaranteed minimum annual payments, or as a percentage of a defined product contribution.

Effective November 1, 2006, the Company acquired the Canadian distribution rights to Metadol<sup>®</sup> 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<sup>®</sup> 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, 2009, the Company has not received or earned any reimbursement. The acquisition of the Canadian distribution rights to Metadol<sup>®</sup> was

not in the normal course of operations and was recorded at an agreed upon exchange amount in accordance with the requirements of accounting standard CICA 3840.

## 5. Related party transactions (cont'd)

All transactions with related parties, except for the Metadol<sup>®</sup> 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		Six-month period	
	ended June 30		ended June 30	
	2009	2008	2009	2008
	\$	\$	\$	\$
Revenues	992	1,044	1,881	1,777
Purchases	1,683	4,692	3,254	7,541
Sales and marketing expenses	1433	1,165	2,672	2,078
Research and development expenses	131	104	264	226
General and administrative expenses	164	110	285	201

## 6. 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 significant 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 10% to 20% of sales, or generally require payments for products at rates ranging from 20% to 40% of the net selling price and in certain cases require revenue sharing at various rates over and above a pre-established net sales threshold.

In addition, the Company may have to pay up to \$8,411 including US\$7,236 if it achieves specific sales volumes on specific products in the future, over a maximum of nine years.

### Milestone based commitments

The Company has also committed to fund certain research and development expenditures of third parties in the amount of \$7,919 including €1,207 over the next five 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 \$5,322, including US\$1,261 and GB£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 \$26,503, including €4,438, to retain exclusive distribution agreements for certain products. These commitments end in 2015 and annual commitments are as follows:

### 6. Commitments (cont'd)

	\$
2009	3,439
2010	13,045
2011	5,247
2012	1,289
2013	1,276
2014 – 2015	2,207

### 7. Financial Instruments

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.

The classification of financial instruments and their respective carrying values and fair values were as follows:

June 30, 2009	Available- for-sale	Loans and receivables	Other financial liabilities	Derivatives	Carrying value	Fair value
	\$	\$	\$	\$	\$	\$
<b>Financial assets</b>						
Cash and cash equivalents	31,354				31,354	31,354
Marketable securities	48,722				48,722	48,722
Accounts receivable		17,696			17,696	17,696
Other current assets		2,836			2,836	2,836
Long-term marketable securities	11,203				11,203	11,203
Investments	3	417			420 <sup>5</sup>	5,903 <sup>6</sup>
<b>Total financial assets</b>	<b>91,282</b>	<b>20,949</b>	—	—	<b>112,231</b>	<b>117,713</b>

<sup>5</sup> In accordance with Section 3855, certain Company investments in private companies 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.

<sup>6</sup> Includes the fair value of the 24,921,312 common shares in IsoPharma with a carrying value of \$nil in accordance with accounting standards. Please refer to note 4 for further details.

## 7. Financial Instruments (cont'd)

June 30, 2009	Available- for-sale	Loans and receivables	Other financial liabilities	Derivatives	Carrying value	Fair value
<b>Financial liabilities</b>						
Accounts payable and accrued liabilities			21,835		21,835	21,835
Accounts payable to related parties			1,439		1,439	1,439
Balance of sale payable			11,050		11,050	11,050
Long-term balance of sale payable			5,525		5,525	5,018
<b>Total financial liabilities</b>	—	—	<b>39,849</b>	—	<b>39,849</b>	<b>39,342</b>

December 31, 2008	Available- for-sale	Loans and receivables	Other financial liabilities	Derivatives	Carrying value	Fair value
	\$	\$	\$	\$	\$	\$
<b>Financial assets</b>						
Cash	4,646				4,646	4,646
Marketable securities	14,753				14,753	14,753
Accounts receivable		17,889			17,889	17,889
Other current assets		158			158	158
Long-term marketable securities	1,943				1,943	1,943
Investments	3,131	1,067		594	4,792 <sup>5</sup>	5,144
<b>Total financial assets</b>	<b>24,473</b>	<b>19,114</b>	—	<b>594</b>	<b>44,181</b>	<b>44,533</b>
<b>Financial liabilities</b>						
Accounts payable and accrued liabilities			16,464		16,464	16,464
Accounts payable to related parties			1,384		1,384	1,384
Balance of sale payable			10,429		10,429	10,429
<b>Total financial liabilities</b>	—	—	<b>28,277</b>	—	<b>28,277</b>	<b>28,277</b>

### 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. Fair values for marketable securities and investments classified "Available for sale" are obtained using quoted active market prices as such securities. In accordance with CICA 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 recoverable amount.

The carrying values of all financial instruments approximate their fair values, except for the 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 that were obtained using the Black-Scholes option pricing valuation model and the long-term balance of sale payable. The allocated loan portion described above classified as "Loans and receivables" is being discounted using an 11% discount rate using the effective interest rate method and the long-term balance of sale payable classified as "Other financial liabilities" is being discounted using a 2.5% discount rate, such approximating market value.

## 7. 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.

### Concentration of credit risk and major customers

The Company's cash and cash equivalents, short-term and long-term investments are held through various institutions. 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 four months to twenty-one months from the date of purchase. Marketable securities are substantially 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, 2009, two customers, a major wholesale distributor and a major retail chain, represented 30% and 15% of revenues, respectively [2008 – 29% and 17%]. For the six-month period ended June 30, 2009, two customers, a major wholesale distributor and a major retail chain, represented 29% and 15% of revenues, respectively [2008 – 29% and 17%]. As at June 30, 2009, two customers, a major wholesale distributor and a major retail chain, represented 42% and 12% of trade accounts receivable, respectively [2008 – 47% and 15%].

The following table provides further details on the Company's accounts receivable balances:

	June 30, 2009	December 31, 2008
	\$	\$
Accounts receivable	21,906	21,869
Allowance for product returns	(4,040)	(3,783)
Allowance for doubtful accounts	(170)	(197)
<b>Total accounts receivable</b>	<b>17,696</b>	<b>17,889</b>

The following table provides the change in the allowance for doubtful accounts and product returns for trade accounts receivable:

	\$
<b>Balance at December 31, 2008</b>	<b>3,980</b>
Change in provision for doubtful accounts	(27)
Change in provision for product returns	257
<b>Balance at June 30, 2009</b>	<b>4,210</b>

## 7. Financial Instruments (cont'd)

The following table provides further details on trade accounts receivable past due but not provisioned:

	June 30, 2009	December 31, 2008
	\$	\$
Trade accounts receivable not passed due	15,437	15,132
Trade accounts receivable passed due and not provisioned		
Under 30 days	6,066	4,573
31 to 60 days	233	1,967
Allowance for product returns	(4,040)	(3,783)
Total accounts receivable, net of allowance for doubtful accounts and product returns	17,696	17,889

### Liquidity risk

The Company generates sufficient cash from operating activities to fund its operations and fulfill its obligations as they become due. The Company has sufficient funds available through its cash, cash equivalents and marketable securities, should its cash requirements exceed cash generated from operations to cover all financial liability obligations. As at June 30, 2009, 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 6 and 10.

All financial liabilities are short term in nature, except for the long-term Balance of Sale Payable further described in note 4.

### Foreign exchange risk

The Company principally operates within Canada, however, a portion of the Company's revenues, expenses, and current assets and liabilities, are denominated in United States (US) dollars and EURO. This results in financial risk due to fluctuations in the value of the US dollar and EURO relative to the Canadian dollar. The Company currently 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 significant balances in foreign currencies as at June 30, 2009 are as follows:

	U.S. dollars	EURO	GBP
	\$	€	£
Cash	1,404	14	—
Accounts receivable	247	1,077	—
Accounts payable and accrued liabilities	(507)	(348)	(20)
<b>Net Exposure</b>	<b>1,144</b>	<b>743</b>	<b>(20)</b>

Based on the aforementioned net exposure as at June 30, 2009, and assuming that all other variables remain constant, a ten-point increase or decrease in the CAD/USD and CAD/EURO exchange rates would have an effect of \$250 on net earnings.

## **7. Financial Instruments (cont'd)**

### **Interest rate risk**

The Company is subject to interest rate risk on its cash 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.

## **8. 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.

## **9. Comparative figures**

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

## **10. Contingencies**

On July 25, 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"). In addition, on August 11, 2008, the Company received a notice of assessment from CRA for the taxation year ending July 31, 2007. The notices of assessment and re-assessment, if they stood, amount to additional Canadian federal tax due of approximately \$5,558 plus interest and penalties of approximately \$1,733. On October 30, 2008, the Company received a Notice of Reassessment from the Ontario Minister of Finance for the taxation year ended August 16, 2005 for additional taxes, due of \$747 plus interest and penalties of \$378. It is likely that the Quebec provincial tax authorities will propose similar adjustments as a result of the CRA re-assessments. 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 \$11,057 including interest and penalties. The Company disagrees with the position taken by the CRA and believes it is without merit. On October 23, 2008, the Company

## **10. Contingencies (cont'd)**

filed a Notice of Objection through the CRA appeals process and intends to pursue further through the courts, if necessary. The Ontario Minister of Finance has agreed to be bound by the decision of the CRA appeals process.

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. In the event of an unfavorable ruling, the Company intends to claim at least \$7,142 from Nuvo under the SPA.

Nuvo has issued a Letter Agreement providing security over the indemnity obligations by entitling the Company to the benefit of security over certain assets and product revenue streams of Nuvo and certain of its subsidiaries.

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 re-assessment, the Company is required to post a deposit of up to one half of the tax and interest assessed. To that effect the Company deposited \$3,755 to the CRA and \$500 to the Ontario Minister of Finance during the year ended December 31, 2008, and may make a claim from Nuvo under the SPA.

If the Company is successful in its appeal of the re-assessment 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 and the relevant provincial authorities 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 year in which an adjustment is recorded or the tax is due or paid.

**Stock Exchange**  
Toronto Stock Exchange: PLB

**Transfer Agent**  
Computershare Investor Services Inc.  
1500 University Street  
Suite 700  
Montreal, Quebec  
H3A 3S8

**Investor Relations**  
Samira Sakhia  
Chief Financial Officer  
Tel.: (514) 669-5367  
Fax: (514) 344-4675  
E-mail: [info@paladin-labs.com](mailto:info@paladin-labs.com)



[www.paladinlabs.com](http://www.paladinlabs.com)