

**PALADIN LABS INC.**  
**CONSOLIDATED FINANCIAL STATEMENTS**

**September 30, 2008**



# Management Discussion and Analysis:

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

This management's discussion and analysis provides our overview of the Company's operations, performance and financial condition for the quarter ended September 30, 2008 and compares these unaudited quarterly results to those of the quarter ended September 30, 2007. It is intended to complement and supplement financial information included in the interim and annual consolidated financial statements, related notes, other financial information found elsewhere in our annual report and in our annual information form or other documents filed on SEDAR at [www.sedar.com](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 November 1, 2008 and 14,840,543 shares and 1,131,514 options were issued and outstanding as at this date. Reference to "Paladin" or the "Company" includes Paladin Labs Inc. and all its subsidiaries.

## Forward-Looking Statements

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

## Overview

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

### Third quarter highlights:

- Revenues reached \$22,191, an increase of 31% over the same period last year
- Net income was \$3,617, an increase of 337% over the same period last year
- EBITDA<sup>1</sup> reached \$9,189, a 81% increase over the same period last year
- Modified the existing licensing arrangements with Nuvo Research Inc. for Pennsaid<sup>®</sup> and its follow-on product, Pennsaid<sup>®</sup> Plus
- Acquired the Canadian, Australian and New Zealandian rights to Unisom<sup>™</sup> and the Canadian rights to Kaopectate<sup>®</sup> from Johnson & Johnson Inc. (NYSE: JNJ)
- Acquired the worldwide rights to Antizol<sup>®</sup> and Antizol-Vet<sup>®</sup> from Jazz Pharmaceuticals, Inc. (NASDAQ: JAZZ)

Paladin's annual and quarterly operating results are primarily affected by the level of acceptance of Paladin's products by physicians and their patients, and the timing and number of product launches. The level of patient and physician acceptance of Paladin's products, the acceptance of provincial government reimbursement on such products, market access, as well as the availability of similar therapies, impact Paladin's revenues by driving the level and timing of prescriptions for its products. Each new product launch requires significant promotional investment during the first three to five years from launch.

### <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 and income taxes. For a more detailed discussion of the Company's critical accounting estimates, please refer to the management's discussion & analysis included in the Company's 2007 Annual Report. There have been no material changes to accounting estimates since December 31, 2007.

### **Results of Operations**

Three-month period ended September 30, 2008 compared to three-month period ended September 30, 2007, and nine-month period ended September 30, 2008 compared to nine-month period ended September 30, 2007.

#### **Revenues**

Revenues increased \$5,256 or 31% to \$22,191 for the three-month period ended September 30, 2008 from \$16,935 for the three-month period ended September 30, 2007. For the nine-month period ended September 30, 2008, revenues increased \$14,429 or 32% to \$59,693 from \$45,264 for the nine-month period ended September 30, 2007. Revenue from products acquired during 2008 contributed \$2,272 to the quarter ended September 30, 2008 and \$3,312 for the nine-month period ended September 30, 2008.

The increase in revenues for the three and nine-month periods ended September 30, 2008 is primarily attributable to the sales growth of certain significant promoted products, including Tridural<sup>™</sup>, Twinject<sup>®</sup>, Seasonale<sup>™</sup>, Plan B<sup>®</sup>, Pennsaid<sup>®</sup>, Metadol<sup>®</sup>, Trelstar<sup>®</sup>, and Testim<sup>®</sup> which combined increased by 34% and 36% for the three and nine-month periods ended September 30, 2008, respectively, compared to 36% and 51% for the same periods last year.

Product revenue highlights for the Company's most significant promoted products using IMS Canada data<sup>2</sup> for the three-month and nine-month period ended September 30, 2008 are as follows:

Promoted Products	Three-month periods ended September 30		Nine-month periods ended September 30	
	Revenue per IMS Canada in 2008	% change vs. 2007	Revenue per IMS Canada in 2008	% change vs. 2007
	\$		\$	
Plan B <sup>®</sup>	2,107	30%	5,720	29%
Twinject <sup>®</sup>	1,872	(8%)	4,967	7%
Pennsaid <sup>®</sup>	2,885	6%	8,349	6%
Metadol <sup>®</sup>	1,760	29%	4,873	30%
Trelstar <sup>®</sup>	409	59%	1,049	122%
Seasonale <sup>™</sup>	491	N/A	776	N/A
Testim <sup>®</sup>	371	N/A	1,009	N/A
Tridural <sup>™</sup>	1,306	N/A	2,727	N/A
<b>Total</b>	<b>11,201</b>	<b>40%</b>	<b>29,470</b>	<b>39%</b>

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

#### Gross Profit

Total gross profit increased \$4,044 or 32% to \$16,749 for the three-month period ended September 30, 2008 from \$12,705 for the three-month period ended September 30, 2007. For the nine-month period ended September 30, 2008, gross profit increased \$10,026 or 29% to \$44,854 from \$34,828 for the same period last year. Gross profit, as a percentage of revenues, remained consistent at 75% for the quarter ended September 30, 2008 compared to the same quarter ended last year. For the nine-month period ended September 30, 2008, gross profit as a percentage of revenues decreased to 75% from 77% for the same period ended last year. This decrease in gross profit as a percentage of revenues is mainly a result of the impact of lower margins from the BioEnvelop<sup>™</sup> edible film business and reduced margins on certain newly launched products. It is expected that gross profit, as a percentage of revenues, will approximate 75% to 77% for the year ending December 31, 2008.

#### Selling and Marketing Expense

Selling and marketing expense increased \$45 or 1% to \$5,443 for the three-month period ended September 30, 2008 from \$5,398 for the three-month period ended September 30, 2007. For the nine-month period ended September 30, 2008, selling and marketing increased \$1,820 or 12% to \$16,545 from \$14,725 for the nine-month period ended September 30, 2007.

Selling and marketing expense, as percentage of revenues, decreased to 25% for the three-month period ended September 30, 2008 from 32% for the same period last year. For the nine-month period ended September 30, 2008, selling and marketing expense, as a percentage of revenues, decreased to 28% from 33% for the same period last year. The decrease in selling and marketing expenses as a percentage of revenues is primarily the result of the timing of certain promotional efforts by the Company. During the quarter ended September 30, 2007, the Company was initiating marketing launch activities for Tridural<sup>™</sup> and Seasonale<sup>™</sup> requiring significant marketing expense outlays. Furthermore, in connection with the co-promotional agreements for Tridural<sup>™</sup> and Seasonale<sup>™</sup>, the Company during the three and nine-month periods ended September 30, 2008 received certain on-going reimbursements for marketing expenditures. In addition during the second quarter, the Company received a \$1,000 reimbursement for certain marketing related expenses related to the launch of Seasonale<sup>™</sup> in connection with the Canadian co-promotion

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

agreement for Seasonale™ with Procter & Gamble Pharmaceuticals Canada Inc. This amount was credited to selling and marketing expenses for the quarter ended June 30, 2008. The promotional activities driving selling and marketing costs primarily relate to Paladin's launch of Tridural™, Seasonale™, Testim® and Trelstar® as well as the continued promotional activities for Twinject®, Plan B®, Pennsaid® and Metadol®. It is expected that selling and marketing expense, as a percentage of revenues, will approximate 30% to 40% for the year ending December 31, 2008.

#### **General and Administrative Expense**

General and administrative expense increased \$336 or 25% to \$1,695 for the three-month period ended September 30, 2008 from \$1,359 for the three-month period ended September 30, 2007. For the nine-month period ended September 30, 2008, general and administrative expense increased \$1,249 or 33% to \$5,064 from \$3,815 for the nine-month period ended September 30, 2007. General and administrative expense, as a percentage of revenues, remained consistent at 8% for the quarters ended September 30, 2008 and 2007. Similarly, general and administrative expense, as a percentage of revenues, remained consistent at 8% for the nine-month period ended September 30, 2008 compared to the same period last year. General and administrative expense, as a percentage of revenues, is expected to approximate 8% to 10% for the year ending December 31, 2008.

#### **Research and Development Expense**

Research and development expense decreased \$405 or 33% to \$828 for the three-month period ended September 30, 2008 from \$1,233 for the three-month period ended September 30, 2007. For the nine-month period ended September 30, 2008, research and development expense increased \$551 or 23% to \$2,949 from \$2,398 for the nine-month period ended September 30, 2007. Research and development expense as a percentage of revenues, decreased to 4% for the quarter ended September 30, 2008 compared to 7% for the same period last year. Research and development expense as a percentage of revenues remained consistent at 5% for the nine-month period ended September 30, 2008 compared to the same period last year. During the three and nine-month periods ended September 30, 2008 and 2007, Paladin's research and development efforts have been to manage development projects with licensors and to prepare new drug submissions to strengthen the Company's pipeline as well as to search and explore potential product opportunities for internal development. It is expected that research and development expense, as a percentage of revenues, will approximate 5% to 7% for the year ending December 31, 2008 primarily as a result of BioEnvelop™'s advancement in its research and development activities and certain costs associated to manufacturing site changes for recently acquired products.

#### **Net Interest Income**

Net interest income increased \$47 or 13% to \$406 for the three-month period ended September 30, 2008 from \$359 for the three-month period ended September 30, 2007. For the nine-month period ended September 30, 2008, net interest income increased \$212 or 19% to \$1,310 from \$1,098 for the nine-month period ended September 30, 2007. This increase is primarily the result of certain accreted interest income on the allocated loan portion of a secured convertible term note investment in a portfolio company, in the amount of \$96 for the three-month period ended September 30, 2008 [2007 - \$21], and \$146 [2007 - \$57] for the nine-month period ended September 30, 2008.

#### **Amortization of Intangible Assets and Deferred Charges**

Amortization expense decreased \$266 or 8% to \$3,171 for the three-month period ended September 30, 2008 from \$3,437 for the three-month period ended September 30, 2007. For the nine-month period ended September 30, 2008, amortization expense decreased \$99 or 1% to \$9,230 from \$9,329 for the same period last year. This decrease in amortization expense relates to the full amortization of certain legacy pharmaceutical product licenses and rights, and deferred charges.

#### **Unrealized (Gain) Loss on Derivative Instruments**

In accordance with Section 3855, the Company used the Black-Scholes option pricing model to re-measure the fair value of a conversion option on a secured convertible term note investment in a portfolio company recording an unrealized loss on the conversion option in the amount of \$51 for the quarter [2007 - \$41] and an unrealized loss on warrants in a portfolio company in the amount of \$8. For the nine-month period ended September 30, 2008, the Company recorded an unrealized loss on the conversion option in the amount of \$42 [2007 - \$351] and an unrealized gain on warrants in a portfolio company in the amount of \$46. During the three and nine-month periods ended September 30, 2007, the Company recorded an

unrealized loss on the conversion of a secured convertible term note investment in a portfolio company in the amount of \$41 and \$351, respectively and recorded an unrealized gain on a contingent stick right in the amount of \$10 and \$76, respectively.

#### **Loss (Gain) on Investment**

During the three and nine-month periods ended September 30, 2008, the Company redeemed a secured convertible term note in a portfolio company with a carrying value of \$291 for proceeds equal to the face value of \$500 resulting in a gain on disposal of \$209. During these same periods, the Company as part of its on-going assessment of investment carrying values determined the investment in Verus Pharmaceuticals Inc. to be permanently impaired and recorded a write-down in the amount of \$393. During the nine-month period ended September 30, 2007, the Company exercised its right to convert \$158 of a secured convertible term note in one of the Company's portfolio investments into common shares and subsequently sold such shares in the public market for \$232, representing a gain of \$74.

#### **Other Income**

Other income was \$200 and \$330 for the three and nine-month periods ended September 30, 2008, respectively, compared to \$nil for the same periods last year. During the quarter, the Company out-licensed a product for \$200 and recorded a \$200 gain in other income on the transaction. During the nine-month period ended September 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. During this same period, the Company also 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.

#### **Income Tax Expense**

Income tax expense increased \$1,580 or 203% to \$2,358 for the three-month period ended September 30, 2008 from \$778 for the three-month period ended September 30, 2007. For the nine-month period ended September 30, 2008, income tax expense increased \$2,514 or 108% to \$4,843 from \$2,329 for the nine-month period ended September 30, 2007. For the three and nine-month periods ended September 30, 2008, the effective tax rate was steady at 39%, respectively, compared to 48% and 43% for the three and nine-month period ended September 30, 2007. 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	12,971	12,176	2024-2027
Provincial	6,172	5,068	2024-2027
<b>Scientific Research and Experimental Development expenditures</b>			
Federal	11,831	3,555	N/A
Provincial	3,318	-	N/A
<b>Investment tax credits</b>			
Federal	670	519	2010-2027

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

Net income before extraordinary gain increased \$2,789 to \$3,617 for the three-month period ended September 30, 2008 compared to net income of \$828 for the same three-month period ended last year. For the nine-month period ended September 30, 2008, net income before extraordinary gain increased \$4,553 to \$7,682 from \$3,129 for the nine-month period ended September 30, 2007.

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

On April 30, 2007, the Company acquired all of the issued and outstanding shares of BioEnvelop Inc. ("BioEnvelop"), a subsidiary of BioEnvelop Technologies Inc. (TSX-V: BIE), for a total consideration of \$1,993 consisting of the assumption of a note payable in BioEnvelop which was immediately repaid. The total purchase price of \$1,993 was allocated to the fair value of the net assets acquired in the amount of \$7,077, representing negative goodwill in the amount of the excess of \$5,084. The Company, as per

applicable accounting standards, eliminated the value previously assigned to certain prescribed assets in the amount of \$210 against the excess of the amounts assigned to assets acquired and liabilities assumed over the cost of the purchase above. The remaining excess is presented as an extraordinary gain in the amount of \$4,874 (see note 5).

### **Net Income**

Net income increased \$2,789 to \$3,617 for the three-month period ended September 30, 2008 compared to net income of \$828 for the three-month period ended September 30, 2007. Due to the factors set forth in the paragraphs above, net income decreased \$321 to \$7,682 for the nine-month period ended September 30, 2008 compared to net income of \$8,003 for the nine-month period ended September 30, 2007.

### **Liquidity and Capital Resources**

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

Paladin's cash, cash equivalents and marketable securities decreased \$9,039 to \$27,177 at September 30, 2008 from \$36,216 at December 31, 2007. This decrease is primarily the result of the Company's acquisition of pharmaceutical product licenses, rights, and deferred charges in the amount of \$19,335, an investment in a portfolio company in the amount of \$3,000 and the repurchase of shares under the terms of the normal course issuer bid in the amount of \$2,270, offset by cash flows generated from operating activities in the amount of \$14,718, cash generated by maturing marketable securities in the amount of \$4,799 and cash generated through the issuance of common shares in the amount of \$955. The Company's Investment Policy regulates the investment activities relating to cash resources. An Investment Committee composed of representatives from management and the Board of Directors monitors compliance with said policy. The Company invests strictly in liquid, high-grade investment securities with varying terms to maturity, selected with regard to the expected timing of investments and expenditures for continuing operations and prevailing interest rates. Working capital (current assets less current liabilities) decreased \$3,604 to \$38,361 at September 30, 2008 from \$41,965 at December 31, 2007 primarily due to an increase in the Company's accounts receivable and income tax receivable balances.

Cash flows from operating activities decreased 41% or \$2,334 to \$3,300 for the three-month period ended September 30, 2008 from \$5,634 for the three-month period ended September 30, 2007. Cash flows from operating activities for the nine-month period ended September 30, 2008 increased \$958 or 7% to \$14,718 compared to \$13,760 for the nine-month period ended September 30, 2007. Cash flows from operating activities represent the cash flows from net earnings, excluding revenues and expenses not affecting cash, principally amortization, future income taxes, stock based compensation expense, gains (losses) on investments and stock dividend income.

Cash flows used in investing activities were \$8,629 compared to cash flows from investing activities in the amount of \$3,087 for the three-month period ended September 30, 2008 and 2007, respectively. During the three-month period ended September 30, 2008, the Company invested \$10,468 towards the acquisition of pharmaceutical product licenses and rights, and deferred charges, a net amount of \$1,500 in a portfolio company, \$531 towards a payment on a balance of sale payable and \$86 towards the acquisition of property, plant and equipment, partially offset by proceeds from maturing marketable securities in the amount of \$3,756 and proceeds from licensing activities in the amount of \$200. During the three-month period ended September 30, 2007, the Company invested \$801 towards an investment in a portfolio company, \$1,533 towards the acquisition of pharmaceutical product licenses and rights, and deferred charges, \$51 for the acquisition of property, plant and equipment, offset by proceeds from maturing marketable securities in the amount of \$5,472.

Cash flows used in investing activities were \$17,764 compared to \$4,462 for the nine-month period ended September 30, 2008 and 2007, respectively. During the nine-month period ended September 30, 2008, the Company invested \$19,335 towards the acquisition of pharmaceutical product licenses and rights, and deferred charges, a net amount of \$2,500 in a portfolio company, \$531 towards a payment on a balance of

sale payable, and \$397 towards the acquisition of property, plant and equipment, partially offset by proceeds from maturing marketable securities in the amount of \$4,799 and proceeds from licensing activities in the amount of \$200. During the nine-month period ended September 30, 2007, the Company invested \$13,291 towards the acquisition of pharmaceutical product licenses, rights and deferred charges, \$801 towards an investment in a portfolio company, \$650 towards the acquisition of BioEnvelop Inc. further described in note 5, and \$122 towards the acquisition of property plant and equipment, partially offset by cash generated by maturing marketable securities in the amount of \$10,170 and proceeds from the disposal of an investment in a portfolio company in the amount of \$232.

Cash flows used in financing activities were \$282 compared to \$3,185 for the three-month period ended September 30, 2008 and 2007, respectively. During the three-month period ended September 30, 2008, \$463 was used by the Company to repurchase 44,000 of its own common shares under the terms of the normal course issuer bid, offset by \$181 received from common stock option exercises and the issuance of common shares under the stock purchase plan for cash. During the three-month period ended September 30, 2007, \$3,242 was used by the Company to repurchase 304,600 of its own common shares under the terms of the normal course issuer bid, offset by \$57 received from common stock option exercises and the issuance of common shares under the stock purchase plan for cash.

Cash flows used in financing activities were \$1,315 compared to cash flows from financing activities in the amount of \$2,678 for the nine-month period ended September 30, 2008 and 2007, respectively. During the nine-month period ended September 30, 2008, the Company repurchased 226,725 of its own common shares under the terms of the normal course issuer bid for an amount of \$2,270 offset by cash generated from stock option exercises and the issuance of common shares under the stock purchase plan in the amount of \$955. During the nine-month period ended September 30, 2007, \$3,615 was used by the Company to repurchase 342,400 of its own common shares under the terms of the normal course issuer bid, offset by \$937 received from common stock option exercises and the issuance of common shares under the stock purchase plan for cash.

### **Related Party Transactions**

Joddes Limited ["Joddes"], a private Canadian corporation, is a significant shareholder holding approximately 43% of the outstanding shares of the Company, and one director of the Company, the Company's President and CEO, is related to Joddes.

The Company engages a wholly-owned subsidiary of Joddes to provide logistics services including: customer service, warehousing, shipping, invoicing, collection services and certain manufacturing services on behalf of the Company. The Company also engages this affiliate to perform certain research and development and information technology services on a contractual pay-for-use basis. The Company also leases its office facilities from another wholly owned subsidiary of Joddes. This lease is for a period of 10 years, ending in 2013 and includes minimum annual payments of \$136 for a total remaining committed amount of \$811 as at September 30, 2008 and is included in the purchase and service based commitments in note 7.

The Company has entered into several license and distribution arrangements with a wholly-owned subsidiary of Joddes to sell and distribute certain over-the-counter products whereby the Company earns royalty revenue based upon the net sales or a defined net contribution of the product.

During 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 September 30, 2008, the Company has not earned or received any reimbursement.

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		Nine-month period	
	ended September 30		ended September 30	
	2008	2007	2008	2007
	\$	\$	\$	\$
Revenues	882	300	2,659	593
Purchases	3,634	5,253	11,175	11,209
Research and development expenses	109	89	335	230
Sales and marketing expenses	1,328	971	3,407	2,559
General and administrative expenses	94	88	296	238

### 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, would amount to additional Canadian federal tax due of approximately \$5,558 plus interest and penalties of approximately \$1,733. It is likely that the Quebec and Ontario provincial tax authorities will propose similar adjustments as a result of the CRA reassessments. As such the Company estimates the total tax liability exposure to the federal and relevant provincial governments as a result of the CRA’s position to be approximately \$11,051 including interest and penalties. The Company disagrees with the position taken by the CRA and believes it is without merit. Subsequent to the quarter, the Company filed a Notice of Objection through the CRA appeals process and intends to pursue further through the courts if necessary.

Under the terms of the Share Purchase Agreement (“SPA”) for Squire, Nuvo provided representations and warranties with respect to the status of the Squire tax accounts and certain tax asset values whereby, if the amounts represented are incorrect then Nuvo is required to indemnify the Company. The Company also holds indemnities from Nuvo relating to all costs relating to reassessment including advisory fees, interest and penalties, as applicable. In the event of an unfavorable ruling, the Company intends to claim at least \$7,175 from Nuvo under the SPA.

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

In connection with the appeals process, in the notice of reassessment, the Company is required to post a deposit of up to one half of the tax and interest assessed. To that effect the Company deposited \$3,640 to the CRA and may make a claim from Nuvo under the SPA. If the Company is successful in its appeal of the reassessment these amounts will be refunded to the Company with accrued interest.

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

### 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 and note 8 in the quarterly financial statements of the Company.

## Off-Balance Sheet Arrangements and Guarantees

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

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

## Contractual Obligations and Commitments

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

	Contractual Obligations		Commitments	
	Purchase and service based commitments	Milestone based commitments	Revenue based commitments	
	\$	\$	\$	\$
<b>October 1, 2008 – December 31, 2008</b>	4,564	273	-	
<b>Fiscal 2009 – fiscal 2011</b>	29,990	1,918	1,416	
<b>Fiscal 2012 – fiscal 2013</b>	1,837	1,454	161	
<b>After fiscal 2014</b>	757	530	13,992	
<b>Total</b>	<b>37,148</b>	<b>4,175</b>	<b>15,569</b>	

## Quarterly Information (unaudited)

(In thousands of Canadian dollars except per share information)

	Q3 F2008	Q2 F2008	Q1 F2008	Q4 F2007	Q3 F2007	Q2 F2007	Q1 F2007	Q4 F2006
Revenues	22,191	20,668	16,834	17,697	16,915	15,436	12,893	14,282
EBITDA <sup>1</sup>	9,189	6,997	5,419	4,925	5,074	5,094	4,820	4,271
Earnings before income taxes	5,975	4,067	2,483	2,500	1,606	1,786	2,066	2,365
Net Income before extraordinary gain	3,617	2,588	1,477	1,030	828	1,037	1,264	1,534
Net Income	3,617	2,588	1,477	1,030	828	5,911	1,264	1,534
Earnings per share before extraordinary gain	\$0.24	\$0.17	\$0.10	\$0.07	\$0.06	\$0.07	\$0.08	\$0.10
Earnings per share	\$0.24	\$0.17	\$0.10	\$0.07	\$0.06	\$0.39	\$0.08	\$0.10
Diluted earnings per share before extraordinary gain	\$0.24	\$0.17	\$0.10	\$0.07	\$0.05	\$0.07	\$0.08	\$0.10
Diluted earnings per share	\$0.24	\$0.17	\$0.10	\$0.07	\$0.05	\$0.38	\$0.08	\$0.10

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.

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

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

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

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

Section 3031, "Inventories", provides guidance on the determination of cost and its subsequent recognition as an expense, including any write-down to net realizable value. It also provides guidance on the cost formulas that are used to assign costs to inventories. These changes, including the related disclosure requirements, did not have a significant effect on the Company's interim consolidated financial statements.

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

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

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

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

## **Controls and procedures**

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

Internal control over financial reporting ("ICFR") is designed to provide reasonable assurance regarding the reliability of the Company's financial reporting and its compliance with Canadian generally accepted accounting principles in its financial statements. The President and Chief Executive Officer and the Chief Financial Officer of the Company have evaluated whether there were changes to its ICFR during the nine-month period ended September 30, 2008 that have materially affected, or are reasonably likely to materially affect, the ICFR. No such significant changes were identified through their evaluation.

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

The consolidated financial statements of Paladin Labs Inc. (the “**Company**”) and the accompanying interim consolidated balance sheet as at September 30, 2008 and the interim consolidated statements of income, cash flows, comprehensive income, accumulated other comprehensive (loss) income and retained earnings for the three-month period ended September 30, 2008 are the responsibility of the Company’s management. These consolidated financial statements have not been audited or reviewed on behalf of the shareholders by the independent external auditors, Ernst & Young LLP.

The interim consolidated financial statements have been prepared by management and include the selection of appropriate accounting principles, judgments and estimates necessary to prepare these financial statements in accordance with Canadian generally accepted accounting principles. Readers are cautioned that these interim consolidated financial 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  
November 5, 2008

*(signed) Samira Sakhia*  
\_\_\_\_\_  
Samira Sakhia C.A., M.B.A.  
Chief Financial Officer  
Montreal, Canada  
November 5, 2008

## CONSOLIDATED BALANCE SHEETS

[In thousands of Canadian dollars]

	September 30 2008 \$	December 31 2007 \$
	(unaudited)	
<b>ASSETS</b>		
<b>Current</b>		
Cash and cash equivalents	1,713	6,074
Marketable securities	23,569	26,041
Accounts receivable	18,172	11,920
Inventory	8,175	6,781
Other current assets	1,702	2,943
Income taxes receivable	3,656	—
Future income tax asset	1,874	2,992
Investment tax credits receivable	—	244
<b>Total current assets</b>	<b>58,861</b>	<b>56,995</b>
Long-term marketable securities	1,895	4,101
Investment tax credits recoverable	562	773
Capital assets	561	300
Pharmaceutical product licences and rights	34,734	24,366
Deferred charges	1,036	1,455
Investments	5,382	4,041
Future income tax assets	6,691	6,874
<b>Total assets</b>	<b>109,722</b>	<b>98,905</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Current</b>		
Accounts payable and accrued liabilities	13,781	11,582
Accounts payable to related parties	1,007	1,032
Income taxes payable	5,712	2,056
Deferred revenue	—	271
Balance of sale payable <i>[note 5]</i>	—	89
<b>Total current liabilities</b>	<b>20,500</b>	<b>15,030</b>
<b>Long-term</b>		
Future income tax liability	731	1,357
Balance of sale payable	—	518
<b>Total liabilities</b>	<b>21,231</b>	<b>16,905</b>
<b>Shareholders' equity</b>		
Capital stock <i>[note 3]</i>	60,074	59,797
Other paid-in capital	2,836	2,019
Accumulated other comprehensive loss	(1,252)	(324)
Retained earnings	26,833	20,508
<b>Total shareholders' equity</b>	<b>88,491</b>	<b>82,000</b>
<b>Total liabilities and shareholders' equity</b>	<b>109,722</b>	<b>98,905</b>

See accompanying notes

## CONSOLIDATED STATEMENTS OF INCOME

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

[unaudited]

	Three-month period ended September 30		Nine-month period ended September 30	
	2008	2007	2008	2007
	\$	\$	\$	\$
Revenues	22,191	16,935	59,693	45,264
Cost of sales	5,442	4,230	14,839	10,436
<b>Gross profit</b>	<b>16,749</b>	<b>12,705</b>	<b>44,854</b>	<b>34,828</b>
<b>Expenses (income)</b>				
Selling and marketing	5,443	5,398	16,545	14,725
General and administrative	1,695	1,359	5,064	3,815
Research and development	828	1,233	2,949	2,398
Interest income, net	(406)	(359)	(1,310)	(1,098)
<b>Earnings before under-noted items</b>	<b>9,189</b>	<b>5,074</b>	<b>21,606</b>	<b>14,988</b>
Amortization of intangible assets and deferred charges	3,171	3,437	9,231	9,329
Unrealized net (gain) loss on derivative instruments	59	31	(4)	275
Loss (gain) on investments	184	—	184	(74)
Other income	(200)	—	(330)	—
<b>Income before income taxes</b>	<b>5,975</b>	<b>1,606</b>	<b>12,525</b>	<b>5,458</b>
<b>Provision for income taxes</b>				
Current	1,450	(545)	3,743	129
Future	908	1,323	1,100	2,200
	<b>2,358</b>	<b>778</b>	<b>4,843</b>	<b>2,329</b>
<b>Net income before extraordinary gain</b>	<b>3,617</b>	<b>828</b>	<b>7,682</b>	<b>3,129</b>
Extraordinary gain (net of \$nil taxes) [note 5]	—	—	—	4,874
<b>Net income for the period</b>	<b>3,617</b>	<b>828</b>	<b>7,682</b>	<b>8,003</b>
<b>Earnings per share before extraordinary gain</b>				
Basic	0.24	0.06	0.52	0.21
Diluted	0.24	0.05	0.51	0.20
<b>Earnings per share</b>				
Basic	0.24	0.06	0.52	0.53
Diluted	0.24	0.05	0.51	0.52
<b>Weighted average number of shares outstanding [note 4]</b>				
Basic	14,857,150	15,046,392	14,839,187	15,050,191
Diluted	15,065,359	15,342,890	15,072,712	15,374,831

See accompanying notes

## CONSOLIDATED STATEMENTS OF CASH FLOWS

[In thousands of Canadian dollars]

[unaudited]

	Three-month period ended September 30		Nine-month period ended September 30	
	2008	2007	2008	2007
	\$	\$	\$	\$
<b>Operating activities</b>				
Net income	3,617	828	7,682	8,003
Add items not affecting cash				
Amortization	3,261	3,463	9,367	9,393
Future income taxes	908	1,323	1,100	(3,570)
Stock based compensation expense [note 3]	340	229	1,049	749
Unrealized net (gain) loss on derivative instruments	59	31	(4)	275
Accreted interest	(96)	(21)	(145)	(57)
Gain on disposal of investments	(209)	—	(209)	(74)
Gain on disposal of pharmaceutical license	(200)	—	(200)	—
Write-down of investment	393	—	393	—
Imputed interest on balance of sale	14	6	26	18
	<b>8,087</b>	<b>5,859</b>	<b>19,059</b>	<b>14,337</b>
Net change in non-cash balances relating to operations	(4,787)	(225)	(4,341)	(977)
<b>Cash flows from operating activities</b>	<b>3,300</b>	<b>5,634</b>	<b>14,718</b>	<b>13,760</b>
<b>Investing activities</b>				
Additions to pharmaceutical product licenses and rights, and deferred charges	(10,468)	(1,533)	(19,335)	(13,291)
Investment in portfolio company	(2,000)	(801)	(3,000)	(801)
Acquisition of property, plant and equipment	(86)	(51)	(397)	(122)
Purchases of short-term marketable securities	(3,895)	—	(29,023)	(25,986)
Maturities of short-term marketable securities	9,546	5,472	35,717	46,534
Purchases of long-term marketable securities	(1,895)	—	(1,895)	(10,378)
Proceeds from disposal of investments	500	—	500	232
Proceeds from disposal of pharmaceutical license	200	—	200	—
Business acquisition	—	—	—	(650)
Balance of sale payment	(531)	—	(531)	—
<b>Cash flows (used in) from investing activities</b>	<b>(8,629)</b>	<b>3,087</b>	<b>(17,764)</b>	<b>(4,462)</b>
<b>Financing activities</b>				
Common shares issued for cash	181	57	955	937
Repurchase of shares	(463)	(3,242)	(2,270)	(3,615)
<b>Cash flows (used in) from financing activities</b>	<b>(282)</b>	<b>(3,185)</b>	<b>(1,315)</b>	<b>(2,678)</b>
<b>Net change in cash and cash equivalents during the period</b>	<b>(5,611)</b>	<b>5,536</b>	<b>(4,361)</b>	<b>6,620</b>
Cash and cash equivalents, beginning of period	7,324	3,853	6,074	2,769
<b>Cash and cash equivalents, end of period</b>	<b>1,713</b>	<b>9,389</b>	<b>1,713</b>	<b>9,389</b>
Cash and cash equivalents	1,713	9,389		
Short-term marketable securities	23,569	23,328		
Long-term marketable securities	1,895	—		
	<b>27,177</b>	<b>32,717</b>		

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 September 30		Nine-month period ended September 30	
	<b>2008</b>	2007	<b>2008</b>	2007
	\$	\$	\$	\$
<b>Net income for the period</b>	<b>3,617</b>	828	<b>7,682</b>	8,003
<b>Other comprehensive income (loss):</b>				
Change in fair value of available-for-sale financial instruments [net of taxes of \$116 for the three-month period [2007 – (\$3)] and (\$197) for the nine-month period [2007 – (\$13)]]	<b>552</b>	(17)	<b>(883)</b>	(69)
Reclassification adjustment for (gains) losses on available-for-sale financial instruments included in net income in the current period net of taxes of (\$2) for the three-month period [2007 – \$0] and (\$10) for the nine-month period [2007 – (\$25)]]	<b>(8)</b>	—	<b>(45)</b>	(134)
<b>Other comprehensive income (loss) for the period</b>	<b>544</b>	(17)	<b>(928)</b>	(203)
<b>Comprehensive income for the period</b>	<b>4,161</b>	811	<b>6,754</b>	7,800
<b>Accumulated other comprehensive (loss) income, beginning of period</b>	<b>(1,796)</b>	506	<b>(324)</b>	—
Cumulative impact of accounting changes upon adoption of new financial instruments accounting standards on January 1, 2007	—	—	—	692
Adjusted balance, beginning of period	<b>(1,796)</b>	506	<b>(324)</b>	692
Other comprehensive income (loss) for the period	<b>544</b>	(17)	<b>(928)</b>	(203)
<b>Accumulated other comprehensive (loss) income, end of period</b>	<b>(1,252)</b>	489	<b>(1,252)</b>	489
<b>Retained earnings, beginning of period</b>	<b>23,501</b>	20,678	<b>20,508</b>	13,711
Net income for the period	<b>3,617</b>	828	<b>7,682</b>	8,003
Excess of purchase price over stated capital of common shares cancelled	<b>(285)</b>	(2,019)	<b>(1,357)</b>	(2,246)
Adjustment to retained earnings upon adoption of new financial instruments accounting standards on January 1, 2007 (net of \$3 taxes)	—	—	—	19
<b>Retained earnings, end of period</b>	<b>26,833</b>	19,487	<b>26,833</b>	19,487

*See accompanying notes*

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

## 1. Governing Statute and Nature of Operations

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

## 2. Basis of Presentation and Accounting policies

The unaudited interim consolidated financial statements have been prepared by the Company in accordance with Canadian generally accepted accounting principles ("GAAP") applicable to interim financial statements and include the accounts of all its subsidiaries. Accordingly, they do not include all the information and disclosures required according to GAAP for annual financial statements and should be read in conjunction with the Company's audited consolidated financial statements and notes thereto in the Company's Annual Report for the year ended December 31, 2007.

Information with respect to the December 31, 2007 balance sheet is derived from the Company's complete audited consolidated financial statements. The accounting policies underlying these interim financial statements are those set forth in note 2 of the audited financial statements for the year ended December 31, 2007.

## 3. Capital Stock

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

### Issued and outstanding:

	Number of shares	Amount
<b>Balance at beginning of year</b>	<b>14,902,784</b>	<b>\$59,797</b>
Issued upon exercise of stock options	156,840	1,110
Issued under employee share purchase plan	7,644	79
Purchase of shares	(226,725)	(912)
<b>Balance at September 30, 2008</b>	<b>14,840,543</b>	<b>\$60,074</b>

During the three-month period ended September 30, 2008, under the terms of the normal course issuer bid, the Company repurchased and cancelled 44,000 shares. During the nine-month period ended September 30, 2008, under the terms of the normal course issuer bid, the Company repurchased and cancelled 226,725 shares.

### 3. Capital Stock (cont'd)

#### Stock option plan

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

	2008		2007	
	#	Weighted average exercise price \$	#	Weighted average exercise price \$
Balance at beginning of year	1,002,844	7.73	819,915	6.07
Granted	342,935	10.86	330,822	11.19
Exercised	(156,840)	5.64	(134,695)	6.39
Expired or forfeited	(57,425)	9.92	(39,764)	9.15
Balance at September 30	1,131,514	8.86	976,278	7.64
Options exercisable at September 30	449,749	6.66	449,814	5.83

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

	Three-month period ended September 30		Nine-month period ended September 30	
	2008	2007	2008	2007
Option compensation expense	\$344	\$228	\$1,040	\$732
Weighted average fair value of options	\$5.50	\$6.79	\$5.74	\$6.69
Weighted average risk-free interest rate	3.65%	4.49%	3.34%	4.19%
Dividend yield	Nil	Nil	Nil	Nil
Weighted average volatility factor	44%	53%	47%	55%
Weighted average expected life	7 years	7 years	7 years	7 years

### 4. Earnings per share

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

	Three-month period ended September 30		Nine-month period ended September 30	
	2008	2007	2008	2007
Basic weighted average number of shares outstanding	14,857,150	15,046,392	14,839,187	15,050,191
Dilutive effect of options	208,209	296,498	233,525	324,640
Diluted weighted average number of shares outstanding	15,065,359	15,342,890	15,072,712	15,374,831

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

## 5. Business acquisition

On April 30, 2007, the Company acquired all of the issued and outstanding shares of BioEnvelop Inc. ("BioEnvelop"), a subsidiary of BioEnvelop Technologies Inc. (TSX-V: BIE), for a total consideration of \$1,993 consisting of the assumption of a note payable in BioEnvelop which was immediately repaid. The consideration was paid as follows: \$650 in cash, \$1,029 in common stock issued on the closing of the transaction representing 98,455 common shares and a \$314 non-interest bearing balance of sale payable 180 days after the closing date, subject to certain acquisition related conditions. The non-interest bearing balance of sale payable consisted of a short term balance of sale payable in the amount of \$148 and \$166 payable in a pre-determined number of common shares issuable at a value of \$10.45 per share, determined on the weighted average trading price of the Company's common shares on the TSX for the ten trading days immediately prior to the closing date. The Company has fully repaid this non-interest bearing balance of sale payable. The Company also incurred transaction costs in the amount of \$179, included in cash above, in connection with the acquisition. BioEnvelop has expertise in developing and manufacturing rapidly dissolving edible films for the pharmaceutical and nutraceutical markets.

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

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

## 6. Related party transactions

Joddes Limited ["Joddes"], a private Canadian corporation, is a significant shareholder holding approximately 43% of the outstanding shares of the Company, and one director of the Company, the Company's President and CEO, is related to Joddes.

The Company engages a wholly-owned subsidiary of Joddes to provide logistics services including: customer service, warehousing, shipping, invoicing, collection services and certain manufacturing services on behalf of the Company. The Company also engages this affiliate to perform certain research and development and information technology services on a contractual pay-for-use basis. The Company also leases its office facilities from another wholly owned subsidiary of Joddes. This lease is for a period of 10 years, ending in 2013 and includes minimum annual payments of \$136 for a total remaining committed amount of \$811 as at September 30, 2008 and is included in the purchase and service based commitments in note 7.

The Company has entered into several license and distribution arrangements with a wholly-owned subsidiary of Joddes to sell and distribute certain over-the-counter products whereby the Company earns royalty revenue based upon the net sales or a defined net contribution of the product.

During 2006, the Company acquired the Canadian distribution rights to Metadol® from a wholly-owned subsidiary of Joddes. Under the terms of the agreement, the Company can purchase the Canadian license for Metadol® on the fourth anniversary of the agreement for \$1 and can receive a reimbursement of up to \$3,750 subject to certain acquisition related conditions. As at September 30, 2008, the Company has not earned or received any reimbursement.

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

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

	Three-month period ended September 30		Nine-month period ended September 30	
	2008	2007	2008	2007
	\$	\$	\$	\$
Revenues	882	300	2,659	593
Purchases	3,634	5,253	11,175	11,209
Research and development expenses	109	89	335	230
Sales and marketing expenses	1,328	971	3,407	2,559
General and administrative expenses	94	88	296	238

## 7. Commitments

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

### Revenue based commitments

Most pharmaceutical product license agreements require that the Company make royalty payments; ranging from 1.5% to 20% of sales, or require payments for products at rates ranging from 20% to 40% of the net selling price.

In addition, the Company may have to pay up to \$15,569, including US\$14,688 if it achieves specific sales volumes on certain products in the future, over a maximum of 10 years.

### Milestone based commitments

The Company has also committed to fund certain research and development expenditures of third parties for \$2,794, including US\$150 and €1,400 over the next six years. In addition, certain additional payments may be required under these agreements if milestones are met, such as regulatory approval in Canada. Based on the outcome of these milestones, the Company may have to pay up to \$1,381, including US\$411 and GBP£500, over a maximum period of 15 years.

## Purchase and service based commitments

The Company is committed to making minimum purchases of inventory, and minimum expenditures for regulatory, selling and marketing services in the amount of \$37,148 including US\$5,100 and €238, to retain exclusive distribution agreements for certain products. These commitments end in 2015 and annual commitments remaining are as follows:

	\$
2008	4,564
2009	11,701
2010	12,835
2011	5,454
2012	917
2013-2015	1,677

## 8. Financial Instruments

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

As at September 30, 2008	Available- for-sale	Held-to- maturity	Loans and receivables	Other financial liabilities	Derivatives	Carrying value	Fair value
	\$	\$	\$	\$	\$	\$	\$
<b>Financial Assets</b>							
Cash and cash equivalents	1,713					1,713	1,713
Marketable securities	23,569					23,569	23,569
Accounts receivable			18,172			18,172	18,172
Other current assets			1,702			1,702	1,702
Long-term marketable securities	1,895					1,895	1,895
Investments	3,292		961		1,129	5,382 <sup>3</sup>	5,840
<b>Total Financial Assets</b>	<b>30,469</b>	<b>—</b>	<b>20,835</b>	<b>—</b>	<b>1,129</b>	<b>52,433</b>	<b>52,891</b>
<b>Financial Liabilities</b>							
Accounts payable and accrued liabilities				13,781		13,781	13,781
Accounts payable to related parties				1,007		1,007	1,007
Income taxes payable				5,712		5,712	5,712
<b>Total Financial Liabilities</b>	<b>—</b>	<b>—</b>	<b>—</b>	<b>20,500</b>	<b>—</b>	<b>20,500</b>	<b>20,500</b>

<sup>3</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.

## 8. Financial Instruments (cont'd)

As at December 31, 2007	Available- for-sale	Held-to- maturity	Loans and receivables	Other financial liabilities	Derivatives	Carrying value	Fair value
	\$	\$	\$	\$	\$	\$	\$
<b>Financial Assets</b>							
Cash and cash equivalents	6,074					6,074	6,074
Marketable securities	16,375	9,666				26,041	26,019
Accounts receivable			11,920			11,920	11,920
Other current assets			2,943			2,943	2,943
Investment tax credits receivable			244			244	244
Long-term marketable securities	4,101					4,101	4,101
Investments	3,809		220		12	4,041 <sup>3</sup>	4,176
<b>Total</b>							
<b>Financial Assets</b>	<b>30,359</b>	<b>9,666</b>	<b>15,327</b>	<b>—</b>	<b>12</b>	<b>55,364</b>	<b>55,477</b>
<b>Financial Liabilities</b>							
Accounts payable and accrued liabilities				11,582		11,582	11,582
Accounts payable to related parties				1,032		1,032	1,032
Income taxes payable				2,056		2,056	2,056
Balance of sale payable				607		607	607
<b>Total</b>							
<b>Financial Liabilities</b>	<b>—</b>	<b>—</b>	<b>—</b>	<b>15,277</b>	<b>—</b>	<b>15,277</b>	<b>15,277</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. The allocated loan portion described above classified as "Loans and receivables" is being discounted using an 11% discount rate, such approximating market value.

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.

## 8. Financial Instruments (cont'd)

### Credit risk

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

The Company is exposed to credit risk from our customers and continually monitors its customers' credit. It establishes the provision for doubtful accounts based upon the credit risk applicable to each customer. For the three-month period ended September 30, 2008, two customers, a major wholesale distributor and a major retail chain, represented 36% and 15% of revenues, respectively [2007 - 31% and 15%]. For the nine-month period ended September 30, 2008, two customers, a major wholesale distributor and a major retail chain, represented 33% and 16% of revenues, respectively [2007 - 32% and 16%]. As at September 30, 2008, two customers, a major wholesale distributor and a major retail chain, represented 46% and 15% of trade accounts receivable, respectively [2007 - 41% and 13%].

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

	September 30, 2008	December 31, 2007
	\$	\$
Trade accounts receivables	21,975	15,116
Allowance for product returns <sup>4</sup>	(3,740)	(3,133)
Allowance for doubtful accounts	(63)	(63)
Income tax credits receivable	—	244
Income taxes receivable	3,656	—
<b>Total accounts receivable</b>	<b>21,828</b>	<b>12,164</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, 2007</b>	<b>\$3,196</b>
Change in provision for doubtful accounts	—
Change in provision for product returns	607
<b>Balance at September 30, 2008</b>	<b>\$3,803</b>

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

	September 30, 2008	December 31, 2007
	\$	\$
Trade accounts receivables not passed due	11,514	7,111
Trade accounts receivables passed due and not provisioned		
Under 30 days	8,039	5,267
31 to 60 days	2,359	2,675
Over 60 days	—	—
Allowance for product returns <sup>4</sup>	(3,740)	(3,133)
<b>Total accounts receivable, net of allowance for doubtful accounts and product returns</b>	<b>18,172</b>	<b>11,920</b>

<sup>4</sup> The Company, as per its trade policy, accepts returns for a period of 12 months after expiry and accordingly provides for an estimate for such returns based on historical return levels by product.

## 8. Financial Instruments (cont'd)

### 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 September 30, 2008, there were no restrictions on the flow of these funds nor have any of these funds been committed in any way, except as set out in note 7 and 11. All financial liabilities are short term in nature.

### Market Risks

#### a) Foreign exchange risk

The Company principally operates within Canada, however, a portion of the Company's expenses, mainly inventory purchases, are incurred in United States (US) dollars. This results in financial risk due to fluctuations in the value of the US dollar relative to the Canadian dollar. The Company does not use derivative financial instruments to reduce its foreign exchange exposure. Fluctuations in foreign exchange rates could cause unanticipated fluctuations in the Company's operating results, financial position or cash flows. The significant balances in foreign currencies as at September 30, 2008 are as follows:

	U.S. dollars \$	EURO €	Other currencies
Cash and cash equivalents	270	—	—
Inventories	274	427	8
Accounts receivable	466	424	156
Accounts payable and accrued liabilities	245	607	59
<b>Net Exposure</b>	<b>765</b>	<b>244</b>	<b>105</b>

Based on the aforementioned net exposure as at September 30, 2008, and assuming that all other variables remain constant, a ten-point increase or decrease in the CAD/USD and CAD/EURO exchange rate would not have a significant effect on net earnings and other comprehensive income.

#### b) Interest rate risk

The Company is subject to interest rate risk on its cash, cash equivalents and marketable securities.

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

## 9. Management of Capital

The Company's objectives when managing capital are:

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

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

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

## **10. Comparative figures**

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

## **11. 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, would amount to additional Canadian federal tax due of approximately \$5,558 plus interest and penalties of approximately \$1,733. It is likely that the Quebec and Ontario provincial tax authorities will propose similar adjustments as a result of the CRA reassessments. As such the Company estimates the total tax liability exposure to the federal and relevant provincial governments as a result of the CRA’s position to be approximately \$11,051 including interest and penalties. The Company disagrees with the position taken by the CRA and believes it is without merit. Subsequent to the quarter, the Company filed a Notice of Objection through the CRA appeals process and intends to pursue further through the courts if necessary.

Under the terms of the Share Purchase Agreement (“SPA”) for Squire, Nuvo provided representations and warranties with respect to the status of the Squire tax accounts and certain tax asset values whereby, if the amounts represented are incorrect then Nuvo is required to indemnify the Company. The Company also holds indemnities from Nuvo relating to all costs relating to reassessment including advisory fees, interest and penalties, as applicable. In the event of an unfavorable ruling, the Company intends to claim at least \$7,175 from Nuvo under the SPA.

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

In connection with the appeals process, in the notice of reassessment, the Company is required to post a deposit of up to one half of the tax and interest assessed. To that effect the Company deposited \$3,640 to the CRA and may make a claim from Nuvo under the SPA. If the Company is successful in its appeal of the reassessment these amounts will be refunded to the Company with accrued interest.

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

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