

PALADIN LABS INC.
FINANCIAL STATEMENTS

March 31, 2005



Management Discussion And Analysis:

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

The following analysis explains the variations in the results of operations, financial position and cash flows for Paladin Labs Inc. ("Paladin" or the "Company") and is current as at May 4, 2005. This discussion should be read in conjunction with the information contained in the Company's interim and annual financial statements and the related notes to these financial statements. As at May 4, 2005, 14,861,500 shares were issued and outstanding.

Forward-Looking Statements

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

Overview

Paladin is a specialty pharmaceutical company focused on selling and marketing innovative pharmaceutical products for the Canadian market. Through a national sales force, the Company markets its pharmaceutical products to Canadian physicians in its key therapeutic areas.

Paladin's strategy is to acquire promotion-sensitive products with existing sales and to increase sales of these products through focused marketing and promotion. The Company also in-licenses late-stage development products, obtains regulatory approval for them and then launches them in the Canadian market.

First quarter highlights:

- Revenues reached \$6,512, an increase of 16% over the same period last year.
- Net income was \$499, an increase of 45% over the same period last year.
- Obtained formulary listing for **Oxytrol**[®] in Quebec.
- Appointed Dr. Patrice Larose Vice-President, Regulatory Affairs, Drug Safety and Medical Services.

Paladin's annual and quarterly operating results are primarily affected by the following factors: the level of acceptance of Paladin's products by physicians and their patients and wholesaler buying patterns. Wholesaler buying patterns, including a tendency to increase inventory levels prior to anticipated or announced price increases, affect the Company's operating results by shifting revenue between quarters. The level of patient and physician acceptance of Paladin's products, as well as the availability of similar therapies, impact Paladin's revenues by driving the level and timing of prescriptions for its products.

Critical Accounting Estimates

Paladin's financial statements are prepared in accordance with Canadian generally accepted accounting principles, applied in a consistent basis. Paladin's critical accounting estimates include revenue recognition, the recording of research and development expenses, the useful lives and fair value of intangible assets and stock based compensation expense. For a more detailed discussion of the Company's critical accounting, please refer to the Management Discussion & Analysis included in the Company's 2004 Annual Report. There have been no material changes to accounting estimates since December 31, 2004.

Results of Operations

Three-month period ended March 31, 2005 compared to three-month period ended March 31, 2004.

Revenues

Revenues increased \$915 or 16% to \$6,512 for the three-month period ended March 31, 2005 from \$5,597 for the three-month period ended March 31, 2004. This increase was due to strong market performance from the Company's key promoted products, including Dostinex[®], Estring[®], Oxytrol[®] and Plan B[®], which increased by 37% compared to the three-month period ended March 31, 2004.

Gross Profit

Total gross profit increased \$584 or 14% to \$4,863 for the three-month period ended March 31, 2005 from \$4,279 for the three-month period ended March 31, 2004. Gross profit, as a percentage of revenues, decreased to 75% for the three-month period ended March 31, 2005 from 76% for the three-month period ended March 31, 2004.

Selling and Marketing Expense

Selling and marketing expense increased \$694 or 48% to \$2,127 for the three-month period ended March 31, 2005 from \$1,433 for the three-month period ended March 31, 2004. Selling and marketing expense, as percentage of revenues, increased to 33% for the three-month period ended March 31, 2005 from 26% for the three-month period ended March 31, 2004. This increase was primarily attributed to increased promotion activities behind the launch of Oxytrol[®] and planning activities behind the re-launch of Plan B[®] as a non-prescription product. It is expected that selling and marketing expense, as a percentage of revenues, will be between 35% and 40% for the year ended December 31, 2005.

General and Administrative Expense

General and administrative expense increased \$136 or 19% to \$841 for the three-month period ended March 31, 2005 from \$705 for the three-month period ended March 31, 2004. General and administrative expense, as a percentage of revenues, was 13% for the three-month period ended March 31, 2005 and for the three-month period ended March 31, 2004.

Research and Development Expense

Research and development expense decreased \$847 or 72% to \$331 for the three-month period ended March 31, 2005 from \$1,178 for the three-month period ended March 31, 2004. During the first quarter of 2005, Paladin's research and development efforts have been to search and explore potential product opportunities for internal development. Research and development expense for the three-month period ended March 31, 2005 included development expenses for PAL#1, Paladin's internally developed women's health pharmaceutical, and \$353 related to certain license payments for unapproved products.

Amortization Expense

Amortization expense increased \$295 or 37% to \$1,086 for the three-month period ended March 31, 2005 from \$791 for the three-month period ended March 31, 2004. This increase in amortization expense is a result of the Company's decision to reduce the estimated useful life of the carrying value of the intellectual property associated with products which may be genericized.

Interest Income

Interest income decreased \$27 or 8% to \$302 for the three-month period ended March 31, 2005 from \$329 for the three-month period ended March 31, 2004. This decrease reflects the impact of lower interest rates in the three-month period ended March 31, 2005 compared to the three-month period ended March 31, 2004.

Income Tax Expense

Income tax expense increased \$124 or 79% to \$281 for the three-month period ended March 31, 2005 from \$157 for the three-month period ended March 31, 2004. The effective tax rate was 36% for the three-month period ended March 31, 2005 compared to 31% for the three-month period ended March 31, 2004.

Net Income

Due to the factors set forth above, net income was \$499 for the three-month period ended March 31, 2005 compared to net income of \$344 for the three-month period ended March 31, 2004.

Liquidity and Capital Resources

The Company believes that its existing cash and cash equivalents and short-term and long-term marketable securities, as well as cash generated from operations, are sufficient to finance its current operations and working capital needs and future product acquisitions. At present, the Company is actively pursuing product acquisitions that may require the use of substantial capital resources. There are no present agreements or commitments with respect to any such acquisitions.

Paladin's cash, cash equivalents, and short-term and long-term marketable securities increased \$1,522 to \$43,646 at March 31, 2004 from \$42,124 at December 31, 2004. Working capital increased \$5,913 to \$45,622 at March 31, 2005 from \$39,709 at December 31, 2004. This increase is primarily due to a decrease in long-term marketable securities.

Cash flows from operating activities were \$2,090 for the three-month period ended March 31, 2005. For the three-month period ended March 31, 2004, cash flows used in operating activities were \$2,448. Cash flows from operating activities represent the cash flows from net earnings, excluding revenues and expenses not affecting cash, principally amortization, future income taxes, and option compensation expense.

Cash flows from investing activities were \$1,367 and \$2,460 for the three-month periods ended March 31, 2005 and 2004, respectively. During the three-month period ended March 31, 2005, the Company invested \$202 in acquisitions of pharmaceutical product licenses and rights and intellectual property. In addition, the Company had a \$1,576 net decrease in short-term and long-term marketable securities. For the three-month period ended March 31, 2004, the Company invested \$1,423 in acquisitions of pharmaceutical product licenses and rights and intellectual property. In addition, the Company had a \$3,883 net decrease in short-term and long-term marketable securities.

Cash flows used in financing activities were \$351 and \$1,407 for the three-month period ended March 31, 2005 and 2004, respectively. For the three-month period ended March 31, 2005, Paladin received \$13 from common stock option exercises and the issuance of common shares under the stock purchase plan. In addition, the Company had a decrease of \$364 in accounts payable related pharmaceutical product licenses. For the three-month period ended March 31, 2004, Paladin received \$37 was provided from common stock option exercises and the issuance of common shares under the stock purchase plan. In addition, the Company had a decrease of \$1,444 in accounts payable related to pharmaceutical product licenses.

Related Party Transactions

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

Effective February 1, 2004, Paladin amended the distribution agreement with this affiliate. As a result of this amendment, Paladin has begun to invoice customers and collect accounts receivables and has taken title to the inventory and accounts receivables related to the products distributed by Paladin. Consequently, on February 1, 2004, Paladin purchased \$4.1 million of accounts receivables and \$2.9 million of inventory from this affiliate. The related party will continue to provide logistics services, including customer service, warehousing and shipping, invoicing and collection services.

The Company also engages this affiliate to perform certain research and development services. These service contracts are on a 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 2 years and includes minimum payments of \$133.

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

The table below reflects all transactions and services with affiliates, including those referred to in the agreements described above:

	Three-month period ended March 31	
	2005	2004
	\$	\$
Revenues	201	489
Purchases	1,142	3,480
Research and development expenses	48	104
Sales and marketing expenses	371	300
General and administrative expenses	70	62

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.

Subsequent Event

Subsequent to the end of the first quarter, in April 2005, Paladin entered into a marketing and supply agreement. Under the contract, the Company paid an initial licensing fee of US\$500 and may be required to make certain payments if certain regulatory or sales volume milestones are met. Based on the outcome of these milestones, the Company may have to pay up to \$6,955 [US\$5,750].

Contractual Obligations and Commitments

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

	Contractual Obligations	Commitments	
	Purchase and service based commitments	Milestone based commitments	Revenue based commitments
	\$	\$	\$
April 1, 2005 – December 31, 2005	1,997	605	363
Fiscal 2006 – fiscal 2008	4,998	605	877
Fiscal 2009 – fiscal 2010	1,538	—	302
After fiscal 2010	683	2,344	9,414
Total	9,216	3,554	10,956

NOTICE TO READER OF THE INTERIM FINANCIAL STATEMENTS

The financial statements of Paladin Labs Inc. (the “**Company**”) and the accompanying interim balance sheet as at March 31, 2005 and the interim statements of income, retained earnings and cash flows for the three month period then ended are the responsibility of the Company’s management. These financial statements have not been audited or reviewed on behalf of the shareholders by the independent external auditors, Ernst & Young LLP.

The interim 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 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
May 4, 2005

(signed) Samira Sakhia
Samira Sakhia, C.A., M.B.A.
Chief Financial Officer
Montreal, Canada
May 4, 2005

BALANCE SHEET

[In thousands of Canadian dollars]

	March 31 2005 \$	December 31 2004 \$
	(unaudited)	
ASSETS		
Current		
Cash and cash equivalents	4,605	1,507
Short-term marketable securities	38,541	36,039
Accounts receivable	4,523	5,878
Inventories	2,564	2,718
Other current assets	483	735
Future income tax assets	702	600
Total current assets	51,418	47,477
Long-term marketable securities	500	4,578
Property, plant and equipment	69	77
Intangible assets	10,216	11,065
Deferred charges	4,141	4,176
Investments	1,433	1,433
Future income tax credits recoverable	450	439
Future income tax assets	1,337	1,715
	69,564	70,960
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Accounts payable and accrued liabilities	3,974	4,723
Accounts payable to related parties	738	1,754
Income taxes payable	386	229
Balance of license agreements payable	698	1,062
Total current liabilities	5,796	7,768
Shareholders' equity [note 4]		
Capital stock	57,850	57,837
Other paid-in capital	618	554
Retained earnings	5,300	4,801
Total shareholders' equity	63,768	63,192
	69,564	70,960

See accompanying notes

STATEMENTS OF INCOME AND RETAINED EARNINGS

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

[unaudited]

	Three-month period ended	
	2005	March 31 2004
	\$	\$
Revenues	6,512	5,597
Cost of sales	1,649	1,318
Gross profit	4,863	4,279
Selling and marketing	2,127	1,433
General and administrative <i>[note 3]</i>	841	705
Research and development	331	1,178
Amortization	1,086	791
Interest income, net	(302)	(329)
Income before income taxes	780	501
Provision for income taxes		
Current	—	25
Future	281	132
	281	157
Net income <i>[note 3]</i>	499	344
Retained earnings, beginning of period	4,801	1,562
Retained earnings, end of period	5,300	1,906
Earnings per share		
Basic	0.03	0.02
Diluted	0.03	0.02
Weighted average number of shares outstanding <i>[note 5]</i>		
Basic	14,859,042	14,802,846
Diluted	14,872,337	14,879,963

See accompanying notes

STATEMENTS OF CASH FLOWS

[In thousands of Canadian dollars]

[unaudited]

	Three-month period ended	
	March 31	
	2005	2004
	\$	\$
Operating activities		
Net income <i>[note 3]</i>	499	344
Add items not affecting cash		
Amortization	1,101	807
Stock based compensation expense <i>[note 3]</i>	67	137
Future income taxes	265	75
Unrealized foreign exchange (gain) loss	(17)	—
	1,915	1,363
Net change in non-cash balances relating to operations	175	(3,811)
Cash flows from (used in) operating activities	2,090	(2,448)
Investing activities		
Additions to pharmaceutical product licenses and rights and intellectual property and deferred charges	(202)	(1,423)
Acquisition of property, plant and equipment	(7)	—
Purchases of short-term marketable securities	(1,196)	(2,753)
Maturities of short-term marketable securities	3,272	8,432
Purchases of long-term marketable securities	(500)	(1,796)
Cash flows from financing activities	1,367	2,460
Financing activities		
Common shares issued for cash	13	37
Accounts payable related to the acquisition of intellectual property and deferred charges	(364)	(1,444)
Cash flows used in financing activities	(351)	(1,407)
Effect of exchange rate change on cash and cash equivalents	(8)	—
Net change in cash and cash equivalents during the period	3,098	(1,395)
Cash and cash equivalents, beginning of period	1,507	1,991
Cash and cash equivalents, end of period	4,605	596
Cash and cash equivalents	4,605	596
Short-term marketable securities	38,541	36,876
Long-term marketable securities	500	1,796
	43,646	39,268

See accompanying notes

NOTES TO FINANCIAL STATEMENTS

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

1. Basis of presentation

Information with respect to the December 31, 2004 balance sheet is derived from the Company's complete audited financial statements. These unaudited interim financial statements should be read in conjunction with the audited financial statements and the notes thereto in the Company's Annual Report for the year ended December 31, 2004.

2. Accounting policies

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, 2004.

3. Capital stock

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

Issued and outstanding:

	Number of shares	Amount
Balance at beginning of year	14,858,469	\$57,837
Issued under employee share purchase plan	3,031	13
Balance at March 31, 2005	14,861,500	\$57,850

Stock option plan

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

	2005		2004	
	#	Weighted average exercise price \$	#	Weighted average exercise price \$
Balance at beginning of year	789,321	5.53	873,984	5.57
Granted	75,250	4.46	72,869	4.99
Exercised	—	—	(5,590)	4.37
Expired or forfeited	(2,400)	4.92	(35,322)	6.67
Balance at March 31	862,171	5.44	905,941	5.49
Options exercisable at March 31	541,593	5.59	446,718	5.60

During 2003, the Company adopted the fair value based method of accounting for employee stock compensation on a prospective basis for options awarded since January 1, 2003. For options, which were granted or modified during fiscal 2002, the Company will continue to present pro forma net income as if the fair value had been applied to those awards.

The Company recorded option compensation expense with a corresponding credit against paid-in-capital and determined the fair value of stock using the Black-Scholes option-pricing model as follows:

	Three-month period ended March 31	
	2005	2004
Option compensation expense	64	136
Weighted average fair value of stock options	\$2.87	\$3.22
Weighted average risk-free interest rate	3.88%	3.86%
Dividend yield	nil	nil
Weighted average volatility factor	62%	66%
Weighted average expected life	7 years	7 years

For purposes of pro forma disclosures, the estimated fair value of the options granted prior to 2003 will continue to be disclosed as an expense on a straight-line basis over the option's vesting period. The fair value of option grants during 2002 was estimated at the date of grant using the following assumptions: weighted-average risk-free interest rate of 5.02%; dividend yield of nil; weighted-average volatility factor of the expected market price of the Company's common shares of 76%; and, a weighted-average expected life of the options of 7 years. The weighted average fair value of stock options granted during 2002, under the Black-Scholes option-pricing model, and above assumptions was \$6.05.

For options for which the option term was amended from five years to seven years, the fair value was estimated at the date of amendment using the following assumptions: weighted-average risk-free interest rate of 4.06%; dividend yield of nil; weighted-average volatility factor of the expected market price of the Company's common shares of 72%; and, a weighted-average expected life of the options of 3.5 years. The weighted average fair value of stock options amended on December 4, 2002, under the Black-Scholes option-pricing model, and above assumptions was \$4.06.

	Three-month period ended March 31	
	2005	2004
	\$	\$
Net income as reported	499	344
Less: Amortization of fair value related to option grants	(11)	(19)
Amortization of fair value related to option life amendment in fiscal 2002	(7)	(26)
Pro-forma net income	481	299
Basic Earnings per share		
As reported	0.03	0.02
Pro-forma	0.03	0.02
Diluted Earnings per share		
As reported	0.03	0.02
Pro-forma	0.03	0.02

4. Earnings per share

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

Earnings per share	Three-month period ended March 31	
	2005	2004
Basic weighted average number of shares outstanding	14,859,042	14,802,846
Dilutive effect of options	13,295	77,117
Diluted weighted average number of shares outstanding	14,872,337	14,879,963

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

5. Related party transactions

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

Effective February 1, 2004, Paladin amended the distribution agreement with this affiliate. As a result of this amendment, Paladin has begun to invoice customers and collect accounts receivable and has taken title to the inventory and accounts receivables related to the products distributed by Paladin. Consequently, on February 1, 2004, Paladin purchased \$4.1 million of account receivable and \$2.9 million of inventory from this affiliate. The related party will continue to provide logistics services, including customer service, warehousing and shipping, invoicing and collection services.

The Company also engages this affiliate to perform certain research and development services. These service contracts are on a 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 2 years and includes minimum payments of \$133.

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

The table below reflects all transactions and services with affiliates, including those referred to in the agreements described above:

	Three-month period ended March 31	
	2005	2004
	\$	\$
Revenues	201	489
Purchases	1,142	3,480
Research and development expenses	48	104
Sales and marketing expenses	371	300
General and administrative expenses	70	62

6. Commitments

In the normal course of business, the Company secures Canadian 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 based commitments.

Revenue based commitments

Most pharmaceutical product license agreements require that the Company make royalty payments ranging from 2.5% to 20% of sales or require payments for products at rates ranging from 26% to 50% of the net selling price, or 60% of the net profit on sales.

In addition, the Company may have to pay up to \$4,506 [US\$3,725] and \$100 if the Company achieves specific sales volumes on specific products in the future. Payments related to sales volume may be due over the next 10 years.

Milestone based commitments

The Company has also committed to fund certain research and development expenditures of third parties for \$302 [US\$250] over the next two years. In addition, additional payments maybe required under these agreements if milestones are met, such as regulatory approval in Canada. Based on the outcome of these milestones, the Company may have to pay up to \$2,453, including US\$2,118, over a maximum period of 15 years.

Purchase and service based commitments

The Company is committed to making minimum spending related to inventory purchases, regulatory, sales and marketing expenditures in the amount of \$9,216, including US\$250, in order to retain exclusive distribution agreements for certain products. These commitments end in 2011 and annual amounts are as follows:

	\$
April 1, 2005-December 31, 2005	1,997
2006	2,541
2007	1,601
2008	856
2009	861
2010-2011	1,360

7. Subsequent event

Subsequent to the end of the first quarter, in April 2005, the Company entered into a marketing and supply agreement. Under the contract, the Company paid an initial licensing fee of US\$500 and may be required to make certain payments if certain regulatory or sales volume milestones are met. Based on the outcome of these milestones, the Company may have to pay up to \$6,955 [US\$5,750].

8. Comparative figures

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

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