

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

**September 30, 2006**



# 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 consolidated results of operations, financial position and cash flows for Paladin Labs Inc. (“Paladin” or the “Company”) and is current as at November 1, 2006. This discussion should be read in conjunction with the information contained in the Company’s interim and annual consolidated financial statements and the related notes to the consolidated financial statements. As at November 1, 2006, 14,940,537 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, timing of new product development and launch, availability of raw materials, changes in 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 at [www.sedar.com](http://www.sedar.com).

## **Overview**

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

## **Third quarter highlights:**

- Revenues reached \$12,702, an increase of 39% over the same period last year
- Net income was \$1,908, an increase of 136% over the same period last year
- Cash flows from operations reached \$4,329, a 43% increase over the same period last year

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

## **Critical Accounting Estimates**

Paladin’s consolidated 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 fair value and useful lives of intangible assets, stock based compensation expense and future income tax asset recording. For a more detailed discussion of the Company’s critical accounting, please refer to the Management Discussion & Analysis included in the Company’s 2005 Annual Report. There have been no material changes to accounting estimates since December 31, 2005.

## **Results of Operations**

Three-month period ended September 30, 2006 compared to three-month period ended September 30, 2005, and nine-month period ended September 30, 2006 compared to nine-month period ended September 30, 2005.

### **Revenues**

Revenues increased \$3,567 or 39% to \$12,702 for the three-month period ended September 30, 2006 from \$9,135 for the three-month period ended September 30, 2005. For the nine-month period ended September 30, 2006, revenues increased \$10,704 or 46% to \$34,075 from \$23,371 for the nine-month period ended September 30, 2005. These increases are due primarily to strong performance from the Company's key promoted products, including Estring<sup>®</sup>, Oxytrol<sup>®</sup>, Plan B<sup>®</sup>, Twinject<sup>®</sup> and Pennsaid<sup>®</sup> which increased by 112% for the three-month period ended September 30, 2006 compared to the three-month period ended September 30, 2005 and by 178% for the nine-month period ended September 30, 2006 compared to the nine-month period ended September 30, 2005.

### **Gross Profit**

Total gross profit increased \$2,932 or 43% to \$9,710 for the three-month period ended September 30, 2006 from \$6,778 for the three-month period ended September 30, 2005. For the nine-month period ended September 30, 2006, gross profit increased \$8,610 or 50% to \$25,882 from \$17,212 for the nine-month period ended September 30, 2005. Gross profit, as a percentage of revenues, increased to 76% for the three and nine-month periods ended September 30, 2006 from 74% for the three and nine-month periods ended September 30, 2005. This increase in gross profit, as a percentage of revenues, resulted primarily from the launch of new products yielding a higher gross profit margin and a change in the proportion of products sold for which the Company earns a distribution fee and consequently does not incur cost of sales related to these products.

### **Selling and Marketing Expense**

Selling and marketing expense increased \$637 or 20% to \$3,838 for the three-month period ended September 30, 2006 from \$3,201 for the three-month period ended September 30, 2005. For the nine-month period ended September 30, 2006, selling and marketing expense increased \$2,736 or 33% to \$10,984 from \$8,248 for the nine-month period ended September 30, 2005. The increase in selling and marketing expense was primarily attributed to the increased promotion activities relating to the launch of Twinject<sup>®</sup>, the continued promotional expenses relating to the previous year's launch of Oxytrol<sup>®</sup>, the re-launch of Plan B<sup>®</sup> as a non-prescription product and the co-promotion expenses relating to Pennsaid<sup>®</sup>. Selling and marketing expense, as percentage of revenues, decreased to 30% for the three-month period ended September 30, 2006 from 35% for the three-month period ended September 30, 2005. Similarly, selling and marketing expense, as percentage of revenues, decreased to 32% for the nine-month period ended September 30, 2006 from 35% for the nine-month period ended September 30, 2005 due to the positive impact of the Company's prior year marketing efforts on revenues for these periods.

### **General and Administrative Expense**

General and administrative expense increased \$415 or 51% to \$1,223 for the three-month period ended September 30, 2006 from \$808 for the three-month period ended September 30, 2005. For the nine-month period ended September 30, 2006 general and administrative expense increased \$1,125 or 46% to \$3,594 from \$2,469 for the nine-month period ended September 30, 2005. General and administrative expense, as percentage of revenues, increased to 10% for the three-month period ended September 30, 2006 from 9% for the three-month period ended September 30, 2005. General and administrative expense, as percentage of revenues, remained steady at 11% for the nine-month period ended September 30, 2006 and 2005.

### **Research and Development Expense**

Research and development expense decreased \$324 or 49% to \$342 for the three-month period ended September 30, 2006 from \$666 for the three-month period ended September 30, 2005. Similarly, for the nine-month period ended September 30, 2006, research and development expense decreased \$149 or 12% to \$1,130 from \$1,279 for the nine-month period ended September 30, 2005. This decrease is primarily attributable to product submission fees related to certain product opportunities during the three-month and nine-month periods ended September 30, 2005 which are currently awaiting regulatory response.

### Amortization

Amortization expense increased \$330 or 26% to \$1,603 for the three-month period ended September 30, 2006 from \$1,273 for the three-month period ended September 30, 2005. For the nine-month period ended September 30, 2006, amortization expense increased \$1,759 or 51% to \$5,214 from \$3,455 for the nine-month period ended September 30, 2005. This increase in amortization expense is the result of the amortization related to the Company's newly acquired pharmaceutical product licenses, rights and deferred charges.

### Net Interest Income

Net interest income increased \$96 or 28% to \$435 for the three-month period ended September 30, 2006 from \$339 for the three-month period ended September 30, 2005 primarily as a result of higher average cash and marketable securities balances and higher interest rates over these same periods. For the nine-month period ended September 30, 2006, interest income increased \$69 or 7% to \$1,035 from \$966 for the nine-month period ended September 30, 2005. This increase is primarily the result of higher average cash and marketable securities balances and higher interest rates over these same periods offset with certain interest payments the Company was required to disburse.

### Other Income

Other income was nil and \$724 for the three and nine month periods ended September 30, 2006, compared to \$37 and \$147 for the three and nine-month periods ended September 30, 2005, respectively. Other income for the nine-month period ended September 30, 2006 relates to a stock dividend received during the period from one of the Company's portfolio investments. Other income for the three and nine-month periods ended September 30, 2005 relates to certain product marketing agreements under which the Company earns a service fee for marketing activities performed by the Company.

### Income Tax Expense

Income tax expense increased \$833 to \$1,231 for the three-month period ended September 30, 2006 from \$398 for the three-month period ended September 30, 2005. For the nine-month period ended September 30, 2006, income tax expense increased \$1,405 to \$2,387 from \$982 for the nine-month period ended September 30, 2005. For the three and nine-month periods ended September 30, 2006 the effective tax rate was 39% and 36%, respectively, compared to 33% and 34% for the three and nine-month period ended September 30, 2005. 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	16,484	11,719	2007-2016
Provincial	14,500	9,735	2007-2016
<b>Scientific Research and Experimental Development expenditures</b>			
Federal	9,518	1,421	N/A
Provincial	10,708	2,611	N/A
<b>Capital losses</b>			
Federal	198	-	N/A
Provincial	891	-	N/A
<b>Investment tax credits</b>			
Federal	2,575	153	2008-2015

### Net Income

Due to the factors set forth above, net income increased \$1,100 or 136% to \$1,908 for the three-month period ended September 30, 2006 compared to net income of \$808 for the three-month period ended September 30, 2005. Net income increased \$2,380 or 126% to \$4,272 for the nine-month period ended September 30, 2006 from \$1,892 for the nine-month period ended September 30, 2005.

## **Liquidity and Capital Resources**

The Company believes that its existing cash and cash equivalents and short-term marketable securities, as well as cash generated from operations, are sufficient to finance its current operations, working capital requirements and future product acquisitions. At present, the Company is actively pursuing product acquisitions that may require the use of substantial capital resources.

Paladin's cash and short-term and long-term marketable securities increased \$5,825 to \$48,144 at September 30, 2006 from \$42,319 at December 31, 2005. This increase is primarily due to positive cash-flows from operations in the amount of \$9,520 in addition to cash received from financing activities in the amount of \$701 net of investing activities, excluding the purchases of marketable securities, of \$4,397. Working capital increased \$7,912 to \$55,428 at September 30, 2006 from \$47,516 at December 31, 2005. This increase is primarily due to cash raised through positive operating cash-flows.

Cash flows from operating activities increased 43% to \$4,329 for the three-month period ended September 30, 2006 from \$3,026 for the three-month period ended September 30, 2005. Cash flows from operating activities increased 34% to \$9,520 for the nine-month period ended September 30, 2006 compared to \$7,098 for the nine-month period ended September 30, 2005. 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 and stock dividend income.

Cash flows used in investing activities were \$5,038 for the three-month period ended September 30, 2006 compared to \$6,684 for the three-month period ended September 30, 2005. During the three month period ended September 30, 2006, the Company invested \$203 towards the acquisition of pharmaceutical product licenses, rights and deferred charges, \$19,703 towards the purchase of short-term marketable securities offset by cash generated by maturing marketable securities in the amount of \$14,869. For the three-month period ended September 30, 2005, the Company had invested \$7,748 for the acquisition of Dimethaid Health Care Ltd., subsequently renamed Squire Pharmaceuticals Inc. ("Squire") described in detail in note 5, \$202 towards the acquisition of pharmaceutical product licenses, rights and deferred charges, \$9,632 towards the purchase of short-term marketable securities, offset by cash generated by maturing marketable securities in the amount of \$10,903.

Cash flows used in investing activities were \$8,888 compared to \$5,228 for the nine-month periods ended September 30, 2006 and 2005, respectively. During the nine month period ended September 30, 2006, the Company invested \$3,857 in acquisitions of pharmaceutical product licenses, rights and deferred charges, \$500 in the form of an investment in a portfolio company, \$40 towards the acquisition of property plant and equipment, offset by net cash outflows from marketable securities investments in the amount of \$4,491. For the nine-month period ended September 30, 2005, the Company had invested \$7,748 for the acquisition of Squire, described in detail in note 5, \$1,211 in acquisitions of pharmaceutical product licenses, rights and deferred charges, \$23 towards the acquisition of property plant and equipment offset by cash flows generated from maturing marketable securities in the amount of \$3,754.

Cash flows from financing activities were \$88 for the three-month period ended September 30, 2006 compared to \$18 for the three-month period ended September 30, 2005. During the three-month period ended September 30, 2006, \$155 was generated from common stock option exercises and the issuance of common shares under the stock purchase plan for cash, offset by \$67 used by the Company to repurchase 8,800 of its own shares under the terms of the normal course issuer bid. For the three-month period ended September 30, 2005, \$18 was generated by common stock option exercises and the issuance of common shares under the stock purchase plan for cash.

Cash flows from financing activities were \$701 for the nine-month period ended September 30, 2006 compared to cash flows used in financing activities of \$1,018 for the nine-month period ended September 30, 2005. During the nine-month period ended September 30, 2006, \$1,002 was generated from common stock option exercises and the issuance of common shares under the stock purchase plan for cash offset by a payment related to the acquisition of intellectual property in the amount of \$234 and \$67 used by the Company to repurchase 8,800 of its own shares under the terms of the normal course issuer bid. For the nine-month period ended September 30, 2005, \$42 was generated from common stock option exercises and the issuance of common shares under the stock purchase plan for cash, \$20 was generated through the repayment of a share purchase loan, offset by a payment related to the acquisition of intellectual property in the amount of \$598 and \$482 used by the Company to repurchase 107,500 of its own shares under the terms of the normal course issuer bid.

### **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.

The Company engages this affiliate to provide logistics services, including customer service, warehousing and shipping, invoicing and collection services as well as to perform certain research and development services on a contractual pay-for-use basis. The Company also leases its office facilities from another wholly-owned subsidiary of Joddes. This lease is for a period of 10 years and includes annual minimum payments of \$159.

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 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		Nine-month period ended	
	September 30		September 30	
	2006	2005	2006	2005
	\$	\$	\$	\$
Revenues	163	182	529	557
Purchases	3,035	2,450	7,678	4,780
Research and development expenses	52	35	125	148
Sales and marketing expenses	663	494	1,958	1,314
General and administrative expenses	68	72	235	215

### **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 found on SEDAR at [www.sedar.com](http://www.sedar.com).

### **Contractual Obligations and Commitments**

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

	<b>Contractual Obligations</b>	<b>Commitments</b>	
	<b>Purchase and service based commitments</b>	<b>Milestone based commitments</b>	<b>Revenue based commitments</b>
	<b>\$</b>	<b>\$</b>	<b>\$</b>
<b>October 1, 2006 – December 31, 2006</b>	2,018	558	139
<b>Fiscal 2007 – fiscal 2009</b>	4,518	1,054	229
<b>Fiscal 2010 – fiscal 2011</b>	1,672	—	279
<b>After fiscal 2012</b>	323	2,090	10,064
<b>Total</b>	<b>8,531</b>	<b>3,702</b>	<b>10,711</b>

**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, 2006 and the interim consolidated statements of income, retained earnings and cash flows for the three-month period then ended are the responsibility of the Company’s management. These consolidated financial statements have not been audited or reviewed on behalf of the shareholders by the independent external auditors, Ernst & Young LLP.

The interim consolidated financial statements have been prepared by management and include the selection of appropriate accounting principles, judgments and estimates necessary to prepare these consolidated financial statements in accordance with Canadian generally accepted accounting principles. Readers are cautioned that these interim consolidated statements may not be appropriate for their purposes.

(signed) Jonathan Ross Goodman  
Jonathan Ross Goodman, B.A., LL.B, M.B.A.  
President & Chief Executive Officer  
Montreal, Canada  
November 1, 2006

(signed) Samira Sakhia  
Samira Sakhia C.A., M.B.A.  
Chief Financial Officer  
Montreal, Canada  
November 1, 2006

## CONSOLIDATED BALANCE SHEETS

[In thousands of Canadian dollars]

	September 30 2006 \$	December 31 2005 \$
	<b>(unaudited)</b>	
<b>ASSETS</b>		
<b>Current</b>		
Cash and cash equivalents	4,169	2,835
Marketable securities	43,975	39,484
Accounts receivable	8,087	8,128
Inventory	4,188	3,178
Other current assets	805	865
Investment tax credits receivable	827	827
Future income tax assets	2,943	3,158
<b>Total current assets</b>	<b>64,994</b>	<b>58,475</b>
Property, plant and equipment	87	96
Pharmaceutical product licenses and rights	7,871	9,135
Deferred charges	3,584	3,908
Investments	2,682	1,433
Future investment tax credits recoverable	153	153
Future income tax assets	3,338	4,479
	<b>82,709</b>	<b>77,679</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Current</b>		
Accounts payable and accrued liabilities	7,721	7,679
Accounts payable to related parties	963	1,044
Deferred revenue	—	903
Income taxes payable	422	408
Balance of license agreements payable	233	698
Balance of sale payable <i>[note 5]</i>	227	227
<b>Total current liabilities</b>	<b>9,566</b>	<b>10,959</b>
<b>Long-term</b>		
Balance of sale payable <i>[note 5]</i>	488	470
Future income tax liabilities	754	—
<b>Total long-term liabilities</b>	<b>1,242</b>	<b>470</b>
<b>Shareholders' equity <i>[note 3]</i></b>		
Capital stock	58,515	57,378
Other paid-in capital	1,209	933
Retained earnings	12,177	7,939
<b>Total shareholders' equity</b>	<b>71,901</b>	<b>66,250</b>
	<b>82,709</b>	<b>77,679</b>

*See accompanying notes*

## CONSOLIDATED STATEMENTS OF INCOME AND RETAINED EARNINGS

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

[unaudited]

	Three-month period ended		Nine-month period ended	
	September 30		September 30	
	2006	2005	2006	2005
	\$	\$	\$	\$
Revenues	12,702	9,135	34,075	23,371
Cost of sales	2,992	2,357	8,253	6,159
<b>Gross profit</b>	<b>9,710</b>	<b>6,778</b>	<b>25,822</b>	<b>17,212</b>
Selling and marketing	3,838	3,201	10,984	8,248
General and administrative	1,223	808	3,594	2,469
Research and development	342	666	1,130	1,279
Amortization of intangible assets and deferred charges	1,603	1,273	5,214	3,455
Interest income, net	(435)	(339)	(1,035)	(966)
Other Income	—	(37)	(724)	(147)
<b>Income before income taxes</b>	<b>3,139</b>	<b>1,206</b>	<b>6,659</b>	<b>2,874</b>
Provision for income taxes	284	—	284	—
Future	947	398	2,103	982
	1,231	398	2,387	982
<b>Net income</b>	<b>1,908</b>	<b>808</b>	<b>4,272</b>	<b>1,892</b>
<b>Retained earnings, beginning of period</b>	<b>10,303</b>	<b>5,821</b>	<b>7,939</b>	<b>4,801</b>
Purchase of common shares	(34)	—	(34)	(64)
<b>Retained earnings, end of period</b>	<b>12,177</b>	<b>6,629</b>	<b>12,177</b>	<b>6,629</b>
<b>Earnings per share</b>				
Basic	0.13	0.05	0.29	0.13
Diluted	0.13	0.05	0.28	0.13
<b>Weighted average number of shares outstanding [note 4]</b>				
Basic	14,927,913	14,757,260	14,863,445	14,820,555
Diluted	15,152,341	14,835,682	15,074,139	14,851,610

See accompanying notes

## CONSOLIDATED STATEMENTS OF CASH FLOWS

[In thousands of Canadian dollars]

[unaudited]

	Three-month period ended		Nine-month period ended	
	2006	2005	2006	2005
	\$	\$	\$	\$
<b>Operating activities</b>				
Net income	1,908	808	4,272	1,892
Add items not affecting cash				
Amortization	1,619	1,416	5,263	3,628
Stock based compensation expense [note 3]	105	66	451	258
Future income taxes	947	398	2,103	959
Imputed interest on balance of sale [note 5]	6	—	18	—
Unrealized foreign exchange (gain) loss	1	2	1	(15)
Stock dividends	—	—	(724)	—
	<b>4,586</b>	<b>2,690</b>	<b>11,384</b>	<b>6,722</b>
Net change in non-cash balances relating to operations	(257)	336	(1,864)	376
Cash flows from operating activities	<b>4,329</b>	<b>3,026</b>	<b>9,520</b>	<b>7,098</b>
<b>Investing activities</b>				
Additions to pharmaceutical product licenses, rights and deferred charges	(203)	(202)	(3,857)	(1,211)
Acquisition of property, plant and equipment	(1)	(5)	(40)	(23)
Purchases of short-term marketable securities	(19,703)	(9,632)	(49,415)	(29,550)
Maturities of short-term marketable securities	14,869	10,903	44,924	35,287
Investment in portfolio company	—	—	(500)	—
Purchases of long-term marketable securities	—	—	—	(1,983)
Business Acquisition	—	(7,748)	—	(7,748)
Cash used in investing activities	<b>(5,038)</b>	<b>(6,684)</b>	<b>(8,888)</b>	<b>(5,228)</b>
<b>Financing activities</b>				
Common shares issued for cash	155	18	1,002	42
Accounts payable related to the acquisition of intellectual property and deferred charges	—	—	(234)	(598)
Repurchase of shares	(67)	—	(67)	(482)
Repayment of share purchase loan	—	—	—	20
Cash flows from (used in) financing activities	<b>88</b>	<b>18</b>	<b>701</b>	<b>(1,018)</b>
Effect of exchange rate change on cash and cash equivalents	1	1	1	(6)
Net change in cash and cash equivalents during the period	<b>(620)</b>	<b>(3,639)</b>	<b>1,334</b>	<b>846</b>
Cash and cash equivalents, beginning of period	4,789	5,992	2,835	1,507
<b>Cash and cash equivalents, end of period</b>	<b>4,169</b>	<b>2,353</b>	<b>4,169</b>	<b>2,353</b>
Cash and cash equivalents	4,169	2,353		
Short-term marketable securities	43,975	36,863		
	<b>48,144</b>	<b>39,216</b>		

See accompanying notes

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

### 1. Basis of presentation

The consolidated financial statements of the Company have been prepared by management in accordance with Canadian generally accepted accounting principles (GAAP) and include the accounts of its wholly-owned subsidiaries, Squire Pharmaceuticals Inc. and Knight Therapeutics Inc. Information with respect to the December 31, 2005 balance sheet is derived from the Company's complete audited consolidated financial statements. These unaudited interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto in the Company's Annual Report for the year ended December 31, 2005.

### 2. Accounting policies

The accounting policies underlying these interim consolidated financial statements are those set forth in note 2 of the audited consolidated financial statements for the year ended December 31, 2005.

### 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>14,732,368</b>	<b>\$57,378</b>
Issued upon exercise of stock options	210,997	1,127
Issued under employee share purchase plan	5,972	44
Purchase of shares	<b>(8,800)</b>	<b>(34)</b>
<b>Balance at September 30, 2006</b>	<b>14,940,537</b>	<b>\$58,515</b>

During the three-month period ended September 30, 2006, under the terms of the normal course issuer bid, the Company repurchased 8,800 shares. As at September 30, 2006, the repurchased shares are in the process of being cancelled.

### 3. Capital Stock [cont.]

#### Stock option plan

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

	2006		2005	
	#	Weighted average exercise price \$	#	Weighted average exercise price \$
Balance at beginning of year	915,743	5.57	789,321	5.53
Granted	154,000	6.91	151,500	4.41
Exercised	(210,997)	4.54	—	—
Expired or forfeited	(15,586)	5.62	(75,078)	5.68
Balance at September 30	843,160	5.88	865,743	5.32
Options exercisable at September 30	498,363	6.05	562,217	5.51

During 2003, the Company adopted the fair value based method of accounting for employee stock compensation on a prospective basis. 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 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	
	2006	2005	2006	2005
Option compensation expense	103	64	445	251
Weighted average fair value of stock options	\$4.70	\$3.01	\$4.28	\$2.81
Weighted average risk-free interest rate	4.24%	3.63%	4.16%	3.83%
Dividend yield	nil	nil	Nil	nil
Weighted average volatility factor	57%	60%	58%	61%
Weighted average expected life	7 years	7 years	7 years	7 years

For purposes of pro forma disclosures, 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. For purposes of pro forma disclosures, the 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 for pro forma purposes. The weighted average fair value of stock options granted during 2002, under the Black-Scholes option-pricing model, and above assumptions was \$6.05.

### 3. Capital Stock [cont.]

#### Stock option plan

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 September 30		Nine-month period ended September 30	
	2006	2005	2006	2005
	\$	\$	\$	\$
Net income as reported	1,908	808	4,272	1,892
Less: Amortization of fair value related to options granted in fiscal 2002	(2)	(13)	(9)	(33)
Amortization of fair value related to option life amendment in fiscal 2002	(1)	(3)	(4)	(13)
<b>Pro-forma net income</b>	<b>1,905</b>	<b>792</b>	<b>4,259</b>	<b>1,846</b>
Basic Earnings per share				
As reported	0.13	0.05	0.29	0.13
Pro-forma	0.13	0.05	0.29	0.12
Diluted Earnings per share				
As reported	0.13	0.05	0.28	0.13
Pro-forma	0.13	0.05	0.28	0.12

#### 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 September 30		Nine-month period ended September 30	
	2006	2005	2006	2005
Basic weighted average number of shares outstanding	14,927,913	14,757,260	14,863,445	14,820,555
Dilutive effect of options	224,428	78,422	210,694	31,055
Diluted weighted average number of shares outstanding	15,152,341	14,835,682	15,074,139	14,851,610

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

## 5. Business acquisition

On August 16, 2005, Paladin acquired all the issued and outstanding shares of Dimethaid Health Care Ltd., subsequently renamed Squire Pharmaceuticals Inc. (“Squire”), a subsidiary of Nuvo Research Inc. (TSX: NRI), formerly Dimethaid Research Inc., for total consideration of \$8,445 consisting of \$5,748 in cash, \$2,000 for the assumption of a note payable in Squire, which was immediately repaid, and a \$827 non-interest bearing balance of sale payable of which \$227 is payable in the short term and \$600 is payable the earlier of meeting certain acquisition related conditions or December 31, 2010. Given the non-interest bearing nature of the \$827 balance of sale payable, the amount has been recorded in these financial statements at its discounted net present value of \$715 which will be accreted through charges to interest expense over the repayment term. Imputed interest on the balance of sale payable for the three and nine-month periods ended September 30, 2006 were \$6 and \$18, respectively. Squire owns the Canadian license for Pennsaid<sup>®</sup>, a lotion approved by Health Canada for the treatment of symptoms of knee osteoarthritis.

## 6. 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.

The Company engages a wholly owned subsidiary of this affiliate to provide logistics services, including customer service, warehousing and shipping, invoicing and collection services as well as to perform certain research and development services on a contractual pay-for-use basis. The Company also leases its office facilities from another wholly owned subsidiary of Joddes. This lease is for a period of 10 years and includes minimum annual payments of \$159.

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 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		Nine-month period ended	
	September 30		September 30	
	2006	2005	2006	2005
	\$	\$	\$	\$
Revenues	163	182	529	557
Purchases	3,035	2,450	7,678	4,780
Research and development expenses	52	35	125	148
Sales and marketing expenses	663	494	1,958	1,314
General and administrative expenses	68	72	235	215

## 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 2.5% to 20% of sales, or require payments for products at rates ranging from 26% to 50% of the net selling price.

In addition, the Company may have to pay up to \$10,611 [US\$9,514] and \$100 if the Company achieves specific sales volumes on specific 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 \$1,368 [US\$1,235] over the next five 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 \$2,334, including US\$2,093, 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 \$8,531, to retain exclusive distribution agreements for certain products. These commitments end in 2013 and annual commitments are as follows:

	\$
July 1, 2006 - December 31, 2006	2,018
2007	2,248
2008	1,256
2009	1,014
2010	832
2011-2013	1,163

## 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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