

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



# Management Discussion and Analysis:

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

This management's discussion and analysis provides our overview of the Company's consolidated operations, performance and financial condition for the quarter ended September 30, 2009 and compares these unaudited quarterly results to those of the quarter ended September 30, 2008. It is intended to complement and supplement financial information included in the interim and annual consolidated financial statements, related notes, other financial information found elsewhere in our annual report and in our annual information form or other documents filed on SEDAR at [www.sedar.com](http://www.sedar.com). As a result, it should be read in conjunction with such financial information. This management's discussion and analysis is current as at November 10, 2009 and as at this date 18,534,212 shares and 1,269,018 options were issued and outstanding. Reference to "Paladin" or the "Company" includes Paladin Labs Inc. and all its subsidiaries, including the acquisition of Isotechnika Inc. as of June 18, 2009 and Virexx Medical Corp. as of December 23, 2008, the effective dates of these acquisitions, respectively, further described in note 4 to these unaudited interim consolidated financial statements.

## Forward-Looking Statements

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

## Overview

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

### Third quarter highlights:

- Revenues reached \$28,374, an increase of 28% over the same period last year
- Net income was \$2,564, a decrease of 29% over the same period last year
- Cash flows from operations reached \$6,078, a 84% increase over the same period last year
- EBITDA<sup>1</sup> was \$10,161, an increase of 12% over the same period last year
- Received a contribution from the National Research Council of Canada Industrial Research Assistance Program (NRC-IRAP) for its Chimigen<sup>®</sup> Platform
- Sold the T-ACT<sup>™</sup> technology platform to IMBiotechnologies Ltd. ("IMBio"), a private biotechnology company based in Edmonton, Canada
- Received approval for GlucaGen<sup>®</sup> (recombinant glucagon for injection) from the Biologics and Genetic Therapies Directorate of Health Canada. GlucaGen<sup>®</sup> is indicated for the treatment of severe hypoglycemia in diabetic patients being treated with insulin, and is the market leader in Europe
- Sold the AIT<sup>®</sup> technology platform to Quest PharmaTech (TSX VENTURE:QPT)("Quest"), an Edmonton-based biotechnology company
- Reached an agreement with Pfizer Canada Inc. to amend the terms of an existing contract and take over all commercial responsibilities for the selling, marketing and distribution of Estring<sup>®</sup> in Canada
- Announced that its Paladin Biosciences division has received a US\$100 Grand Challenges Explorations grant for innovative global health research from the Bill & Melinda Gates Foundation

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, foreign exchange gains (losses) and unusual items; such as write-downs and gains (losses) on intellectual property and investments. EBITDA is calculated and presented consistently from period to period and agrees, on a consolidated basis, with the amount disclosed as "*Earnings before under-noted items*" on the consolidated statement of income. The Company believes EBITDA to be an important measurement that allows it to assess the operating performance of its ongoing business on a consistent basis without the impact of amortization expenses. The Company excludes amortization expenses because their level depends substantially on non-operating factors such as the historical cost of intangible and capital assets. The Company's method for calculating EBITDA may differ from that used by other issuers and, accordingly, this measure may not be comparable to EBITDA used by other issuers.

### **Critical Accounting Estimates**

Paladin's consolidated financial statements are prepared in accordance with Canadian GAAP, applied in a consistent basis. Paladin's critical accounting estimates include revenue recognition, inventory valuation, the recording of research and development expenses and related tax credits, the useful lives and fair value of intangible assets, stock based compensation expense, income taxes and the determination of fair value of financial instruments. For a more detailed discussion of the Company's critical accounting estimates, please refer to the management's discussion & analysis included in the Company's 2008 Annual Report. There have been no material changes to accounting estimates since December 31, 2008.

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

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

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

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

### **IFRS Changeover Plan**

In February 2008 the Canadian Accounting Standards Board (AcSB) confirmed that the use of International Financial Reporting Standards ("IFRS") would be required for Canadian publicly accountable enterprises for years beginning on or after January 1, 2011. The Company will implement these standards as at January 1, 2011. The AcSB also stated that, during the transition period, enterprises will be required to provide comparative figures in accordance with IFRS. Under IFRS, there is significantly more disclosure required. Further, while IFRS uses a conceptual framework similar to Canadian GAAP, there are significant differences in accounting policy that must be addressed. Pursuant to the Canadian Securities Administrators Staff Notice 52-320, Disclosure of Expected Changes in Accounting Policies Relating to

Changeover to IFRS, the Company is presenting below the progress towards the completion to our changeover plan.

The Company's IFRS project is progressing according to plan. The Company has performed a detailed analysis of current IFRS standards, compared these to existing accounting policies and has analyzed the impact of the transition on the Company's financial statements, business practices, systems and internal controls over financial reporting. The Company continues to monitor standards to be issued by the IASB, but it is difficult to predict the IFRS that will be effective at the end of the Company's first IFRS reporting period, as the IASB work plan anticipates the completion of several projects in calendar years 2010 and 2011. The Company continues to provide training to key employees and is finalizing its assessment of the full impact of the transition. At this time, the Company cannot quantify the impact that the future adoption of IFRS will have on the financial statements and operating performance measures, however, such impact may be material. The Company will provide updates as further progress is achieved and final conclusions reached.

## Results of Operations

Three-month period ended September 30, 2009 compared to three-month period ended September 30, 2008, and nine-month period ended September 30, 2009 compared to nine-month period ended September 30, 2008.

### Revenues

Revenues increased \$6,183 or 28% to \$28,374 for the three-month period ended September 30, 2009 from \$22,191 for the three-month period ended September 30, 2008. For the nine-month period ended September 30, 2009, revenues increased \$20,721 or 35% to \$80,414 from \$59,693 for the nine-month period ended September 30, 2008. Revenues from products acquired and launched in 2009 contributed \$5,766 for the quarter ended September 30, 2009 and \$12,760 for the nine-month period ended September 30, 2009.

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

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

---

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

Promoted Products	Three-month period ended September 30		Nine-month period ended September 30	
	Revenue per IMS Canada in 2009 \$	% change vs. 2008	Revenue per IMS Canada in 2009 \$	% change vs. 2008
Plan B <sup>®</sup>	2,379	12%	6,493	12%
Twinject <sup>®</sup>	1,742	(7%)	4,501	(9%)
Pennsaid <sup>®</sup>	2,726	(5%)	8,320	0%
Metadol <sup>®</sup>	2,033	15%	5,796	19%
Trelstar <sup>®</sup>	898	120%	2,184	108%
Seasonale <sup>®</sup>	1,105	125%	2,682	157%
Testim <sup>®</sup>	573	55%	1,533	52%
Tridural <sup>®</sup>	2,488	90%	6,860	152%
	13,944	24%	38,369	29%

### Gross Profit

Total gross profit increased \$3,949 or 24% to \$20,698 for the three-month period ended September 30, 2009 from \$16,749 for the three-month period ended September 30, 2008. For the nine-month period ended September 30, 2009, gross profit increased \$14,161 or 32% to \$59,015 from \$44,854 for the same period last year. Gross profit, as a percentage of revenues, decreased to 73% from 75% for both the quarter and the nine-month period ended September 30, 2009. The decrease in gross profit as a percentage of revenues is mainly the result of lower margins from the BioEnvelop<sup>®</sup> business and the effect of reduced margins on the Company's product mix as a result of growth in certain promoted products.

### Selling and Marketing Expense

Selling and marketing expense increased \$1,012 or 19% to \$6,455 for the three-month period ended September 30, 2009 from \$5,443 for the three-month period ended September 30, 2008. For the nine-month period ended September 30, 2009, selling and marketing increased \$2,306 or 14% to \$18,851 from \$16,545 for the nine-month period ended September 30, 2008. Selling and marketing expense, as percentage of revenues, decreased to 23% for the quarter ended September 30, 2009 from 25% for the same quarter last year. For the nine-month period ended September 30, 2009, selling and marketing expense, as a percentage of revenues decreased to 23% from 28% for the same period last year. The decrease in selling and marketing expenses as a percentage of revenues is primarily the result of the Company's growth in non-promoted product revenue for the quarter and nine-month period ended September 30, 2009, driving selling and marketing expense as a percentage of revenues downward for the quarter and nine-months ended September 30, 2009. Furthermore, during the first nine months of 2008, the Company was in the first year of promotional market launch activities for Tridural<sup>®</sup> and Seasonale<sup>®</sup>, requiring significant marketing expense outlays. The promotional activities driving selling and marketing costs primarily relate to Paladin's continued promotional activities for Tridural<sup>®</sup>, Trelstar<sup>®</sup>, Twinject<sup>®</sup>, Plan B<sup>®</sup>, Metadol<sup>®</sup> and Testim<sup>®</sup>.

### General and Administrative Expense

General and administrative expense increased \$90 or 5% to \$1,904 for the three-month period ended September 30, 2009 from \$1,814 for the three-month period ended September 30, 2008. For the nine-month period ended September 30, 2009, general and administrative expense increased \$1,055 or 20% to \$6,235 from \$5,180 for the nine-month period ended September 30, 2008. The increase in general and administrative expenses for the three and nine-month periods ended September 30, 2009 is mainly the result of an increase in headcount, an increase in stock-based compensation expense and business development activities supporting the Company's growth. General and administrative expense, as percentage of revenues, decreased slightly to 7% for the quarter ended September 30, 2009 from 8% for the same quarter last year. For the nine-month period ended September 30, 2009, general and administrative expense, as a percentage of revenues, decreased slightly to 8% from 9% for the same period last year.

### Research and Development Expense

Research and development expense increased \$1,520 or 184% to \$2,348 for the three-month period ended September 30, 2009 from \$828 for the three-month period ended September 30, 2008. For the nine-month period ended September 30, 2009, research and development expense increased \$1,920 or 65% to \$4,869 from \$2,949 for the nine-month period ended September 30, 2008. Research and development expense as a

percentage of revenues, increased to 8% for the quarter ended September 30, 2009 from 4% for the same quarter last year. For the nine-month period ended September 30, 2009, research and development expense, as a percentage of revenues increased to 6% from 5% for the same period last year. The increase in research and development expense for the three and nine-month periods ended September 30, 2009, primarily relates to the recently initiated and on-going research and development efforts at IsoPharma and Virexx<sup>®</sup>, as further described in note 4 to the unaudited interim consolidated financial statements, and research activities related to the BioEnvelop<sup>®</sup> and Impavido<sup>®</sup> businesses. In addition to the above, the research activities driving research and development expense include managing development projects with licensors and preparing new drug submissions to strengthen the Company's pipeline as well as to search and explore potential product opportunities for internal development.

#### **Net Interest Income**

Net interest income decreased \$236 or 58% to \$170 for the three-month period ended September 30, 2009 from \$406 for the three-month period ended September 30, 2008. For the nine-month period ended September 30, 2009, net interest income decreased \$848 or 65% to \$462 from \$1,310 for the nine-month period ended September 30, 2008. The decrease in the net interest income for the three and nine-month periods ended September 30, 2009 are primarily the result of significantly reduced interest rates, the effective termination of accretive interest income on a convertible debenture sold during the quarter ended June 30, 2009 and accretive interest expense on the balance of sale payable pursuant to the Dexedrine<sup>®</sup> transaction, partially offset by significantly higher average daily cash and marketable securities balances over the three and nine-month periods ended September 30, 2009 compared to the three and nine-month periods ended September 30, 2008.

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

Amortization expense increased \$3,218 or 101% to \$6,389 for the three-month period ended September 30, 2009 from \$3,171 for the same period last year. For the nine-month period ended September 30, 2009, amortization expense increased \$9,222 or 100% to \$18,453 from \$9,231 for the same period last year. The increase in amortization expense for both the three and the nine-month periods ended September 30, 2009 is the result of the amortization related to the Company's recently acquired pharmaceutical product licenses and rights, principally: Dexedrine<sup>®</sup>, Antizol<sup>®</sup>, Impavido<sup>®</sup>, Anacin<sup>®</sup>, Anbnesol<sup>®</sup> and Auralgan<sup>®</sup>.

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

In accordance with Section 3855, the Company used the Black-Scholes option pricing model to re-measure the fair value of the conversion option on a secured convertible term note investment in a portfolio company recognizing an unrealized gain on the conversion option of \$nil [2008 – loss of \$51] and \$344 [2008 – loss of \$42] for the three and nine-month periods ended September 30, 2009, respectively. In addition, the Company recognized an unrealized gain on warrants in a portfolio company of \$nil [2008 – loss of \$8] and \$14 [2008 – gain of \$46] for the three and nine-month periods ended September 30, 2009, respectively.

#### **Net (Gain) Loss on Investments**

During the nine-month period ended September 30, 2009, the Company disposed of shares held in a portfolio company for proceeds of \$1,340, representing a gain of \$215. The Company also exercised its right to convert a convertible term note in this same portfolio investment into common shares subsequently selling such shares in the public market for proceeds of \$3,168 and realizing a gain of \$1,000. Furthermore the Company also exercised its right to convert warrants in the portfolio investment discussed above into common shares and subsequently disposed such shares for proceeds of \$304, representing a gain of \$133. During the same period, the Company as part of its on-going assessment of investment carrying values determined its investment in a certain private company, to be permanently impaired and recorded a write-down in the amount of \$801. In addition, during the nine-month period ended September 30, 2009, Endo Pharmaceuticals Inc. ("Endo") acquired Indevus Pharmaceuticals Inc. ("Indevus") for \$4.50 per Indevus share in cash and up to an additional \$3.00 per share in cash upon achievement of certain regulatory and sales milestones. The Company received proceeds in the amount of \$2,167 (US\$1,720) for the investment it held in 382,253 common shares of Indevus, resulting in a realized loss on disposal in the amount of \$414. Furthermore, the Company recorded a \$416 contingent right receivable in relation to the potential achievement of certain regulatory and sales milestones, determined to represent the fair value upon receipt

and measured based upon the average incremental Indevus common stock trading price over the \$4.50 cash payment received over a 31 day trading period on NASDAQ.

During the three 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.

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

During the three and nine-month periods ended September 30, 2009, the Company recorded a foreign exchange loss of \$128 and of \$132, respectively, on the Company's foreign operating results, mainly as a result of the strengthening of the Canadian dollar relative to the US dollar and Euro.

During the three and nine-month periods ended September 30, 2008, the Company recorded a foreign exchange gain of \$119 and of \$4, respectively, on the Company's foreign operating results, mainly as a result of the strengthening of the US dollar and Euro relative to the Canadian dollar.

#### **Other Income**

Other income was \$557 and \$667 for the three and nine-month periods ended September 30, 2009, compared to \$200 and \$330 for the same periods last year. During the quarter ended September 30, 2009, the Company disposed of certain pharmaceutical product licenses and rights for proceeds of \$557, representing a net gain of \$557. During the nine-month period ended September 30, 2009, the Company disposed of certain pharmaceutical product licenses and rights for proceeds of \$667, representing a net gain of \$667.

During the quarter ended September 30, 2008, the Company out-licensed a product for proceeds of \$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 decreased \$710 or 30% to \$1,648 for the three-month period ended September 30, 2009 from \$2,358 for the three-month period ended September 30, 2008. For the nine-month period ended September 30, 2009, income tax expense decreased \$123 or 3% to \$4,720 from \$4,843 for the nine-month period ended September 30, 2008. The effective tax rate remained consistent at 39%, for the three and nine-month periods ended September 30, 2009 and 2008. 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	41,545	24,371	2013-2029
Provincial	38,374	24,371	2013-2029
<b>Scientific Research and Experimental Development expenditures</b>			
Federal	88,272	68,869	N/A
Provincial	90,698	69,592	N/A
<b>Investment tax credits</b>			
Federal	23,002	15,722	2016-2029

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

**Net Income before Extraordinary Gain**

Due to the factors set forth above, net income before extraordinary gain decreased \$1,053 to \$2,564 for the three-month period ended September 30, 2009 compared to net income of \$3,617 for the three-month period ended September 30, 2008. For the nine-month period ended September 30, 2009, net income before extraordinary gain decreased \$295 to \$7,387 from \$7,682 for the nine-month period ended September 30, 2008.

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

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

**Net Income**

Due to the factors set forth above, net income decreased \$1,053 to \$2,564 for the three-month period ended September 30, 2009 compared to net income of \$3,617 for the three-month period ended September 30, 2008. Similarly, net income increased \$25,664 to \$33,346 from \$7,682 for the nine-month period ended September 30, 2008.

**Liquidity and Capital Resources**

The Company's Investment Policy regulates the investment activities relating to cash resources. An Investment Committee composed of representatives from management and the Board of Directors monitors compliance with said policy. The Company invests strictly in liquid, high-grade investment securities with varying terms to maturity, selected with regard to the expected timing of investments and expenditures for continuing operations and prevailing interest rates. As at September 30, 2009, there were no restrictions on the flow of these funds nor have any of these funds been committed in any way, except as set out in note 6 and note 10 to the unaudited interim consolidated financial statements.

The Company has entered into a one-year \$2,000 revolving unsecured credit facility with one of the Company's bankers effective August 10, 2009. The credit facility may be used for general corporate purposes including financing acquisitions.

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

	Three-month period ended		Nine-month period	
	September 30		ended September 30	
	2009	2008	2009	2008
	\$	\$	\$	\$
Cash flows from operating activities	<b>6,078</b>	3,300	<b>25,624</b>	14,718
Cash flows used in investing activities	<b>(17,083)</b>	(8,629)	<b>(66,669)</b>	(17,764)
Cash flows from (used) in financing activities	<b>176</b>	(282)	<b>56,925</b>	(1,315)
Increase in cash position	<b>(10,829)</b>	(5,611)	<b>15,880</b>	(4,361)
Cash and cash equivalents, beginning of period	<b>31,354</b>	7,324	<b>4,645</b>	6,074
Cash and cash equivalents, end of period	<b>20,525</b>	1,713	<b>20,525</b>	1,713
Short and long-term marketable securities, end of period	<b>77,106</b>	25,464	<b>77,106</b>	25,464
Cash, cash equivalents and marketable securities, end of period	<b>97,631</b>	27,177	<b>97,631</b>	27,177

Paladin's cash, cash equivalents and marketable securities increased \$76,289 to \$97,631 at September 30, 2009 from \$21,342 at December 31, 2008. This increase is primarily a result of the Company's cash inflows from financing activities whereby the Company issued 3,450,000 common shares in the form of a bought deal share offering at a price of \$17.00 per common share generating total net proceeds of \$55,871. Furthermore, the Company generated \$6,979 from the disposal of investments in portfolio companies and cash flows generated from operating activities in the amount of \$25,624, partially offset by the acquisition of Isotechnika Inc. in the amount of \$7,594 and by additions to pharmaceutical product licenses and rights in the amount of \$5,476. Working capital (current assets less current liabilities) increased \$68,645 to \$94,064 at September 30, 2009 from \$25,419 at December 31, 2008 primarily due to an increase in the Company's financing activities as described above.

Cash flows from operating activities increased 84% or \$2,778 to \$6,078 for the three-month period ended September 30, 2009 from \$3,300 for the three-month period ended September 30, 2008. Cash flows from operating activities for the nine-month period ended September 30, 2009 were \$25,624 compared to \$14,718 for the nine-month period ended September 30, 2008, representing a \$10,906 increase or 74%. 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, derivative instruments and pharmaceutical licenses, accreted interest and extraordinary gains.

Cash flows used in investing activities were \$17,083 compared to \$8,629 for the three-month period ended September 30, 2009 and 2008, respectively. During the quarter ended September 30, 2009, the Company invested \$17,410 towards the acquisition of short and long-term marketable securities net of cash flows generated by maturing marketable securities and \$115 towards the acquisition of property, plant and equipment, offset by proceeds from disposal of pharmaceutical licenses in the amount of \$442. During the quarter 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.

Cash flows used in investing activities were \$66,669 compared to \$17,764 for the nine-month period ended September 30, 2009 and 2008, respectively. During the nine-month period ended September 30, 2009, the Company invested \$60,666 towards the acquisition of short and long-term marketable securities net of cash flows generated by maturing marketable securities, \$5,476 for the acquisition of pharmaceutical product licenses and rights and \$7,594 for the business acquisition of Isotechnika Inc. further described in note 4 of these unaudited interim consolidated financial statements, partially offset by proceeds from disposal of investments in portfolio companies in the amount of \$6,979. 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.

Cash flows from financing activities were \$176 compared to cash flows used in financing activities of \$282 for the three-month periods ended September 30, 2009 and 2008, respectively. During the quarter ended September 30, 2009, an amount of \$248 was generated from stock option exercises and the issuance of common shares under the stock purchase plan for cash, offset by \$72 used by the Company to repurchase 4,500 of its own common shares under the terms of the normal course issuer bid. During the quarter 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.

Cash flows from financing activities were \$56,925 compared to cash flows used in financing activities in the amount of \$1,315 for the nine-month periods ended September 30, 2009 and 2008, respectively. During the nine-month period ended September 30, 2009, the Company issued 3,450,000 common shares in the form of a bought deal share offering at a price of \$17.00 per common share for total gross proceeds to the Company in the amount of \$58,650. In conjunction with the offering the Company incurred share issue costs of approximately \$2,779 for total net proceeds amounting to \$55,871. In addition, an amount of \$1,126 was generated from stock option exercises and the issuance of common shares under the stock purchase plan for cash, offset by \$72 used by the Company to repurchase 4,500 of its own common shares under the terms of the normal course issuer bid. 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.

#### **2009 - Acquisition of Isotechnika Inc.**

On June 18, 2009, the Company acquired all the issued and outstanding shares of Isotechnika Inc. ("Isotechnika")(TSX:ISA) in accordance with a court supervised Plan of Arrangement. As part of the transaction the Company paid \$7,594 in cash and Isotechnika entered into a collaborative research and development agreement with Isotechnika Pharma Inc. ("IsoPharma") in exchange for supporting research and development services for the commercialization of voclosporin, Isotechnika's next-generation calcineurin inhibitor, in Canada, Mexico, Central & South America, Israel and South Africa ("Paladin-acquired territories"). The research and development services extend for a period of seven years and included an amount of \$4,350 payable by the Company to IsoPharma over the next 12 months. Furthermore, the Research and Development Agreement in conjunction with the Company's Licence Agreement for voclosporin in the Paladin acquired territories, contains certain other voclosporin research, development and commercialization payment arrangements including possible licensing and royalty revenue payments over the remaining period. As at September 30, 2009, the Company has expensed \$1,037 to IsoPharma with respect to these research and development services.

As part of the acquisition, the Company received the international rights to a portfolio of products under development and a commercialized diagnostic product portfolio and has also assumed an obligation to pay out certain future contractually pre-defined amounts over a period of seven years, currently estimated to amount to approximately \$5,950. While the Company believes, based on historical sales of the product, current expenditure levels and market conditions that it will make payments estimated to total \$5,950 over the seven year period pursuant to its Research and Development Agreement, it is reasonably possible, based on existing knowledge, that changes in future conditions could require a material change in the recognized amount. As at September 30, 2009, the Company has not disbursed any funds with respect to these Research and Development payments. Furthermore, as part of the purchase price, the Company received 24,921,312 common shares, representing a 19 percent interest in IsoPharma as at the date of acquisition, with an approximate value of \$4,348 using the weighted average trading price of the common shares on the TSX for the 20 trading days pre and post acquisition. In connection with the acquisition, the Company has incurred transaction costs in the amount of \$530 included in the purchase price below. Isotechnika Inc. is an international biopharmaceutical company dedicated to the discovery, development and commercialization of novel immunosuppressive therapeutics for the treatment of autoimmune diseases

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

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

#### **2008 - Acquisition of Virexx Medical Corp.**

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

#### **Related Party Transactions**

Joddes Limited ["Joddes"], a private Canadian corporation, together with its affiliates, own in aggregate approximately 38% of the outstanding shares of the Company and one director of the Company, the Company's President and CEO, is related to this group.

The Company engages a wholly-owned subsidiary of Joddes to provide logistics services including: customer service, warehousing, shipping, invoicing, collection services and certain manufacturing and selling services on behalf of the Company. The Company also engages this affiliate to perform certain research and development services on a contractual pay-for-use basis. The Company also leases its office facilities from another wholly-owned subsidiary of Joddes. This lease is for a period of 10 years, ending in 2013 and includes minimum annual payments for a total remaining committed amount of \$748 as at September 30, 2009 and is included in the purchase and service based commitments amount as set out in the "Contractual Obligations and Commitments" section below.

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

Effective November 1, 2006, the Company acquired the Canadian distribution rights to Metadol® from a wholly-owned subsidiary of Joddes for cash consideration of \$15,000. Under the terms of the agreement, the Company can purchase the Canadian license for Metadol® 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, 2009, the Company has not received or earned any reimbursement. The acquisition of the Canadian distribution rights to Metadol® was not in the normal course of operations and was recorded at an agreed upon exchange amount in accordance with the requirements of accounting standard CICA 3840.

All transactions with related parties except for the Metadol® 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 Company owns a 19% shareholder interest in Isotechnika Pharma Inc. ["IsoPharma"] and considers it a related party. Please refer to Note 4 for further information regarding detailed transactions and agreements with this related party.

The table below reflects all transactions and services with all 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	
	2009	2008	2009	2008
	\$	\$	\$	\$
Revenues	<b>954</b>	882	<b>2,835</b>	2,659
Purchases	<b>1,616</b>	3,634	<b>4,870</b>	11,175
Sales and marketing expenses	<b>1,604</b>	1,328	<b>4,276</b>	3,407
Research and development expenses	<b>1,146</b>	109	<b>1,420</b>	335
General and administrative expenses	<b>132</b>	94	<b>417</b>	296

### Quarterly Information (unaudited)

(In thousands of Canadian dollars except per share information)

	Q3	Q2	Q1	Q4	Q3	Q2	Q1	Q4
	F2009	F2009	F2009	F2008	F2008	F2008	F2008	F2007
Revenues	<b>28,374</b>	26,255	25,815	23,051	22,191	20,668	16,834	17,697
EBITDA <sup>1</sup>	<b>10,161</b>	8,410	10,955	7,415	9,189	6,997	5,419	4,925
Earnings before income taxes	<b>4,212</b>	3,051	4,844	3,512	5,975	4,067	2,483	2,500
Net Income before extraordinary gain	<b>2,564</b>	1,771	3,052	2,044	3,617	2,588	1,477	1,030
Net Income	<b>2,564</b>	27,730	3,052	6,116	3,617	2,588	1,477	1,030
Earnings per share before extraordinary gain	<b>\$0.14</b>	\$0.11	\$0.20	\$0.14	\$0.24	\$0.17	\$0.10	\$0.07
Earnings per share	<b>\$0.13</b>	\$1.77	\$0.20	\$0.41	\$0.24	\$0.17	\$0.10	\$0.07
Diluted earnings per share before extraordinary gain	<b>\$0.14</b>	\$0.11	\$0.20	\$0.14	\$0.24	\$0.17	\$0.10	\$0.07
Diluted earnings per share	<b>\$0.13</b>	\$1.71	\$0.20	\$0.41	\$0.24	\$0.17	\$0.10	\$0.07

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

### Off-Balance Sheet Arrangements

The Company's off balance sheet arrangements consist of contractual obligations and agreements for development, sales, marketing and distribution rights to innovative drug products. The effect of terminating these arrangements under normal operating circumstances consists of an effective transition of the remaining responsibilities and obligations to the licensor under agreed upon time frames and conditions. Please refer to this section below or note 6 of the Company's unaudited interim consolidated financial statements for additional details. Other than these contractual obligations and commitments, the Company does not have any off-balance sheet arrangements that have, or are reasonably likely to have, a current or future effect on the Company's financial condition, changes in revenues or expenses, results of operations, liquidity, capital expenditures, or capital resources that are material to investors.

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

### Concentration of Credit Risk and Major Customers

The Company's cash and cash equivalents, short-term and long-term investments are held through various institutions. Marketable securities are mainly investments in liquid, high-grade investment securities. They

are subject to minimal risk of changes in value and have an original maturity from four months to twenty-one months from the date of purchase. Marketable securities are substantially all invested with large Canadian financial institutions.

The Company is exposed to credit risk from our customers and continually monitors its customers' credit. It establishes the provision for doubtful accounts based upon the credit risk applicable to each customer. For the three-month period ended September 30, 2009, two customers, a major wholesale distributor and a major retail chain, represented 29% and 17% of revenues, respectively [2008 – 36% and 15%]. For the nine-month period ended September 30, 2009, two customers, a major wholesale distributor and a major retail chain, represented 28% and 15% of revenues, respectively [2008 – 33% and 16%]. As at September 30, 2009, two customers, a major wholesale distributor and a major retail chain, represented 39% and 10% of trade accounts receivable, respectively [2008 – 46% and 15%]. For a more detailed analysis and disclosure of credit risk please refer to note 7 to the quarterly unaudited consolidated financial statements.

### **Liquidity risk**

The Company generates sufficient cash from operating activities to fund its operations and fulfill its obligations as they become due. The Company has sufficient funds available through its cash, cash equivalents and marketable securities, should its cash requirements exceed cash generated from operations to cover all financial liability obligations. As at September 30, 2009, there were no restrictions on the flow of these funds nor have any of these funds been committed in any way, except as set out in the “Contractual Obligations and Commitments” section below and note 10 to the unaudited interim consolidated financial statements.

### **Foreign exchange risk**

The Company principally operates within Canada, however, a portion of the Company's revenues, expenses, and current assets and liabilities, are denominated in United States dollars (“USD”) and EURO. This results in financial risk due to fluctuations in the value of the USD and EURO relative to the Canadian dollar (“CAD”). The Company currently does not use derivative financial instruments to reduce its foreign exchange exposure. Based on the net exposure described in note 7 to the unaudited interim consolidated financial, and assuming that all other variables remain constant, a ten-point increase or decrease in the CAD/USD and CAD/EURO exchange rates would have an effect of \$309 on net earnings.

### **Interest rate risk**

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

### **Risk Factors**

For a more detailed discussion of the risk factors that could materially affect the results of operations and the financial condition of the Company, please refer to the Company's Annual Information Form.

### **Internal Control Over Financial Reporting**

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

### **Contractual Obligations and Commitments**

In the normal course of business, Paladin secures development, sales, marketing and distribution rights to innovative drug products and has entered into various agreements, which include contractual obligations extending beyond the current year. The Company is committed to making minimum purchases of inventory, and minimum expenditures for regulatory, selling and marketing services in the amount of \$26,699, including €4,231, to retain exclusive distribution agreements for certain products. These commitments end in 2015 and annual commitments are as follows:

<b>Contractual Obligations</b>	<b>Total</b>	<b>Less than 1 year</b>	<b>1-3 years</b>	<b>4-5 years</b>	<b>After 5 years</b>
Purchase and service based commitments (\$)	<b>26,699</b>	3,726	19,469	2,442	1,062

In addition, under certain agreements, Paladin may have to pay additional consideration should the Company achieve certain sales volumes or if certain milestones are met, such as regulatory approval in Canada. The Company may have to pay up to \$23,878 including US\$12,492, €1,193 and GBP£500 over a maximum period of 15 years if it achieves certain product, regulatory or sales milestones on specific products in the future. The Company has the following commitments related to product license, trademark and distribution agreements:

<b>Commitments</b>	<b>Total</b>	<b>Less than 1 year</b>	<b>1-3 years</b>	<b>4-5 years</b>	<b>After 5 years</b>
Milestone based commitments (\$)	<b>16,179</b>	6,658	4,039	1,035	4,447
Revenues based commitments (\$)	<b>7,699</b>	—	2,804	127	4,768

The Company, as further discussed, has issued a bank guarantee of \$655 plus accrued interest to the Ontario Minister of Finance during the quarter ended September 30, 2009. The bank guarantee will expire on February 1, 2010 and the amount and timing of any withdrawals are not determinable. The bank guarantee is guaranteed by one of the Company's bankers.

### **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 and on July 22, 2009, the Company received a further notice of assessment from CRA for the taxation year ending December 31, 2008. The notices of assessment and re-assessment, if they stood, amount to additional Canadian federal tax due of approximately \$5,641 plus interest and penalties of approximately \$1,733. On October 30, 2008, the Company received a Notice of Reassessment from the Ontario Minister of Finance for the taxation year ended August 16, 2005 for additional taxes, due of \$747 plus interest and penalties of \$378. It is likely that the Quebec provincial tax authorities will propose similar adjustments as a result of the CRA re-assessments. As such the Company estimates the total tax liability exposure to the federal and relevant provincial governments as a result of the CRA's position to be approximately \$11,625 including interest and penalties.

The Company disagrees with the position taken by the CRA and believes it is without merit. On October 23, 2008, the Company filed a Notice of Objection through the CRA appeals process and intends to pursue further through the courts, if necessary. The Ontario Minister of Finance has agreed to be bound by the decision of the CRA appeals process.

Under the terms of the Share Purchase Agreement ("SPA") for Squire, Nuvo provided representations and warranties with respect to the status of the Squire tax accounts and certain tax asset values whereby, if the amounts represented are incorrect then Nuvo is required to indemnify the Company. The Company also holds indemnities from Nuvo relating to all costs relating to reassessment including advisory fees, interest and penalties, as applicable. In the event of an unfavorable ruling, the Company intends to claim at least \$7,907 from Nuvo under the SPA.

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

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

In connection with the appeals process, in the notice of re-assessment, the Company is required to post a deposit of up to one half of the tax and interest assessed. To that effect the Company deposited \$3,752 to the CRA and \$500 to the Ontario Minister of Finance during the year ended December 31, 2008, and may make a claim from Nuvo under the SPA. In addition, the Company has issued a bank guarantee of \$655 plus accrued interest to the Ontario Minister of Finance during the quarter ended September 30, 2009.

If the Company is successful in its appeal of the re-assessment these amounts will be refunded to the Company with accrued interest.

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

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

The consolidated financial statements of Paladin Labs Inc. (the “**Company**”) and the accompanying interim consolidated balance sheet as at September 30, 2009 and the interim consolidated statements of income, cash flows, comprehensive income, accumulated other comprehensive (loss) income and retained earnings for the three-month period then ended are the responsibility of the Company’s management. These consolidated financial statements have not been audited or reviewed on behalf of the shareholders by the independent external auditors, Ernst & Young LLP.

The interim consolidated financial statements have been prepared by management and include the selection of appropriate accounting principles, judgments and estimates necessary to prepare these financial statements in accordance with Canadian generally accepted accounting principles. Management has determined such amounts on a reasonable basis in order to ensure that the consolidated financial statements are presented fairly in all material respects. The Company’s accounting procedures and related systems of internal controls are designed to provide a reasonable assurance that its assets are safeguarded and its financial records are reliable. Readers are cautioned that these interim consolidated statements may not be appropriate for their purposes.

*(signed) Jonathan Ross Goodman*  
\_\_\_\_\_  
Jonathan Ross Goodman, B.A., LL.B, M.B.A.  
President and Chief Executive Officer

Montreal, Canada  
November 10, 2009

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

Montreal, Canada  
November 10, 2009

## CONSOLIDATED BALANCE SHEETS

[In thousands of Canadian dollars]

	September 30 2009 (unaudited)	December 31 2008 (audited <sup>3</sup> )
<b>ASSETS</b>		
<b>Current</b>		
Cash and cash equivalents	20,525	4,646
Marketable securities	65,450	14,753
Accounts receivable [note 7]	20,492	17,889
Inventories	11,352	8,643
Other current assets	2,350	2,531
Income taxes receivable [note 10]	4,410	4,209
Investment tax credits receivable	56	36
Investment tax credits recoverable	—	43
Future income tax assets	8,115	9,120
<b>Total current assets</b>	<b>132,750</b>	<b>61,870</b>
Long-term marketable securities	11,656	1,943
Property, plant and equipment	606	594
Pharmaceutical product licences and rights	46,056	58,152
Investments	540	4,792
Investment tax credits recoverable	15,721	—
Future income tax assets	29,842	4,789
<b>Total assets</b>	<b>237,171</b>	<b>132,140</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Current</b>		
Accounts payable and accrued liabilities	19,382	16,464
Accounts payable to related parties	1,535	1,384
Deferred revenue	—	1,693
Income taxes payable	6,193	6,391
Balance of sale payable	11,576	10,429
Future income tax liabilities	—	90
<b>Total current liabilities</b>	<b>38,686</b>	<b>36,451</b>
<b>Long-term</b>		
Future income tax liabilities	4,259	341
Balance of sale payable [note 5]	4,837	—
<b>Total liabilities</b>	<b>47,782</b>	<b>36,792</b>
<b>Shareholders' equity</b>		
Capital stock [note 3]	119,009	60,664
Other paid-in capital	4,179	3,155
Accumulated other comprehensive (loss) income	(51)	(1,420)
Retained earnings	66,252	32,949
<b>Total shareholders' equity</b>	<b>189,389</b>	<b>95,348</b>
<b>Total liabilities and shareholders' equity</b>	<b>237,171</b>	<b>131,799</b>

See accompanying notes

<sup>3</sup> Derived from the audited annual financial statements filed on SEDAR at [www.sedar.com](http://www.sedar.com)

## 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	
	2009	2008	2009	2008
Revenues	28,374	22,191	80,414	59,693
Cost of sales	7,676	5,442	21,399	14,839
<b>Gross profit</b>	<b>20,698</b>	16,749	<b>59,015</b>	44,854
<b>Expenses (income)</b>				
Selling and marketing	6,455	5,443	18,851	16,545
General and administrative	1,904	1,814	6,235	5,180
Research and development	2,348	828	4,869	2,949
Interest income, net	(170)	(406)	(462)	(1,310)
<b>Earnings before under-noted items</b>	<b>10,161</b>	9,070	<b>29,522</b>	21,490
Amortization of pharmaceutical product licenses, rights and deferred charges	6,389	3,171	18,453	9,231
Unrealized net (gain) loss on derivative financial instruments	—	59	(358)	(4)
Net (gain) loss on investments	(11)	184	(145)	184
Foreign exchange net loss (gain)	128	(119)	132	(116)
Other income	(557)	(200)	(667)	(330)
<b>Income before income taxes</b>	<b>4,212</b>	5,975	<b>12,107</b>	12,525
<b>Provision for income taxes</b>				
Current	1,572	1,450	(462)	3,743
Future	76	908	5,182	1,100
	<b>1,648</b>	2,358	<b>4,720</b>	4,843
<b>Net income before extraordinary gain</b>	<b>2,564</b>	3,617	<b>7,387</b>	7,682
Extraordinary gain (net of \$nil taxes) [note 4]	—	—	25,959	—
<b>Net income for the period</b>	<b>2,564</b>	3,617	<b>33,346</b>	7,682
<b>Earnings per share before extraordinary gain</b>				
Basic	0.14	0.24	0.45	0.52
Diluted	0.13	0.24	0.44	0.51
<b>Earnings per share</b>				
Basic	0.14	0.24	2.03	0.52
Diluted	0.13	0.24	1.98	0.51
<b>Weighted average number of shares outstanding</b>				
Basic	18,501,987	14,857,150	16,392,384	14,839,187
Diluted	19,059,385	15,065,359	16,866,256	15,072,712

*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	
	2009	2008	2009	2008
<b>Operating activities</b>				
Net income	2,564	3,617	33,346	7,682
Add items not affecting cash				
Extraordinary gain [note 4]	—	—	(25,959)	—
Amortization	6,476	3,261	18,663	9,367
Future income taxes	76	908	5,182	1,100
Stock based compensation expense [note 3]	483	340	1,572	1,049
Unrealized net (gain) loss on derivative financial instruments	—	59	(359)	(4)
Net (gain) loss on investments	(11)	184	(145)	184
Gain on disposal of pharmaceutical product licenses and rights	(557)	200	(557)	200
Net accreted interest	98	(82)	97	(119)
	9,129	8,087	31,840	19,059
Net change in non-cash balances relating to operations	(3,051)	(4,787)	(6,216)	(4,341)
<b>Cash flows from operating activities</b>	<b>6,078</b>	<b>3,300</b>	<b>25,624</b>	<b>14,718</b>
<b>Investing activities</b>				
Additions to pharmaceutical product licenses and rights, and deferred charges	—	(10,468)	(5,476)	(19,335)
Investments in portfolio company	—	(2,000)	(130)	(3,000)
Acquisition of property, plant and equipment	(115)	(86)	(224)	(397)
Purchases of short-term marketable securities	(28,624)	(3,895)	(71,974)	(29,023)
Maturities of short-term marketable securities	13,781	9,546	25,079	35,717
Purchases of long-term marketable securities	(2,567)	(1,895)	(13,771)	(1,895)
Proceeds from the disposal of investments	—	500	6,979	500
Proceeds from the disposal of pharmaceutical product licenses and rights	442	200	442	200
Business acquisition [note 4]	—	—	(7,594)	—
Balance of sale payable	—	(531)	—	(531)
<b>Cash flows used in investing activities</b>	<b>(17,083)</b>	<b>(8,629)</b>	<b>(66,669)</b>	<b>(17,764)</b>
<b>Financing activities</b>				
Net proceeds on issuance of common shares	248	181	56,997	955
Repurchase of shares	(72)	(463)	(72)	(2,270)
<b>Cash flows from (used in) financing activities</b>	<b>176</b>	<b>(282)</b>	<b>56,925</b>	<b>(1,315)</b>
<b>Net change in cash and cash equivalents during the period</b>	<b>(10,829)</b>	<b>(5,611)</b>	<b>15,880</b>	<b>(4,361)</b>
Cash and cash equivalents, beginning of period	31,354	7,324	4,645	6,074
<b>Cash and cash equivalents, end of period</b>	<b>20,525</b>	<b>1,713</b>	<b>20,525</b>	<b>1,713</b>
Cash and cash equivalents	20,525	1,713		
Short-term marketable securities	65,450	23,569		
Long-term marketable securities	11,656	1,895		
	97,631	27,177		

See accompanying notes

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME, ACCUMULATED OTHER COMPREHENSIVE (LOSS) INCOME, AND RETAINED EARNINGS

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

	Three-month period ended September 30		Nine-month period ended September 30	
	<b>2009</b>	2008	<b>2009</b>	2008
<b>Net income for the period</b>	<b>2,564</b>	3,617	<b>33,346</b>	7,682
<b>Other comprehensive (loss) income:</b>				
Change in fair value of available-for-sale financial instruments [net of taxes of \$14 for the three-month period [2008 – \$116] and (\$15) for the nine-month period [2008 – (\$197)]]	<b>(80)</b>	552	<b>94</b>	(883)
Reclassification adjustment for (losses) gains on available-for-sale financial instruments included in net income in the current period [net of taxes of \$13 for the three-month period [2008 – (\$2)] and (\$203) for the nine-month period [2008 – (\$10)]]	<b>(75)</b>	(8)	<b>1,275</b>	(45)
<b>Other comprehensive (loss) income for the period</b>	<b>(155)</b>	544	<b>1,369</b>	(928)
<b>Comprehensive income for the period</b>	<b>2,409</b>	4,161	<b>34,715</b>	6,754
<b>Accumulated other comprehensive income (loss), beginning of period</b>	<b>104</b>	(1,796)	<b>(1,420)</b>	(324)
Other comprehensive (loss) income for the period	<b>(155)</b>	544	<b>1,369</b>	(928)
<b>Accumulated other comprehensive (loss) income, end of period</b>	<b>(51)</b>	(1,252)	<b>(51)</b>	(1,252)
<b>Retained earnings, beginning of period</b>	<b>63,731</b>	23,501	<b>32,949</b>	20,508
Net income for the period	<b>2,564</b>	3,617	<b>33,346</b>	7,682
Excess of purchase price over stated capital of common shares cancelled	<b>(43)</b>	(285)	<b>(43)</b>	(1,357)
<b>Retained earnings, end of period</b>	<b>66,252</b>	26,833	<b>66,252</b>	26,833

*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 amalgamated under the Canada Business Corporations Act, focused on developing, acquiring, marketing and distributing innovative pharmaceutical products. Paladin Labs Inc., together with its subsidiaries, is hereinafter referred to as the “Company”.

## 2. Basis of Presentation and Accounting policies

The unaudited interim consolidated financial statements have been prepared by the Company in accordance with Canadian generally accepted accounting principles (“GAAP”) applicable to interim financial statements and include the accounts of all its subsidiaries. Accordingly, they do not include all the information and disclosures required according to GAAP for annual financial statements and should be read in conjunction with the Company’s audited consolidated financial statements and notes thereto in the Company’s Annual Report for the year ended December 31, 2008.

Information with respect to the December 31, 2008 balance sheet is derived from the Company’s complete audited consolidated financial statements. The accounting policies underlying these interim financial statements are those set forth in note 2 of the audited consolidated financial statements for the year ended December 31, 2008.

### Changes in accounting policies

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

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

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

## 3. Capital Stock

### Authorized

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

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

#### Issued and outstanding

	Number of shares	Amount
<b>Balance at beginning of year</b>	<b>14,921,446</b>	<b>\$60,664</b>
Issued upon exercise of stock options	139,917	1,554
Issued under employee share purchase plan	9,324	141
Issued upon common share offering <sup>4</sup>	3,450,000	56,632
Purchase of shares <sup>5</sup>	(4,500)	(29)
<b>Balance at September 30, 2009</b>	<b>18,516,187</b>	<b>\$118,962</b>

#### Stock option plan

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

	2009		2008	
	#	Weighted average exercise price \$	#	Weighted average exercise price \$
<b>Balance at beginning of year</b>	<b>1,067,948</b>	<b>9.03</b>	1,002,844	7.73
Granted	420,000	13.09	342,935	10.86
Exercised	(139,917)	7.18	(156,840)	5.64
Expired or forfeited	(40,638)	11.83	(57,425)	9.92
<b>Balance at September 30</b>	<b>1,307,393</b>	<b>10.45</b>	1,131,514	8.86
<b>Options exercisable at September 30</b>	<b>374,935</b>	<b>7.68</b>	449,749	6.66

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

	Three-month period ended September 30		Nine-month period ended September 30	
	2009	2008	2009	2008
Option compensation expense	<b>\$483</b>	\$344	<b>\$1,572</b>	\$1,040
Weighted average fair value of options	<b>\$8.35</b>	\$5.50	<b>\$6.17</b>	\$5.74
Weighted average risk-free interest rate	<b>3.20%</b>	3.65%	<b>2.49%</b>	3.34%
Dividend yield	<b>Nil</b>	Nil	<b>Nil</b>	Nil
Weighted average volatility factor	<b>41%</b>	44%	<b>42%</b>	47%
Weighted average expected life	<b>7 years</b>	7 years	<b>7 years</b>	7 years

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

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

<sup>5</sup> During the quarter ended September 30, 2009, under the terms of the normal course issuer bid, the Company purchased and cancelled 4,500 of its shares.

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

##### ***2009 - Isotechnika Inc. acquisition***

On June 18, 2009, the Company acquired all the issued and outstanding shares of Isotechnika Inc. ("Isotechnika")(TSX:ISA) in accordance with a court supervised Plan of Arrangement. As part of the transaction the Company paid \$7,594 in cash and Isotechnika entered into a collaborative research and development agreement with Isotechnika Pharma Inc. ("IsoPharma") in exchange for supporting research and development services for the commercialization of voclosporin, Isotechnika's next-generation calcineurin inhibitor, in Canada, Mexico, Central & South America, Israel and South Africa ("Paladin-acquired territories"). The research and development services extend for a period of seven years and included an amount of \$4,350 payable by the Company to IsoPharma over the next 12 months. Furthermore, the Research and Development Agreement in conjunction with the Company's Licence Agreement for voclosporin in the Paladin acquired territories, contains certain other voclosporin research, development and commercialization payment arrangements including possible licensing and royalty revenue payments over the remaining period. As at September 30, 2009, the Company has expensed \$1,037 to IsoPharma with respect to these research and development services.

As part of the acquisition, the Company also received the international rights to a portfolio of products under development and a commercialized diagnostic product portfolio and has also assumed an obligation to pay out certain future contractually pre-defined amounts over a period of seven years, currently estimated to amount to approximately \$5,950. While the Company believes, based on historical sales of the product, current expenditure levels and market conditions that it will make payments estimated to total \$5,950 over the seven year period pursuant to its Research and Development Agreement, it is reasonably possible, based on existing knowledge, that changes in future conditions could require a material change in the recognized amount. As at September 30, 2009, the Company has not disbursed any funds with respect to these Research and Development payments. Furthermore, as part of the purchase price, the Company received 24,921,312 common shares, representing a 19 percent interest in IsoPharma as at the date of acquisition, with an approximate value of \$4,348 using the weighted average trading price of the common shares on the TSX for the 20 trading days pre and post acquisition. In connection with the acquisition, the Company has incurred transaction costs in the amount of \$530 included in the purchase price below. Isotechnika Inc. is an international biopharmaceutical company dedicated to the discovery, development and commercialization of novel immunosuppressive therapeutics for the treatment of autoimmune diseases and for use in the prevention of organ rejection in transplantation. In addition to the Company's drug pipeline, Isotechnika also has commercialized diagnostic products.

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

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

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

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

#### ***2008 - Virexx Medical Corp. acquisition***

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

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

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

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

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

#### 5. Related party transactions

Joddes Limited ["Joddes"], a private Canadian corporation, together with its affiliates, own in aggregate approximately 38% of the outstanding shares of the Company and one director of the Company, the Company's President and CEO, is related to this group.

The Company engages a wholly-owned subsidiary of Joddes to provide logistics services including: customer service, warehousing, shipping, invoicing, collection services and certain manufacturing and selling services on behalf of the Company. The Company also engages this affiliate to perform certain research and development services on a contractual pay-for-use basis. The Company also leases its office facilities from another wholly-owned subsidiary of Joddes. This lease is for a period of 10 years, ending in 2013 and includes minimum annual payments for a total remaining committed amount of \$748 as at September 30, 2009 and is included in the purchase and service based commitments in Note 6.

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

Effective November 1, 2006, the Company acquired the Canadian distribution rights to Metadol<sup>®</sup> from a wholly-owned subsidiary of Joddes for cash consideration of \$15,000. Under the terms of the agreement, the Company can purchase the Canadian license for Metadol<sup>®</sup> on the fourth anniversary of the agreement for \$1 and can receive a reimbursement of up to \$3,750 subject to certain acquisition related conditions. As at September 30, 2009, the Company has not received or earned any reimbursement. The acquisition of the Canadian distribution rights to Metadol<sup>®</sup> was not in the normal course of operations and was recorded at an agreed upon exchange amount in accordance with the requirements of accounting standard CICA 3840.

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

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

The Company owns a 19% shareholder interest in Isotechnika Pharma Inc. [“IsoPharma”] and considers it a related party. Please refer to Note 4 for further information regarding detailed transactions and agreements with this related party.

The table below reflects all transactions and services with all 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	
	2009	2008	2009	2008
	\$	\$	\$	\$
Revenues	954	882	2,835	2,659
Purchases	1,616	3,634	4,870	11,175
Sales and marketing expenses	1,604	1,328	4,276	3,407
Research and development expenses	1,146	109	1,420	335
General and administrative expenses	132	94	417	296

## 6. Commitments

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

### Revenue based commitments

Most pharmaceutical product license agreements require that the Company make royalty payments ranging from 10% to 20% of sales, or generally require payments for products at rates ranging from 20% to 40% of the net selling price and in certain cases require revenue sharing at various rates over and above a pre-established net sales threshold.

In addition, the Company may have to pay up to \$7,699 including US\$7,181 if it achieves specific sales volumes on specific products in the future, over a maximum of nine years.

### Milestone based commitments

The Company has also committed to fund certain research and development expenditures of third parties in the amount of \$6,727 including €1,193 over the next five years. In addition, certain additional payments may be required under these agreements if milestones are met, such as regulatory approval in Canada. Based on the outcome of these milestones, the Company may have to pay up to \$9,453, including US\$5,311 and GB£500, over a maximum period of 15 years.

## 6. Commitments (cont'd)

### 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 \$24,599, including €4,231, to retain exclusive distribution agreements for certain products. These commitments end in 2015 and annual commitments are as follows:

	\$
2009	1,626
2010	12,940
2011	5,210
2012	1,319
2013	1,307
2014 – 2015	2,197

The Company, as further discussed in Note 10, has issued a bank guarantee of \$655 plus accrued interest to the Ontario Minister of Finance during the quarter ended September 30, 2009. The bank guarantee will expire on February 1, 2010 and the amount and timing of any withdrawals are not determinable. The bank guarantee is guaranteed by one of the Company's bankers.

## 7. Financial Instruments

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

September 30, 2009	Available- for-sale	Loans and receivables	Other financial liabilities	Derivatives	Carrying value	Fair value
	\$	\$	\$	\$	\$	\$
<b>Financial assets</b>						
Cash and cash equivalents	20,525				20,525	20,525
Marketable securities	65,450				65,450	65,450
Accounts receivable		20,492			20,492	20,492
Other current assets		2,350			2,350	2,350
Long-term marketable securities	11,656				11,656	11,656
Investments	124	416			540 <sup>6</sup>	5,524 <sup>7</sup>
<b>Total</b>						
<b>financial assets</b>	<b>97,754</b>	<b>23,258</b>	—	—	<b>121,013</b>	<b>125,997</b>
<b>Financial liabilities</b>						
Accounts payable and accrued liabilities			19,382		19,382	19,382
Accounts payable to related parties			1,535		1,535	1,535
Balance of sale payable			11,576		11,576	11,513
Long-term balance of sale payable			4,837		4,837	4,478
<b>Total</b>						
<b>financial liabilities</b>	—	—	<b>37,330</b>	—	<b>37,330</b>	<b>36,908</b>

<sup>6</sup> In accordance with Section 3855, certain Company investments in private companies included in the balance above, are carried at cost as there are no quoted market prices in an active market for such equity instruments. Fair value has not been disclosed because fair value cannot be measured reliably.

<sup>7</sup> Includes the fair value of the 24,921,312 common shares in IsoPharma with a carrying value of \$nil in accordance with applicable accounting standards. Please refer to note 4 for further details.

## 7. Financial Instruments (cont'd)

December 31, 2008	Available- for-sale	Loans and receivables	Other financial liabilities	Derivatives	Carrying value	Fair value
	\$	\$	\$	\$	\$	\$
<b>Financial assets</b>						
Cash	4,646				4,646	4,646
Marketable securities	14,753				14,753	14,753
Accounts receivable		17,889			17,889	17,889
Other current assets		158			158	158
Long-term marketable securities	1,943				1,943	1,943
Investments	3,131	1,067		594	4,792 <sup>6</sup>	5,144
<b>Total</b>						
<b>financial assets</b>	<b>24,473</b>	<b>19,114</b>	<b>—</b>	<b>594</b>	<b>44,181</b>	<b>44,533</b>
<b>Financial liabilities</b>						
Accounts payable and accrued liabilities			16,464		16,464	16,464
Accounts payable to related parties			1,384		1,384	1,384
Balance of sale payable			10,429		10,429	10,429
<b>Total</b>						
<b>financial liabilities</b>	<b>—</b>	<b>—</b>	<b>28,277</b>	<b>—</b>	<b>28,277</b>	<b>28,277</b>

### Fair Value

Fair value is the amount of consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act. Fair values for marketable securities and investments classified "Available for sale" are obtained using quoted active market prices for 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 a bifurcated conversion option within a secured convertible term note in a portfolio company classified as a derivative, certain warrants in a portfolio company that were obtained using the Black-Scholes option pricing valuation model and the long-term balance of sale payable. The allocated loan portion described above classified as "Loans and receivables" is being discounted using an 11% discount rate using the effective interest rate method and the long-term balance of sale payable classified as "Other financial liabilities" is being discounted using a 2.5% discount rate, such approximating market value.

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.

## 7. Financial Instruments (cont'd)

### Concentration of credit risk and major customers

The Company's Investment Policy regulates the investment activities relating to cash resources. An Investment Committee composed of representatives from management and the Board of Directors monitors compliance with said policy. The Company invests in strategic investments in the form of equity or strictly in liquid, high-grade investment securities with varying terms to maturity from four months to twenty-four months from the date of purchase, selected with regard to the expected timing of investments and expenditures for continuing operations and prevailing interest rates.

The Company's cash and cash equivalents, short and long-term investments are held through various institutions. Marketable securities are mainly investments in liquid, high-grade investment securities. They are subject to minimal risk of changes in value. Marketable securities are substantially all invested with large Canadian financial institutions.

The Company is exposed to credit risk from our customers and continually monitors its customers' credit. It establishes the provision for doubtful accounts based upon the credit risk applicable to each customer. For the three-month period ended September 30, 2009, two customers, a major wholesale distributor and a major retail chain, represented 29% and 17% of revenues, respectively [2008 – 36% and 15%]. For the nine-month period ended September 30, 2009, two customers, a major wholesale distributor and a major retail chain, represented 28% and 15% of revenues, respectively [2008 – 33% and 16%]. As at September 30, 2009, two customers, a major wholesale distributor and a major retail chain, represented 39% and 10% of trade accounts receivable, respectively [2008 – 46% and 15%].

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

	September 30, 2009	December 31, 2008
	\$	\$
Accounts receivable	25,131	21,869
Allowance for product returns	(4,469)	(3,783)
Allowance for doubtful accounts	(170)	(197)
<b>Total accounts receivable</b>	<b>20,492</b>	<b>17,889</b>

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

	\$
<b>Balance at December 31, 2008</b>	<b>3,980</b>
Change in provision for doubtful accounts	(27)
Change in provision for product returns	686
<b>Balance at September 30, 2009</b>	<b>4,639</b>

## 7. Financial Instruments (cont'd)

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

	September 30, 2009	December 31, 2008
	\$	\$
Trade accounts receivable not past due	15,911	15,132
Trade accounts receivable past due and not provisioned		
Under 30 days	6,958	4,573
31 to 60 days	2,092	1,967
Allowance for product returns	(4,469)	(3,783)
Total accounts receivable, net of allowance for doubtful accounts and product returns	20,492	17,889

### Liquidity risk

The Company generates sufficient cash from operating activities to fund its operations and fulfill its obligations as they become due. The Company has sufficient funds available through its cash, cash equivalents and marketable securities, should its cash requirements exceed cash generated from operations to cover all financial liability obligations. As at September 30, 2009, there were no restrictions on the flow of these funds nor have any of these funds been committed in any way, except as set out in note 6 and 10.

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

### Foreign exchange risk

The Company principally operates within Canada, however, a portion of the Company's revenues, expenses, and current assets and liabilities, are denominated in United States (US) dollars and EURO. This results in financial risk due to fluctuations in the value of the US dollar and EURO relative to the Canadian dollar. The Company currently does not use derivative financial instruments to reduce its foreign exchange exposure. Fluctuations in foreign exchange rates could cause unanticipated fluctuations in the Company's operating results, financial position or cash flows. The significant balances in foreign currencies as at September 30, 2009 are as follows:

	U.S. dollars	EURO
	\$	€
Cash	2,802	359
Accounts receivable	89	538
Accounts payable and accrued liabilities	(1,119)	(137)
<b>Net Exposure</b>	<b>1,772</b>	<b>760</b>

Based on the aforementioned net exposure as at September 30, 2009, and assuming that all other variables remain constant, a ten-point increase or decrease in the CAD/USD and CAD/EURO exchange rates would have an effect of \$309 on net earnings.

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

### **Interest rate risk**

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

## **8. Management of Capital**

The Company's objectives when managing capital are:

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

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

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

## **9. Comparative figures**

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

## **10. Contingencies**

On July 25, 2008, the Company received notices of re-assessment from the Canada Revenue Agency ("CRA") relating to the taxation years ending August 16, 2005 and July 31, 2006 containing adjustments relating to the use of certain non-capital losses acquired as part of the Dimethaid Health Care Ltd. (subsequently renamed Squire Pharmaceuticals Inc. "Squire") acquisition from Nuvo Research Inc. ("Nuvo"). In addition, on August 11, 2008, the Company received a notice of assessment from CRA for the taxation year ending July 31, 2007 and on July 22, 2009, the Company received a further notice of assessment from CRA for the taxation year ending December 31, 2008. The notices of assessment and re-assessment, if they stood, amount to additional Canadian federal tax due of approximately \$5,641 plus interest and penalties of approximately \$1,733. On October 30, 2008, the Company received a Notice of Reassessment from the Ontario Minister of Finance for the taxation year ended August 16, 2005 for additional taxes, due of \$747 plus interest and penalties of \$378. It is likely that the Quebec provincial tax authorities will propose similar adjustments as a result of the CRA re-assessments. As such the Company estimates the total tax liability exposure to the federal and relevant provincial governments as a result of the CRA's position to be approximately \$11,625 including interest and penalties.

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

The Company disagrees with the position taken by the CRA and believes it is without merit. On October 23, 2008, the Company filed a Notice of Objection through the CRA appeals process and intends to pursue further through the courts, if necessary. The Ontario Minister of Finance has agreed to be bound by the decision of the CRA appeals process.

Under the terms of the Share Purchase Agreement (“SPA”) for Squire, Nuvo provided representations and warranties with respect to the status of the Squire tax accounts and certain tax asset values whereby, if the amounts represented are incorrect then Nuvo is required to indemnify the Company. The Company also holds indemnities from Nuvo relating to all costs relating to reassessment including advisory fees, interest and penalties, as applicable. In the event of an unfavorable ruling, the Company intends to claim at least \$7,907 from Nuvo under the SPA.

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

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

In connection with the appeals process, in the notice of re-assessment, the Company is required to post a deposit of up to one half of the tax and interest assessed. To that effect the Company deposited \$3,752 to the CRA and \$500 to the Ontario Minister of Finance during the year ended December 31, 2008, and may make a claim from Nuvo under the SPA. In addition, the Company has issued a bank guarantee of \$655 plus accrued interest to the Ontario Minister of Finance during the quarter ended September 30, 2009.

If the Company is successful in its appeal of the re-assessment these amounts will be refunded to the Company with accrued interest.

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

**Stock Exchange**  
Toronto Stock Exchange: PLB

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

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



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