

PALADIN LABS INC.
CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2005



Management Discussion And Analysis:

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

The following analysis explains the variations in the results of consolidated operations, financial position and cash flows for Paladin Labs Inc. (“Paladin” or the “Company”) and is current as at October 26, 2005 . This discussion should be read in conjunction with the information contained in the Company’s interim consolidated and annual financial statements and the related notes to these consolidated financial statements. As at October 26, 2005, 14,759,865 shares were issued and outstanding.

Forward-Looking Statements

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

Overview

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

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

Third quarter highlights:

- Revenues reached \$9,196, an increase of 16% over the same period last year
- Net income was \$808, a decrease of 22% over the same period last year
- Cash flows from operations reached \$3,026, a 21% increase over the same period last year
- Acquired the Canadian license to Pennsaid[®] through the acquisition of Dimethaid Health Care Ltd.
- Launched Twinject[™], a novel epinephrine auto-injector indicated for the emergency treatment of severe allergic reactions (anaphylaxis)

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

Critical Accounting Estimates

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

Acquisition of Dimethaid Health Care Ltd.

On August 16, 2005, Paladin acquired all the issued and outstanding shares of Dimethaid Health Care Ltd. (DHCL), a subsidiary of Nuvo Research Inc. (TSX: DMX), formerly Dimethaid Research Inc., for total consideration of \$8,445 consisting of \$5,748 in cash, \$2,000 for the assumption and simultaneous payment of a note payable in DHCL and a \$827 non-interest bearing balance of sale payable of which \$227 is payable in the short term and \$600 is payable the earlier of meeting certain acquisition related conditions or December 31, 2010. DHCL owns the Canadian license for Pennsaid[®], a lotion approved by Health Canada for the treatment of symptoms of knee osteoarthritis.

Results of Operations

Three-month period ended September 30, 2005 compared to three-month period ended September 30, 2004, and nine-month period ended September 30, 2005 compared to nine-month period ended September 30, 2004.

Revenues

Revenues increased \$1,258 or 16% to \$9,196 for the three-month period ended September 30, 2005 from \$7,938 for the three-month period ended September 30, 2004. For the nine-month period ended September 30, 2005, revenues increased \$3,638 or 18% to \$23,570 from \$19,932 for the nine-month period ended September 30, 2004. These increases are due primarily to strong performance from the Company's key promoted products, including Dostinex[®], Estring[®], Oxytrol[®], Plan B[®] and Twinject[™] which increased by 80% and 61% for the three and nine-month periods ended September 30, 2005, respectively, compared to the three and nine-month periods ended September 30, 2004. Additionally, the Company's acquisition of Dimethaid Health Care Ltd. effective August 16, 2005 contributed \$658 to the Company's revenues for the period since the date of acquisition (see Acquisition of Dimethaid Health Care Ltd. for additional information).

Gross Profit

Total gross profit increased \$1,160 or 20% to \$6,839 for the three-month period ended September 30, 2005 from \$5,679 for the three-month period ended September 30, 2004. For the nine-month period ended September 30, 2005, gross profit increased \$2,690 or 18% to \$17,411 from \$14,721 for the nine-month period ended September 30, 2004. Gross profit, as a percentage of revenues, increased to 74% for the three-month period ended September 30, 2005 from 72% for the three-month period ended September 30, 2004. Gross profit, as a percentage of revenues, remained steady at 74% for the nine-month period ended September 30, 2005 and the nine-month period ended September 30, 2004.

Selling and Marketing Expense

Selling and marketing expense increased \$1,364 or 72% to \$3,262 for the three-month period ended September 30, 2005 from \$1,898 for the three-month period ended September 30, 2004. For the nine-month period ended September 30, 2005 selling and marketing expense increased \$3,332 or 65% to \$8,447 from \$5,115 for the nine-month period ended September 30, 2004. Selling and marketing expense, as percentage of revenues, increased to 35% for the three-month period ended September 30, 2005 from 24% for the three-month period ended September 30, 2004. Selling and marketing expense, as percentage of revenues, increased to 36% for the nine-month period ended September 30, 2005 from 26% for the nine-month period ended September 30, 2004. These increases were primarily attributed to increased promotion activities relating to the launch of Twinject[™] and Oxytrol[®] as well as the re-launch of Plan B[®] as a non-prescription product. It is expected that selling and marketing expense, as a percentage of revenues, will remain between 35% and 40% for the year ended December 31, 2005.

General and Administrative Expense

General and administrative expense increased \$153 or 23% to \$808 for the three-month period ended September 30, 2005 from \$655 for the three-month period ended September 30, 2004. For the nine-month period ended September 30, 2005 general and administrative expense increased \$345 or 16% to \$2,469 from \$2,124 for the nine-month period ended September 30, 2004. General and administrative expense, as percentage of revenues, increased to 9% for the three-month period ended September 30, 2005 from 8% for the three-month period ended September 30, 2004. General and administrative expense, as percentage of revenues, declined to 10% for the nine-month period ended September 30, 2005 from 11% for the nine-month period ended September 30, 2004.

Research and Development Expense

Research and development expense decreased \$108 or 14% to \$666 for the three-month period ended September 30, 2005 from \$774 for the three-month period ended September 30, 2004. For the nine-month period ended September 30, 2005 research and development expense decreased \$1,173 or 48% to \$1,279 from \$2,452 for the nine-month period ended September 30, 2004. During 2005, Paladin's research and development efforts have been to search and explore potential product opportunities for internal development. Research and development expense for the three and nine-month periods ended September 30, 2004 included development expenses for PAL#1, Paladin's internally developed women's health pharmaceutical; expenses related to the preparation of New Drug Submissions for VantasTM and GlucaGen[®]; and, \$353 related to certain license payments for unapproved products.

Amortization of Intangible Assets and Deferred Charges Expense

Amortization expense increased \$164 or 15% to \$1,273 for the three-month period ended September 30, 2005 from \$1,109 for the three-month period ended September 30, 2004. For the nine-month period ended September 30, 2005, amortization expense increased \$445 or 15% to \$3,455 from \$3,010 for the nine-month period ended September 30, 2004. The increase in amortization expense for the three-month period ended September 30, 2005 relates mainly to the amortization of the Canadian license to Pennsaid[®] (See Acquisition of Dimethaid Health Care Ltd. for additional information). The increase in amortization expense for the nine-month period ended September 30, 2005 is primarily a result of the Company's decision to reduce the estimated useful life of the carrying value of the intellectual property associated with products which may be genericized as well as the amortization of the Canadian license to Pennsaid[®] (See Acquisition of Dimethaid Health Care Ltd. for additional information).

Interest Income

Interest income increased \$72 or 27% to \$339 for the three-month period ended September 30, 2005 from \$267 for the three-month period ended September 30, 2004. For the nine-month period ended September 30, 2005, interest income increased \$100 or 12% to \$966 from \$866 for the nine-month period ended September 30, 2004. This increase reflects the higher interest rates and average cash and marketable securities balances over the three and nine-month periods ended September 30, 2005 compared to the three and nine-month periods ended September 30, 2004.

Other Income

Other income was \$37 and \$147 for the three and nine-month periods ended September 30, 2005, respectively. Other income relates to certain product marketing agreements under which the Company earns a service fee for marketing activities performed by the Company.

Income Tax Expense

Income tax expense decreased \$74 or 16% to \$398 for the three-month period ended September 30, 2005 from \$472 for the three-month period ended September 30, 2004. For the nine-month period ended September 30, 2005, income tax expense increased \$159 or 19% to \$982 from \$823 for the nine-month period ended September 30, 2004. For the three and nine-month periods ended September 30, 2005 the effective tax rate was 33% and 34%, respectively, compared to 31% and 29% for the three and nine-month periods ended September 30, 2004.

Net Income

Due to the factors set forth above, net income decreased \$230 to \$808 for the three-month period ended September 30, 2005 compared to net income of \$1,038 for the three-month period ended September 30, 2004 and decreased \$171 to \$1,892 for the nine-month period ended September 30, 2005 from \$2,063 for the nine-month period ended September 30, 2004.

Liquidity and Capital Resources

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

Paladin's cash, cash equivalents, short-term and long-term marketable securities decreased \$2,908 to \$39,216 at September 30, 2005 from \$42,124 at December 31, 2004. This decrease is primarily due to the \$7,748 cash investment in Dimethaid Health Care Ltd. (See Acquisition of Dimethaid Health Care Ltd. for additional information) offset by cash flows generated from operations.

Working capital increased \$3,177 to \$42,886 at September 30, 2005 from \$39,709 at December 31, 2004. This increase is primarily due to increased cash, cash equivalents, and short-term and long-term marketable securities position generated from operations as well as a decrease in long-term marketable securities.

Cash flows from operating activities increased 21% to \$3,026 from \$2,493 for the three-month period ended September 30, 2005 and 2004, respectively. For the nine-month period ended September 30, 2005 and 2004 cash flows from operating activities were \$7,098 and \$598, respectively. Cash flows from operating activities represent the cash flows from net earnings, excluding revenues and expenses not affecting cash, principally amortization, future income taxes, and stock based compensation expense.

Cash flows used in investing activities were \$6,684 and \$2,136 for the three-month periods ended September 30, 2005 and 2004, respectively. During the three month period ended September 30, 2005, the Company invested \$7,748 for the acquisition of Dimethaid Health Care Ltd. (See Acquisition of Dimethaid Health Care Ltd. for additional information), and \$202 in acquisitions of pharmaceutical product licenses, rights and intellectual property, offset by cash flows generated from maturing marketable securities. For the three-month period ended September 30, 2004, the Company invested \$1,468 in long-term marketable securities and \$519 in acquisitions of pharmaceutical product licenses, rights and intellectual property.

Cash flows used in investing activities were \$5,228 for the nine-month period ended September 30, 2005 compared to cash flows from investing activities of \$5,058 for the nine-month period ended September 30, 2004. During the nine-month period ended September 30, 2005, the Company invested \$7,748 for the acquisition of Dimethaid Health Care Ltd. (See Acquisition of Dimethaid Health Care Ltd. for additional information), \$1,211 in acquisitions of pharmaceutical product licenses, rights and intellectual property offset by cash flows generated from maturing marketable securities. For the nine-month period ended September 30, 2004, the Company invested \$2,460 in acquisitions of pharmaceutical product licenses, rights and intellectual property offset by cash flows generated from maturing marketable securities.

Cash flows from financing activities were \$18 for the three-month period ended September 30, 2005. For the three-month period ended September 30, 2004, \$1,025 was used for financing activities. During the three-month period ended September 30, 2005, \$18 was generated by the issuance of common shares for cash. For the three-month period ended September 30, 2004, accounts payable related to pharmaceutical product licenses decreased by \$1,039 offset by \$14 generated by the issuance of common shares for cash.

Cash flows used in financing activities were \$1,018 and \$3,235 for the nine-month periods ended September 30, 2005 and 2004, respectively. During the nine-month period ended September 30, 2005, under the terms of the normal course issuer bid, the Company repurchased 107,500 of its own shares for \$482. In addition, accounts payable related to pharmaceutical product licenses decreased by \$598, offset by \$62 generated by the issuance of common shares for cash and a repayment of a share purchase loan. For the nine-month period ended September 30, 2004, accounts payable related to pharmaceutical product licenses decreased by \$3,522 offset by \$287 was generated by the issuance of common shares for cash and a repayment of a share purchase loan.

Related Party Transactions

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

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

The Company also engages this affiliate to perform certain research and development services. These service contracts are on a pay-for-use basis. The Company also leases its office facilities from another wholly owned subsidiary of JODDES. This lease is for a period of 2 years and includes minimum payments of \$133.

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

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

| | Three-month period ended | | Nine-month period ended | |
|-------------------------------------|--------------------------|-------|-------------------------|-------|
| | September 30 | | September 30 | |
| | 2005 | 2004 | 2005 | 2004 |
| | \$ | \$ | \$ | \$ |
| Revenues | 182 | 805 | 557 | 1,308 |
| Purchases | 2,450 | 2,901 | 4,780 | 8,288 |
| Research and development expenses | 35 | 96 | 148 | 318 |
| Sales and marketing expenses | 494 | 436 | 1,314 | 1,115 |
| General and administrative expenses | 72 | 65 | 215 | 212 |

Risk Factors

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

Subsequent Event

On October 26, 2005 the Company signed a License and Distribution agreement with Duramed Pharmaceuticals, Inc., a wholly-owned subsidiary of Barr Pharmaceuticals, Inc., which grants Paladin an exclusive license to seek approval for and to market Seasonale[®], an extended-cycle oral contraceptive, in Canada. Under the contract, the Company paid an initial licensing fee of US\$100 and may be required to make additional payments if certain regulatory or sales volume milestones are met. Based on the outcome of these milestones, the Company may have to pay up to \$1,990 [US\$1,700].

Contractual Obligations and Commitments

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

| | Contractual Obligations | Commitments | |
|---|---|------------------------------------|----------------------------------|
| | Purchase and service based commitments | Milestone based commitments | Revenue based commitments |
| | \$ | \$ | \$ |
| July 1, 2005 – December 31, 2005 | 1,038 | 235 | 144 |
| Fiscal 2006 – fiscal 2008 | 6,249 | 1,849 | 854 |
| Fiscal 2008 – fiscal 2010 | 1,538 | - | 294 |
| After fiscal 2011 | 682 | 2,201 | 10,343 |
| Total | 9,507 | 4,285 | 11,635 |

**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, 2005 and the interim consolidated statements of income, retained earnings and cash flows for the three-month period then ended are the responsibility of the Company’s management. These consolidated financial statements have not been audited or reviewed on behalf of the shareholders by the independent external auditors, Ernst & Young LLP.

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

(signed) Jonathan Ross Goodman _____
Jonathan Ross Goodman, B.A., LL.B, M.B.A.
President and Chief Executive Officer
Montreal, Canada
October 26, 2005

(signed) Samira Sakhia _____
Samira Sakhia C.A., M.B.A.
Chief Financial Officer
Montreal, Canada
October 26, 2005

CONSOLIDATED BALANCE SHEET

[In thousands of Canadian dollars]

| | September 30 2005 \$ | December 31 2004 \$ |
|---|----------------------------|---------------------------|
| (unaudited) | | |
| ASSETS | | |
| Current | | |
| Cash and cash equivalents | 2,353 | 1,507 |
| Short-term marketable securities | 36,863 | 36,039 |
| Accounts receivable | 6,650 | 5,878 |
| Inventories | 2,613 | 2,718 |
| Income tax credits receivable | 827 | — |
| Other current assets | 686 | 735 |
| Future income tax assets | 1,124 | 600 |
| Total current assets | 51,116 | 47,477 |
| Long-term marketable securities | — | 4,578 |
| Property, plant and equipment | 55 | 77 |
| Intangible assets | 11,396 | 11,065 |
| Deferred charges | 3,943 | 4,176 |
| Investments | 1,434 | 1,433 |
| Future income tax credits recoverable | 457 | 439 |
| Future income tax assets | 5,214 | 1,715 |
| | 73,615 | 70,960 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current | | |
| Accounts payable and accrued liabilities | 6,251 | 4,723 |
| Accounts payable to related parties | 838 | 1,754 |
| Income taxes payable | 450 | 229 |
| Balance of license agreements payable | 464 | 1,062 |
| Balance of sale payable <i>[note 5]</i> | 227 | — |
| Total current liabilities | 8,230 | 7,768 |
| Long-Term | | |
| Balance of sale payable <i>[note 5]</i> | 470 | — |
| Shareholders' equity <i>[note 3]</i> | | |
| Capital stock | 57,482 | 57,837 |
| Other paid-in capital | 804 | 554 |
| Retained earnings | 6,629 | 4,801 |
| Total shareholders' equity | 64,915 | 63,192 |
| | 73,615 | 70,960 |

See accompanying notes

CONSOLIDATED STATEMENTS OF INCOME AND RETAINED EARNINGS

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

[unaudited]

| | Three-month period ended | | Nine-month period ended | |
|---|--------------------------|--------------|-------------------------|---------------|
| | September 30 | | September 30 | |
| | 2005 | 2004 | 2005 | 2004 |
| | \$ | \$ | \$ | \$ |
| Revenues | 9,196 | 7,938 | 23,570 | 19,932 |
| Cost of sales | 2,357 | 2,259 | 6,159 | 5,211 |
| Gross profit | 6,839 | 5,679 | 17,411 | 14,721 |
| Selling and marketing | 3,262 | 1,898 | 8,447 | 5,115 |
| General and administrative | 808 | 655 | 2,469 | 2,124 |
| Research and development | 666 | 774 | 1,279 | 2,452 |
| Amortization of intangible assets and deferred charges | 1,273 | 1,109 | 3,455 | 3,010 |
| Interest income, net | (339) | (267) | (966) | (866) |
| Other Income | (37) | — | (147) | — |
| Income before income taxes | 1,206 | 1,510 | 2,874 | 2,886 |
| Provision for income taxes | | | | |
| Current | — | 25 | — | 75 |
| Future | 398 | 447 | 982 | 748 |
| | 398 | 472 | 982 | 823 |
| Net income | 808 | 1,038 | 1,892 | 2,063 |
| Retained earnings, beginning of period | 5,821 | 2,587 | 4,801 | 1,562 |
| Purchase of common shares | — | — | (64) | — |
| Retained earnings, end of period | 6,629 | 3,625 | 6,629 | 3,625 |
| Earnings per share | | | | |
| Basic | 0.05 | 0.07 | 0.13 | 0.14 |
| Diluted | 0.05 | 0.07 | 0.13 | 0.14 |
| Weighted average number of shares outstanding [note 4] | | | | |
| Basic | 14,757,260 | 14,851,775 | 14,820,555 | 14,828,278 |
| Diluted | 14,835,682 | 14,909,415 | 14,851,610 | 14,908,868 |

See accompanying notes

CONSOLIDATED STATEMENTS OF CASH FLOWS

[In thousands of Canadian dollars]

[unaudited]

| | Three-month period ended | | Nine-month period ended | |
|--|--------------------------|--------------|-------------------------|--------------|
| | 2005 | 2004 | 2005 | 2004 |
| | \$ | \$ | \$ | \$ |
| Operating activities | | | | |
| Net income | 808 | 1,038 | 1,892 | 2,063 |
| Add items not affecting cash | | | | |
| Amortization | 1,416 | 1,124 | 3,628 | 3,057 |
| Stock based compensation expense [note 3] | 66 | 62 | 258 | 280 |
| Future income taxes | 391 | 408 | 959 | 558 |
| Unrealized foreign exchange loss (gain) | 2 | — | (15) | — |
| | 2,683 | 2,632 | 6,722 | 5,958 |
| Net change in non-cash balances relating to operations | 343 | (139) | 376 | (5,360) |
| Cash flows from operating activities | 3,026 | 2,493 | 7,098 | 598 |
| Investing activities | | | | |
| Additions to pharmaceutical product licenses, rights, intellectual property and deferred charges | (202) | (519) | (1,211) | (2,460) |
| Acquisition of property, plant and equipment | (5) | (2) | (23) | (4) |
| Purchases of short-term marketable securities | (9,632) | (7,895) | (29,550) | (24,664) |
| Maturities of short-term marketable securities | 10,903 | 7,748 | 35,287 | 36,272 |
| Purchases of long-term marketable securities | — | (1,468) | (1,983) | (4,086) |
| Business acquisition [note 5] | (7,748) | — | (7,748) | — |
| Cash flows (used in) from investing activities | (6,684) | (2,136) | (5,228) | 5,058 |
| Financing activities | | | | |
| Common shares issued for cash | 18 | 14 | 42 | 267 |
| Accounts payable related to the acquisition of intellectual property and deferred charges | — | (1,039) | (598) | (3,522) |
| Repurchase of shares | — | — | (482) | — |
| Repayment of share purchase loan | — | — | 20 | 20 |
| Cash flows from (used in) financing activities | 18 | (1,025) | (1,018) | (3,235) |
| Effect of exchange rate change on cash and cash equivalents | 1 | — | (6) | — |
| Net change in cash and cash equivalents during the period | (3,639) | (668) | 846 | 2,421 |
| Cash and cash equivalents, beginning of period | 5,992 | 5,080 | 1,507 | 1,991 |
| Cash and cash equivalents, end of period | 2,353 | 4,412 | 2,353 | 4,412 |
| Cash and cash equivalents | 2,353 | 4,412 | | |
| Short-term marketable securities | 36,863 | 30,948 | | |
| Long-term marketable securities | — | 4,086 | | |
| | 39,216 | 39,446 | | |

See accompanying notes

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

1. Basis of presentation

The consolidated financial statements of the Company have been prepared in accordance with Canadian generally accepted accounting principles (GAAP) and include the accounts of its subsidiary, Dimethaid Health Care Ltd. as of August 16, 2005, the effective date of acquisition, described in more detail in note 5. Information with respect to the December 31, 2004 balance sheet is derived from the Company's complete audited financial statements. These unaudited interim consolidated financial statements should be read in conjunction with the audited financial statements and the notes thereto in the Company's Annual Report for the year ended December 31, 2004.

2. Accounting policies

The accounting policies underlying these interim consolidated financial statements are those set forth in note 2 of the audited financial statements for the year ended December 31, 2004.

3. Capital Stock

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

Issued and outstanding:

| | Number of shares | Amount |
|---|-------------------|-----------------|
| Balance at beginning of year | 14,858,469 | \$57,837 |
| Issued under employee share purchase plan | 8,896 | 43 |
| Purchase of shares | (107,500) | (418) |
| Employee share purchase loan | — | 20 |
| Balance at September 30, 2005 | 14,759,865 | \$57,482 |

During the nine-month period ended September 30, 2005, under the terms of the normal course issuer bid, the Company repurchased and cancelled 107,500 shares.

Stock option plan

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

| | 2005 | | 2004 | |
|-------------------------------------|----------|------------------------------------|----------|------------------------------------|
| | # | Weighted average exercise price \$ | # | Weighted average exercise price \$ |
| Balance at beginning of year | 789,321 | 5.53 | 873,984 | 5.57 |
| Granted | 151,500 | 4.41 | 101,869 | 5.22 |
| Exercised | — | — | (47,590) | 4.84 |
| Expired or forfeited | (75,078) | 5.68 | (80,966) | 6.08 |
| Balance at September 30 | 865,743 | 5.32 | 847,297 | 5.52 |
| Options exercisable at September 30 | 562,217 | 5.51 | 451,453 | 5.59 |

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

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

| | Three-month period ended September 30 | | Nine-month period ended September 30 | |
|--|--|---------|---|---------|
| | 2005 | 2004 | 2005 | 2004 |
| Option compensation expense | 64 | 60 | 251 | 276 |
| Weighted average fair value of stock options | \$3.01 | \$5.40 | \$2.81 | \$3.54 |
| Weighted average risk-free interest rate | 3.63% | 4.45% | 3.83% | 3.95% |
| Dividend yield | nil | nil | nil | nil |
| Weighted average volatility factor | 60% | 63% | 61% | 66% |
| Weighted average expected life | 7 years | 7 years | 7 years | 7 years |

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

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

| | Three-month period ended | | Nine-month period ended | |
|--|--------------------------|-------|-------------------------|-------|
| | September 30 | | September 30 | |
| | 2005 | 2004 | 2005 | 2004 |
| | \$ | \$ | \$ | \$ |
| Net income as reported | 808 | 1,038 | 1,892 | 2,063 |
| Less: Amortization of fair value related to option grants | (13) | (16) | (33) | (54) |
| Amortization of fair value related to option life amendment in fiscal 2002 | (3) | (7) | (13) | (44) |
| Pro-forma net income | 792 | 1,015 | 1,846 | 1,965 |
| Basic Earnings per share | | | | |
| As reported | 0.05 | 0.07 | 0.13 | 0.14 |
| Pro-forma | 0.05 | 0.07 | 0.12 | 0.13 |
| Diluted Earnings per share | | | | |
| As reported | 0.05 | 0.07 | 0.13 | 0.14 |
| Pro-forma | 0.05 | 0.07 | 0.12 | 0.13 |

4. Earnings per share

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

| Earnings per share | Three-month period ended | | Nine-month period ended | |
|---|--------------------------|------------|-------------------------|------------|
| | September 30 | | September 30 | |
| | 2005 | 2004 | 2005 | 2004 |
| Basic weighted average number of shares outstanding | 14,757,260 | 14,851,775 | 14,820,555 | 14,828,278 |
| Dilutive effect of options | 78,422 | 57,640 | 31,055 | 80,590 |
| Diluted weighted average number of shares outstanding | 14,835,682 | 14,909,415 | 14,851,610 | 14,908,868 |

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

5. Business acquisition

On August 16, 2005, Paladin acquired all the issued and outstanding shares of Dimethaid Health Care Ltd. (DHCL), a subsidiary of Nuvo Research Inc. (TSX: DMX), formerly Dimethaid Research Inc., for total consideration of \$8,445 consisting of \$5,748 in cash, \$2,000 for the assumption and simultaneous payment of a note payable in DHCL and a \$827 non-interest bearing balance of sale payable of which \$227 is payable in the short term and \$600 is payable the earlier of meeting certain acquisition related conditions or December 31, 2010. Given the non-interest bearing nature of the \$827 balance of sale payable, the amount has been recorded in these financial statements at its discounted net present value of \$697 which will be accreted through charges to interest expense over the repayment term. Paladin also incurred transaction costs in the amount of \$0.1 million, included in cash above, in connection with the acquisition. DHCL owns the Canadian license for Pennsaid[®], a lotion approved by Health Canada for the treatment of symptoms of knee osteoarthritis.

The acquisition was accounted for using the purchase method. The results of DHCL operations have been included in the Company's results since August 16, 2005, the date of acquisition. The total purchase price was \$8.4 million and was preliminarily allocated to the identifiable net assets acquired on the basis of their fair values as follows:

| Purchase price allocation | \$ |
|---|--------------|
| Current Assets | 1,614 |
| Acquired pharmaceutical product license and rights | 2,470 |
| Future income tax asset | 5,000 |
| Current liabilities | (639) |
| Net assets acquired | 8,445 |
| Consideration represented by: | |
| Cash | 5,748 |
| Assumption and simultaneous payment of note payable | 2,000 |
| Balance of sale payable | 697 |
| | 8,445 |

The Company expects to finalize the purchase price allocation during the fourth quarter of 2005.

6. Related party transactions

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

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

The Company also engages this affiliate to perform certain research and development services. These service contracts are on a pay-for-use basis. The Company also leases its office facilities

from another wholly owned subsidiary of JODDES. This lease is for a period of 2 years and includes minimum payments of \$133.

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

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

| | Three-month period ended | | Nine-month period ended | |
|-------------------------------------|--------------------------|-------|-------------------------|-------|
| | September 30 | | September 30 | |
| | 2005 | 2004 | 2005 | 2004 |
| | \$ | \$ | \$ | \$ |
| Revenues | 182 | 805 | 557 | 1,308 |
| Purchases | 2,450 | 2,901 | 4,780 | 8,288 |
| Research and development expenses | 35 | 96 | 148 | 318 |
| Sales and marketing expenses | 494 | 436 | 1,314 | 1,115 |
| General and administrative expenses | 72 | 65 | 215 | 212 |

7. Commitments

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

Revenue based commitments

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

In addition, the Company may have to pay up to \$10,357 [US\$8,796] and \$100 if the Company achieves specific sales volumes on specific products in the future. Payments related to sales volume may be due over the next 10 years.

Milestone based commitments

The Company has also committed to fund certain research and development expenditures of third parties for \$883 [US\$750] over the next five years. In addition, additional payments maybe required under these agreements if milestones are met, such as regulatory approval in Canada. Based on the outcome of these milestones, the Company may have to pay up to \$2,578, including US\$2,118, over a maximum period of 15 years.

Purchase and service based commitments

The Company is committed to making minimum spending related to inventory purchases, regulatory, sales and marketing expenditures in the amount of \$9,507 including US\$125 in order to retain exclusive distribution agreements for certain products. These commitments end in 2011 and annual amounts are as follows:

| | \$ |
|----------------------------------|-------|
| July 1, 2005 - December 31, 2005 | 1,038 |
| 2006 | 3,291 |
| 2007 | 2,102 |
| 2008 | 856 |
| 2009 | 861 |
| 2010-2011 | 1,359 |

8. Comparative figures

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

9. Subsequent event

On October 26, 2005 the Company signed a License and Distribution agreement with Duramed Pharmaceuticals, Inc., a wholly-owned subsidiary of Barr Pharmaceuticals, Inc., which grants Paladin an exclusive license to seek approval for and to market Seasonale[®], an extended-cycle oral contraceptive, in Canada. Under the contract, the Company paid an initial licensing fee of US\$100 and may be required to make additional payments if certain regulatory or sales volume milestones are met. Based on the outcome of these milestones, the Company may have to pay up to \$1,990 [US\$1,700].

Stock Exchange

Toronto Stock Exchange: PLB

Transfer Agent

Computershare Trust Company of Canada
1500 University Street
Suite 700
Montreal, Quebec
H3A 3S8

Investor Relations

Samira Sakhia
Chief Financial Officer
Tel.: (514) 340-5067
Fax: (514) 344-4675
E-mail: info@paladin-labs.com



www.paladinlabs.com