



***paladin***

*A Leader in Specialty Pharma Innovation*



**Annual Report 2004**



# A Leader

*in Specialty Pharma Innovation*

## For the years ended December 31

*(In thousands of Canadian dollars except share and per share amounts)*

### Financial Highlights

	2004	2003	2002	2001	2000	1999	1998	1997	1996
<b>Revenues</b>	28,017	23,859	23,355	17,795	12,607	11,201	6,023	830	41
<b>Net income (loss)</b>	3,239	(4,172)	5,162	1,485	2,797	2,016	836	(1,006)	(1,868)
<b>Earnings (loss) per share (basic)</b>	0.22	(0.37)	0.12	0.12	0.24	0.22	0.13	(0.25)	(0.50)
<b>EBITDA</b>	7,633	4,564	8,377	5,040	2,905	2,873	2,555	114	(311)
<b>Cash and marketable securities</b>	42,124	44,547	45,612	22,448	24,339	9,886	8,545	563	759
<b>Shareholders' equity</b>	63,079	59,332	63,178	37,836	35,769	13,830	9,886	2,390	3,146
<b>Shares issued and outstanding</b>	14,858,469	14,799,588	14,780,205	12,539,247	12,394,038	9,466,338	9,057,731	3,990,659	3,823,991

# Financial Review

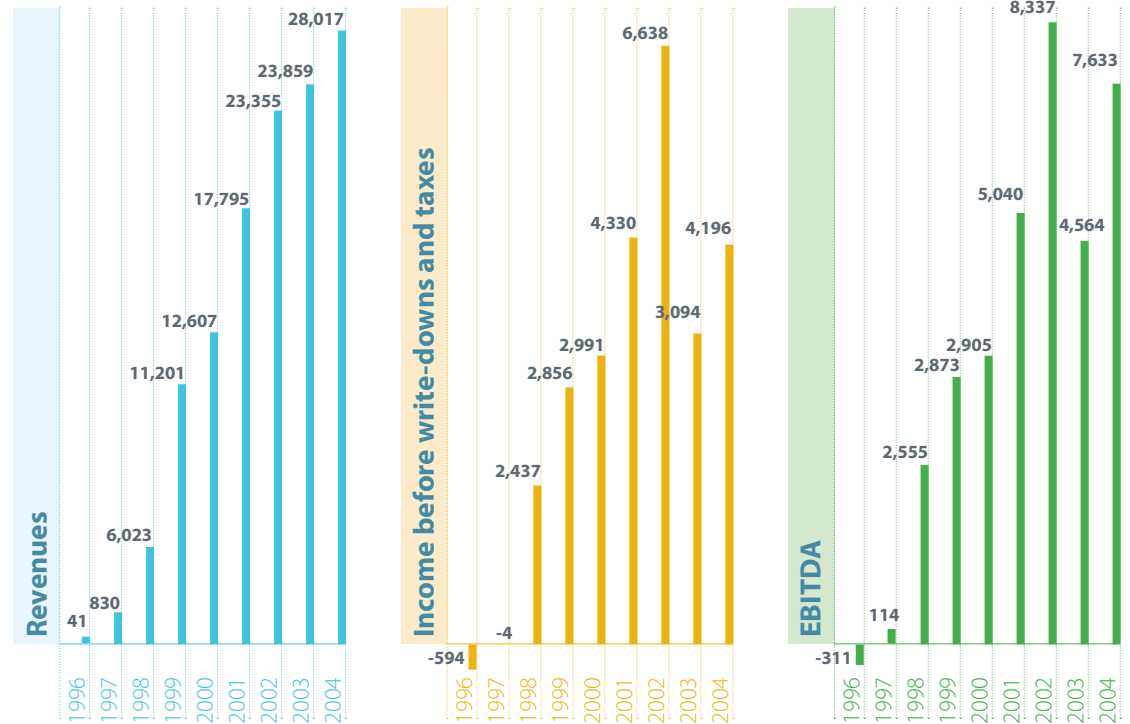
Paladin Labs Inc. is a specialty pharmaceutical company focused on marketing innovative urology, endocrinology and women's health products for the Canadian market.

Growth will be sustained through the acquisition of Canadian rights to promotion-sensitive pharmaceuticals and to promising products in late-stage clinical development.

Headquartered in Montreal, Paladin is a publicly traded company listed on the Toronto Stock Exchange (TSX) under the symbol PLB.



(In thousands of Canadian dollars)



## 2004 Operational Highlights

- JANUARY** Paladin enters into licensing agreement with Watson Pharmaceuticals for Oxytrol® in Canada
- FEBRUARY** Paladin signs exclusive distribution agreement for Replagal™ with Transkaryotic Therapies
- MAY** Health Canada proposes amendment to allow access to Plan B® without a prescription  
Paladin signs distribution agreement with Ovation Pharmaceuticals for two central nervous system drugs
- JUNE** Health Canada approves Oxytrol®
- JULY** Paladin files new drug submission for GlucaGen®  
Paladin files new drug submission for Vantas™ (Histrelin Hydrogel Implant)
- SEPTEMBER** Paladin signs marketing agreement with Duramed Pharmaceuticals for two women's health products
- OCTOBER** Paladin announces Canadian launch of Oxytrol®

**Our mission is  
to be the leader  
in specialty  
pharmaceutical  
innovation.**

**We will make a  
positive impact  
on the lives  
of patients.**

## Message to Shareholders

### **To our shareholders,**

Paladin Labs achieved its ninth consecutive year of record revenue in 2004, a performance that spans back to our founding in 1996. We have achieved this growth by consistently executing our strategy of acquiring Canadian rights to promotion-sensitive pharmaceutical brands and then leveraging our proven sales and marketing team to drive market penetration. We have also built a foundation for future growth by acquiring Canadian rights to promising products in late-stage clinical development and actively working with our partners to advance product commercialization. We enter 2005 with an extensive product portfolio of 46 marketed brands and 6 products in late-stage development. Our product portfolio covers a broad spectrum of therapeutic areas but we have developed particular strength in urology, endocrinology and women's health.

### **2004 Financial Performance**

For the year ended December 31, 2004, our revenue increased 17 percent to a record \$28.0 million compared to \$23.9 million in 2003. Sales of our key promoted brands, which include Dostinex®, Estring®, Plan B® and Oxytrol® were up 36 percent in 2004, compared to 2003. Subsequent to the end of the third quarter, Paladin announced the Canadian launch of Oxytrol®. This action will significantly strengthen our urology franchise as well as drive strong organic sales growth.

Net income for 2004 was \$3.2 million or \$0.22 per fully diluted share compared to a net loss of \$4.2 million or \$0.37 per fully diluted share in 2003. Paladin's 2004 earnings before interest, taxes, depreciation, and amortization (EBITDA) increased to \$7.6 million compared to EBITDA of \$4.6 million in 2003. Paladin's portfolio continues to generate positive cash flows from operations, which will be used to strengthen our product pipeline through acquisition of additional products.

## Expanding Our Portfolio

Our most significant product development in 2004 was the Canadian launch of Oxytrol®, a novel transdermal patch for the treatment of overactive bladder. We obtained the Canadian rights to Oxytrol® from Watson Pharmaceuticals, Inc. in January 2004 and launched the product in October 2004. Oxytrol® represents a tremendous opportunity to expand our urology franchise. According to IMS Canada, the total Canadian market for overactive bladder in 2004 was \$50 million.

Other product developments for Paladin in 2004 included: an exclusive Canadian distribution agreement with Transkaryotic Therapies, Inc. for Replagal™, an innovative, long-term enzyme replacement therapy for the treatment of Fabry disease; an exclusive Canadian distribution agreement with Ovation Pharmaceuticals, Inc. for Sabril® and Frisium®, two central nervous system pharmaceutical products; and, an exclusive Canadian marketing and promotion agreement with Duramed Pharmaceuticals, Inc., for Loestrin® and Minestrin®, two oral contraceptive pharmaceutical products.

We are also pleased to report that during 2004, Health Canada announced that it is moving forward with a proposal to amend regulations, which if approved, would allow Plan B®, an emergency contraceptive pill, to be sold in Canada on a “behind-the-counter” (BTC) basis without a physician prescription. We expect BTC approval from Health Canada in the first half of 2005. We believe that BTC status will result in increased sales for Plan B® and we are excited about the opportunity to initiate our direct-to-consumer marketing campaign.



**Jonathan Ross Goodman, B.A., LL.B., M.B.A.**

## Message to Shareholders

### Advancing Our Pipeline

In terms of our pipeline products, in 2004 we filed new drug submissions with Health Canada for GlucaGen® and Vantas™ (Histrelin Hydrogel Implant). Pending Health Canada approvals, we expect to launch GlucaGen® and Vantas™ (Histrelin Hydrogel Implant) in 2006.

GlucaGen® is an emergency treatment of hypoglycemia in insulin-dependent diabetics. According to IMS Canada, GlucaGen® will compete in a market that was valued at approximately \$5.8 million in 2004 and grew by 43 percent over the prior year. We expect that with our superior packaging and focused promotion to endocrinologists, an audience we already target, Paladin will be able to capture a significant share in this growing market.

Vantas™ (Histrelin Hydrogel Implant) is a unique, once-yearly luteinizing hormone-releasing hormone (LHRH) implant for the treatment of prostate cancer, the most prevalent form of cancer afflicting Canadian men. The once-yearly implant represents an attractive alternative to other LHRH agonists, which are administered via injection every one, three or four months. Vantas™ (Histrelin Hydrogel Implant) provides an excellent strategic fit with our strong and growing urology franchise. According to IMS Canada, in 2004 the total agonist LHRH for prostate cancer market was \$127 million and had a compound annual growth rate of 12 percent since 1999.

## Outlook

Looking ahead, we will continue to actively apply our extensive knowledge of the Canadian specialty pharmaceutical market to identify unmet needs and mobilize our resources to exploit market opportunities. We will maintain and strengthen our relationships with our physician network through the continued promotion of our existing product portfolio, and through the introduction of innovative new products.

Supported by more than \$42.1 million in cash and marketable securities as of December 31, 2004, an extensive product portfolio covering a broad spectrum of therapeutic areas, and proven pharmaceutical development and sales expertise, we are well positioned to build long-term value for our shareholders.

On behalf of our Board of Directors and employees, thank you for your continued support.

Sincerely,

A handwritten signature in black ink, appearing to read 'J. Goodman', is positioned over a light blue rectangular background.

Jonathan Ross Goodman, B.A., LL.B., M.B.A.  
President & CEO



**People and Experience**



**Highly Targeted  
Sales Force Strategy**



**Non-Traditional  
Marketing Approaches**



**New Insights into  
Pharma Strategy**

## OXYTROL®

Oxytrol® is the first and only transdermal therapy in Canada indicated for the treatment of overactive bladder (OAB) characterized by symptoms of urinary incontinence, urgency and frequency. Oxytrol® is a thin, flexible, clear patch which is applied to the abdomen, hip or buttock twice weekly. The active ingredient in Oxytrol® is oxybutynin, a medication that has been widely used in oral form for over 25 years, and is still the most prescribed OAB treatment in Canada today. The Oxytrol transdermal system delivers oxybutynin consistently and continuously through the skin into the bloodstream, bypassing the initial metabolism in the liver and the gastrointestinal tract associated with oral medications to provide relief of overactive bladder symptoms for up to four days. Clinical trials have demonstrated that Oxytrol® is well tolerated by patients, and has a favourable anticholinergic side effect profile (dry mouth, constipation and dizziness) which is comparable to placebo.

According to The Canadian Continence Foundation, approximately three million Canadians suffer from an overactive bladder, and IMS Canada indicates that the total Canadian market for overactive bladder in 2004 was \$50 million.

Oxytrol® was developed and launched in the U.S. by Watson Pharmaceuticals in April 2003. Paladin entered into a licensing agreement with Watson Pharmaceuticals in January 2004 to market Oxytrol® in Canada and launched Oxytrol® across Canada in October 2004.

Subsequent to year-end, Paladin announced that Quebec's *Conseil du médicament*, which provides drug insurance coverage for an estimated 3.2 million residents of Quebec, has given its approval to register Oxytrol® on its formulary.

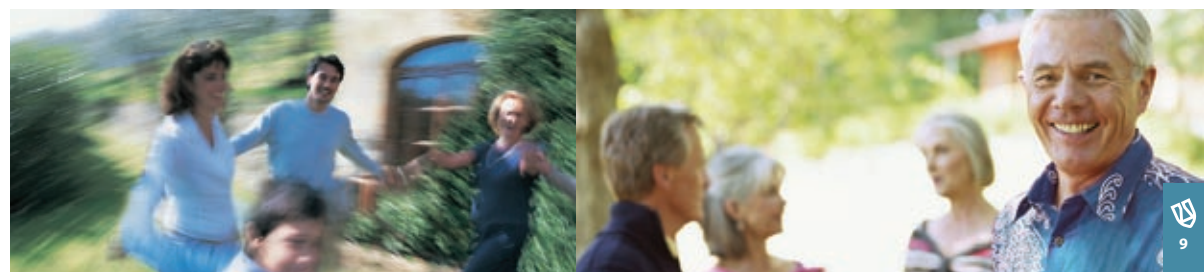


Existing →

New in 2004 →

PRODUCT	INDICATION	LICENSOR/VENDOR	PHASE I & II	PHASE III	REGULATORY APPROVAL	SALES & MARKETING
Androderm	Testosterone Deficiency	Watson Pharmaceuticals	Existing	Existing	Existing	Existing
Muse	Erectile Dysfunction	Vivus	Existing	Existing	Existing	Existing
Pacis	Bladder Cancer	Shire Pharmaceuticals	Existing	Existing	Existing	Existing
pms-Yohimbine	Alpha-adrenergic Blocking Agent	Pharmascience	Existing	Existing	Existing	Existing
Rogitine	Alpha Adrenoreceptor Antagonist	Novartis Pharmaceuticals	Existing	Existing	Existing	Existing
Urispas	Urinary Incontinence	Altana Pharma	Existing	Existing	Existing	Existing
Valtatin	Bladder Cancer	Anthra Pharmaceuticals	Existing	Existing	Existing	Existing
Oxytrol	Urinary Incontinence	Watson Pharmaceuticals	Existing	Existing	New in 2004	Existing
Vantas (Histrelin Hydrogel Implant)	Prostate Cancer	Valera Pharmaceuticals	Existing	Existing	Existing	Existing

# OXYTROL®



# Endocrinology



## DOSTINEX®

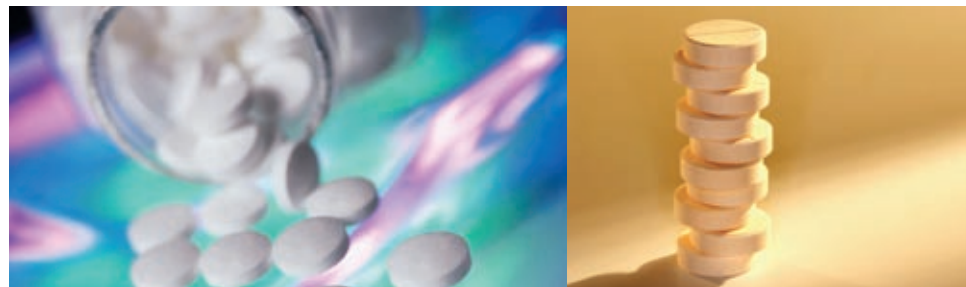
Dostinex® is indicated for the treatment of hyperprolactinemia, a chronic condition characterized by an excess secretion of the hormone prolactin. Symptoms in women include infertility, absence of menstrual periods and the discharge of breast milk. In men, hyperprolactinemia can cause lowered testosterone levels resulting in decreased libido, impotence and infertility.

Dostinex® competes in a market currently valued at \$10 million with approximately 10,000 patients being treated every year in Canada for hyperprolactinemia. Dostinex® offers superior efficacy and patient compliance compared to treatment with older therapies.

Paladin has increased Dostinex® sales at a compound annual growth rate of more than 35 percent since its acquisition from Pfizer in 2002. Paladin continued to focus its effort in 2004, building physician support for the Canadian consensus guidelines for the diagnosis and management of hyperprolactinemia, authored by four of Canada's leading endocrinologists.

Source: The prevalence of hyperprolactinemia in an unselected normal population is 0.4 percent (Billir, 1998). Based on population data taken from Statistics Canada 2002, the patient population is estimated to be 126,000.

Billir BMK, Daniels GH: Neuroendocrine regulation and diseases of the anterior pituitary and hypothalamus. In Harrison's Principles of Internal Medicine. Fourteenth edition. Edited by AS Fauci, E Braunwald, KJ Isselbacher, et al. New York, McGraw Hill, 1998, pp 1972-1999. Novel Canadian Guidelines for the Diagnosis and Management of Hyperprolactinemia, CMAJ 2003: 169(6) 575-581.



Existing →  
 New in 2004 →

PRODUCT	INDICATION	LICENSOR/VENDOR	PHASE I & II	PHASE III	REGULATORY APPROVAL	SALES & MARKETING
Dostinex	Hyperprolactinemia	Pfizer	Existing	Existing	Existing	Existing
Propyl-Thyracil	Hyperthyroidism	Merck Frosst	Existing	Existing	Existing	Existing
Tapazole	Hyperthyroidism	Eli Lilly	Existing	Existing	Existing	Existing
Replagal	Fabry Disease	Transkaryotic Therapies	New in 2004	New in 2004	New in 2004	New in 2004
Glucagen	Hypoglycemia	Novo Nordisk	Existing	Existing	Existing	Existing
Fidelin (DHEA)	Addison's Disease	Neuroscience Pharma	Existing	Existing	Existing	Existing

# DOSTINEX®



## PLAN B®

Plan B® is the only emergency contraceptive (EC) pill approved in Canada. Plan B® is indicated for use in preventing pregnancy after known or suspected contraceptive failure or unprotected sex. The simple dosing regimen comes pre-packaged with two tablets in a convenient, two-step process. The first pill must be taken within seventy-two hours of intercourse, the second, twelve hours later.

An estimated 50 percent of the approximately 470,000 pregnancies in Canada annually are unintended. Current oral EC prescriptions represent less than 10 percent of the potential market.

In 2004, the federal government, based on Health Canada's recommendation, began the final stage of regulatory change proceedings that, upon completion, will allow Plan B® (levonorgestrel) to be sold in Canada without a physician prescription. Paladin acquired the exclusive Canadian distribution rights to Plan B® in December 1999 and applied for a switch to non-prescription status in March 2002.

Source: Task Force on Postovulatory Methods of Fertility Regulation. Randomized controlled trial of levonorgestrel versus the Yuzpe regimen of combined oral contraceptives for emergency contraception. *Lancet* 1998;352:428-433.

Warner MS, Couchenour RL. *Pharmacotherapy* 2002, 22(1):43-53.

SOGC Clinical Practice Guidelines, published in the *JOGC* Np. 131, August 2003.



Existing →  
New in 2004 →

PRODUCT	INDICATION	LICENSOR/VENDOR	PHASE I & II	PHASE III	REGULATORY APPROVAL	SALES & MARKETING
Dalacin Vaginal Cream	Bacterial Vaginosis	Pfizer	Existing	Existing	Existing	Existing
Estring	Urogenital-Menopause Symptoms	Pfizer	Existing	Existing	Existing	Existing
Oesclim	Menopause Symptoms	Laboratoires Fournier	Existing	Existing	Existing	Existing
Plan B	Emergency Contraceptive	Duramed Pharmaceuticals	Existing	Existing	Existing	Existing
Prepidil	Cervical Ripening	Pfizer	Existing	Existing	Existing	Existing
Prostin	Labour Induction	Pfizer	Existing	Existing	Existing	Existing
Loestrin	Oral Contraceptive	Duramed Pharmaceuticals	Existing	Existing	Existing	Existing
Minestrin	Oral Contraceptive	Duramed Pharmaceuticals	Existing	Existing	Existing	Existing
Estradiol + Testosterone Gel	Menopause Symptoms	BioSante Pharmaceuticals	New in 2004			
Estradiol Gel	Menopause Symptoms	BioSante Pharmaceuticals	New in 2004			

# PLAN B®



## Women's Health



### ESTRING®

Estring® is a local estrogen therapy indicated for the treatment of postmenopausal urogenital discomfort due to estrogen deficiency. Estring® provides continuous, long-lasting relief for the vaginal dryness, soreness, itching, urinary urgency and painful or difficult urination commonly associated with urogenital atrophy (UGA).

IMS Canada data shows the total annual value of the Canadian hormone replacement therapy (HRT) market to be approximately \$108 million, with clear domination by systemic forms of therapy. Recent studies on the long-term use of HRT have brought about more cautious use of systemic female HRT, resulting in local estrogen therapies gaining favour as a safe and effective treatment for UGA. The May 2004 publication of The Society of Obstetricians and Gynaecologists of Canada (SOGC) guidelines for the treatment of UGA has reinforced the benefit of local estrogen therapy use.

Local estrogen sales in Canada have grown by more than five percent over the last year. Paladin, through its targeted promotion strategies for Estring®, has been successful in building brand sales at a compound annual growth rate of 22 percent since its acquisition from Pfizer in 2002.

Source: Laurie A. Willhite et al. Urogenital Atrophy: Prevention and treatment. *Pharmacotherapy*, 21(4): 464-480, 2001.  
Ayton RA et al. A comparative study of safety and efficacy of continuous low dose oestradiol released from a vaginal ring compared with a conjugated equine oestrogen vaginal cream in the treatment of postmenopausal urogenital atrophy. *Br J Obstet Gynecol* 1996; 103:351-358.



## Management Team



**JONATHAN ROSS GOODMAN, B.A., LL.B., M.B.A.  
PRESIDENT & CEO**

Prior to founding Paladin, Mr. Goodman was Vice President of Business Development at Pharmascience Inc. Mr. Goodman was formerly a consultant with Bain & Company, and also worked in brand management for Procter & Gamble.



**MARK BEAUDET, B.Comm  
VICE PRESIDENT OF MARKETING & SALES**

Prior to joining Paladin, Mr. Beaudet managed marketing and sales for Pharmascience's Innovative Business Unit. Mr. Beaudet was previously a Marketing Manager with Pizza Hut Canada. Prior to that, Mr. Beaudet was a Brand Manager in Procter & Gamble's Healthcare division.



**SAMIRA SAKHIA, B.Comm, C.A., M.B.A.  
CHIEF FINANCIAL OFFICER**

Prior to joining Paladin, Ms. Sakhia held several leadership positions at Discreet Logic Inc. Prior to Discreet Logic, Ms. Sakhia worked as an auditor at Arthur Andersen & Co.



**MARK NAWACKI, C.A., M.B.A.  
VICE PRESIDENT OF BUSINESS DEVELOPMENT**

Prior to joining Paladin, Mr. Nawacki held several leadership positions with Pharmacia Corporation, including all Canadian business development activities. Before Pharmacia, Mr. Nawacki worked for the Pillsbury Company and Arthur Andersen & Co.

## Board of Directors

**TED WISE ▲ – CHAIRMAN (since 1995)**

Mr. Wise is a co-founder, previous President and Vice-Chairman of Pharmascience Inc. Mr. Wise, a pharmacist by profession, has more than forty years of experience in the pharmaceutical industry, having worked for Ayerst Laboratories, Winley-Morris Ltd. and ICN Canada.

**JONATHAN ROSS GOODMAN – DIRECTOR (since 1995)**

(Please see Management Team)

**MARK BEAUDET – DIRECTOR (since 1996)**

(Please see Management Team)

**ROBERT LANDE\* – DIRECTOR (since 1995)**

Mr. Lande is the former Chief Financial Officer of Telecom Américas Ltd. and former President of Bell Canada International do Brasil, the representative office of Bell Canada International in Brazil.

**GER VAN AMERSFOORT\* – DIRECTOR (since 2001)**

Mr. van Amersfoort was President & CEO of Novartis Canada Ltd., until his retirement in 2001. From 1987 to 1999 he was a regional President & CEO of SmithKline Beecham in the Netherlands, Canada, the United Kingdom and Ireland.

**ALDO BAUMGARTNER ▲ – DIRECTOR (since 2003)**

Dr. Baumgartner was President & CEO of Wyeth-Ayerst Canada Inc. from 1992 until his retirement in 2003. Prior to joining Wyeth-Ayerst, Dr. Baumgartner was President and General Manager of Hoffmann-LaRoche's Belgian operations. He also served as President & CEO of Hoffmann-LaRoche Canada from 1981 until 1988.

**GERALD McDOLE\* – DIRECTOR (since March 2004)**

Mr. McDole was President & CEO of AstraZeneca Canada Inc., until his retirement in October 2003. He is the former Chairman of the Advanced Coronary Treatment Foundation and a former Director of the Institute of Health Economics in Edmonton and the Canadian Stroke Network. He is past President of the Canadian Foundation for Pharmacy.

\* member of the Audit Committee

▲ member of the Compensation Committee



### **STOCK EXCHANGE LISTING**

Toronto Stock Exchange

Trading symbol: PLB

### **SHARES OUTSTANDING**

14,858,469 Common Shares

(at December 31, 2004)

### **FISCAL 2004 TRADING SUMMARY**

High: \$6.25

Low: \$4.30

Close: \$4.84

Average daily volume: 6,838 shares

### **TRANSFER AGENT**

Computershare Trust Company of Canada

1-800-564-6253

### **AUDITORS**

Ernst & Young LLP

### **ANNUAL GENERAL MEETING**

May 3, 2005, 5 p.m.

6111 Royalmount Avenue

Suite 102

Montreal, Quebec

Canada H4P 2T4

This Annual Report is also available on our website at [www.paladinlabs.com](http://www.paladinlabs.com).

*Ce document est aussi disponible en français.*





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

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**PALADIN LABS INC.**  
**2004**

**MANAGEMENT DISCUSSION & ANALYSIS**  
**FINANCIAL STATEMENTS**  
**NOTES TO FINANCIAL STATEMENTS**



Paladin Labs Inc. is a specialty pharmaceutical company focused on marketing innovative urology, endocrinology and women's health products for the Canadian market. Growth will be sustained through the acquisition of Canadian rights to promotion-sensitive pharmaceuticals and to promising products in late-stage development. Headquartered in Montreal, Paladin is a publicly traded company listed on the Toronto Stock Exchange under the symbol PLB.

### **Forward-Looking Statements**

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

**SELECTED FINANCIAL INFORMATION**  
(In thousands of dollars except share and per share amounts)

**INCOME STATEMENT DATA**

	For the years ended December 31					
	2004		2003		2002	
Revenues . . . . .	<b>\$28,017</b>	<b>100%</b>	\$23,859	100%	\$23,355	100%
Gross profit . . . . .	<b>20,443</b>	<b>73</b>	17,695	74	16,968	73
Earnings before write-downs and income taxes . . . . .	<b>4,196</b>	<b>15</b>	3,094	11	6,638	28
Write-down of intellectual property and investments . . . . .	—	—	9,062	36	474	2
Earnings before income taxes . . . . .	<b>4,196</b>	<b>15</b>	(5,968)	(25)	6,164	26
Net income (loss) . . . . .	<b><u>\$ 3,239</u></b>	<b><u>12%</u></b>	<u>\$(4,172)</u>	<u>(17)%</u>	<u>\$ 5,162</u>	<u>22%</u>
Income per common share						
Basic . . . . .	<b>0.22</b>		(0.28)		0.37	
Diluted . . . . .	<b>0.22</b>		(0.28)		0.36	

**BALANCE SHEET DATA**

	As at December 31		
	2004	2003	2002
Cash and short-term and long-term marketable securities . . . . .	<b>\$42,124</b>	\$44,547	\$45,612
Current assets . . . . .	<b>47,477</b>	49,561	42,745
Total assets . . . . .	<b>70,960</b>	68,970	68,655
Shareholders' equity . . . . .	<b>63,192</b>	59,332	63,178

## MANAGEMENT DISCUSSION AND ANALYSIS

(In thousands of Canadian dollars except for share and per share amounts)

The following analysis explains the variations in the results of operations, financial position and cash flows for Paladin Labs Inc. (“Paladin” or the “Company”) and is current as at March 10, 2005. This discussion should be read in conjunction with the information contained in the Company’s audited financial statements and the related notes to the financial statements for the year ended December 31, 2004. As at March 10, 2005, 14,858,469 shares were issued and outstanding.

### 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.

In 2004, Paladin continued to make progress in acquiring the rights to innovative products, advancing regulatory status of its product pipeline, and expanding sales of key promoted products:

- Paladin signed a licensing agreement with Watson Pharmaceuticals, Inc. for the Canadian distribution rights for **Oxytrol**<sup>®</sup>, a novel transdermal patch for the treatment of overactive bladder and launched **Oxytrol**<sup>®</sup> in October 2004.
- Paladin obtained the exclusive distribution rights to i) **Sabril**<sup>®</sup> and **Frisium**<sup>®</sup>, two central nervous products from Ovation Pharmaceuticals, Inc.; ii) **Replagal**<sup>®</sup>, an innovative treatment for Fabry disease from Transkaryotic Therapies, Inc.
- Paladin signed an exclusive Canadian marketing and promotion agreement for **Loestrin**<sup>®</sup> and **Minestrin**<sup>®</sup>, two oral contraceptive pharmaceutical products, with Duramed Pharmaceuticals, Inc. a subsidiary of Barr Pharmaceuticals, Inc.
- Paladin advanced its product pipeline and filed New Drug Submissions for **Vantas**<sup>™</sup> (Histrelin Hydrogel Implant) and **GlucaGen**<sup>®</sup> during the third quarter of 2004.
- Health Canada proposed amendments to the Food Drug Regulations to allow **Plan B**<sup>®</sup>, an emergency contraceptive, to be switched to non-prescription status.
- Paladin achieved solid growth of its key promoted products, including **Dostinex**<sup>®</sup>, **Estring**<sup>®</sup>, **Oxytrol**<sup>®</sup> and **Plan B**<sup>®</sup>, which increased by 36% in 2004.

Paladin’s revenues reached \$28,017 for the year ended December 31, 2004 compared to \$23,859 for the year ended December 31, 2003. For the year ended December 31, 2004, the Company’s net income was \$3,239 or \$0.22 per diluted share compared to a net loss of \$4,172 or \$0.28 per share for the year ended December 31, 2003.

As at December 31, 2004, the Company’s total assets were \$70,960, and shareholders’ equity was \$63,192. The Company’s cash and short-term and long-term marketable securities amounted to \$42,124 as at December 31, 2004.

## MANAGEMENT DISCUSSION AND ANALYSIS

(In thousands of Canadian dollars except for share and per share amounts)

As at December 31, 2003, the Company's total assets were \$68,970, and shareholders' equity was \$59,332. The Company's cash and short-term marketable securities amounted to \$44,547 as at December 31, 2003.

Paladin's revenue is principally derived from sales of pharmaceutical products to large pharmaceutical wholesalers and large chain pharmacies.

The Company's expenses have been comprised primarily of selling, marketing and administrative expenses, cost of goods sold (including royalty payments to those companies from whom Paladin licenses its products) and research and development expenses. In addition, because Paladin acquires many of the products that it markets, a substantial portion of the Company's expenses are related to amortization of intangible assets and deferred charges.

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

### CRITICAL ACCOUNTING ESTIMATES

Paladin's financial statements are prepared in accordance with Canadian generally accepted accounting principles, applied in a consistent basis. Paladin's critical accounting estimates include revenue recognition, the recording of research and development expenses, the useful lives and fair value of intangible assets and stock based compensation expense.

#### Revenue Recognition

Revenue is recognized when the product is shipped to the Company's customers, provided the Company has not retained any significant risks of ownership or future obligations with respect to the product shipped. Revenue from product sales is recognized net of sales discounts and allowances. In certain circumstances, returns of products are allowed under the Company's policy, and provisions are made for such returns. Management is required to estimate the level of sales which may be returned, and record a related reserve at the time of sale. These amounts are deducted from gross sales to determine net revenues. These estimates take into consideration historical returns of a given product and product specific conditions including market trends and historical purchasing patterns. Management periodically reviews the reserves established for returns and adjusts them based on actual experience.

#### Inventory

Inventory is valued at the lower of cost determined on a first-in, first-out basis, and net realizable value. Paladin establishes reserves for inventory to reflect situations in which the cost of the inventory is not expected to be recovered. The reserve for inventory is equal to all or portion of the inventory which has reached its expiration or is close to expiration and not expected to be sold, based on the specific facts and circumstances. In order to determine whether the inventory is properly stated at the lower of cost or market, management reviews the amount of inventory on hand, the remaining shelf life and estimates the time required to sell such inventory taking into account current and expected market conditions and competition.

## MANAGEMENT DISCUSSION AND ANALYSIS

(In thousands of Canadian dollars except for share and per share amounts)

### Intangible Assets

Intellectual property acquired is recorded at cost and consists primarily of process know-how covered by certain patented and non-patented information. Pharmaceutical product licenses, rights and intellectual property are amortized on a straight-line basis over the lesser of the term of the agreement, the life of the patent or the expected useful life of the product. The terms generally range from 4 to 10 years, but may extend to 20 years. Management reviews the carrying value based on projected future results annually and whenever events or changes in circumstances indicate that the asset may be impaired. Management must make estimates of the future cash flows related to the intellectual property. Any impairment in the carrying value results in a write-down of the pharmaceutical product license and right and intellectual property which is charged to income during the year.

During the fourth quarter of 2003, the Company reduced the estimated useful life of intellectual property associated with products with no patent protection or protection under a license agreement. This intellectual property relates to products which may be genericized and the estimated useful life has been reduced to 5 years from the date of acquisition.

### Research and Development Expenses

Research costs are charged to income in the year of expenditure and include milestone payments for products currently under development. Development costs are charged against income in the year of expenditure unless a development project meets the criteria under generally accepted accounting principles for deferral and amortization. The Company has not deferred any such development costs to date. Research and development expenses are recorded net of government assistance, including investment tax credits, which are based on estimates of amounts expected to be recovered and are subject to audit by taxation authorities.

### Stock-Based Compensation Plans

The Company has stock-based compensation plans. During the fourth quarter of 2003, the Company adopted the fair value method of accounting for stock-based compensation plans. A charge for stock-based compensation has been recorded as an expense and reflected in net income of fiscal 2003 and 2004. The calculation of stock-based compensation is dependent on estimates to determine the fair value. The fair value of the option is calculated using the Black-Scholes option-pricing model, which requires making assumptions of the volatility factor of the market price of the Company's common shares and the expected life of the option. The Company has selected the prospective method of adoption; accordingly, results from prior years have not been restated.

## MANAGEMENT DISCUSSION AND ANALYSIS

(In thousands of Canadian dollars except for share and per share amounts)

### RESULTS OF OPERATIONS

Year ended December 31, 2004 compared to year ended December 31, 2003

#### Revenues

Revenues increased \$4,158 or 17% to \$28,017 for the year ended December 31, 2004 from \$23,859 for the year ended December 31, 2003. This increase was due to strong market performance from the Company's key promoted products, including Dostinex<sup>®</sup>, Estrin<sup>®</sup>, Oxytrol<sup>®</sup> and Plan B<sup>®</sup>, which increased by 36% compared to the year ended December 31, 2003. The increase in revenues was partially offset by decline in sales of Urispas<sup>®</sup>, as a result of generic competition, and, a decline in sales of Oesclim<sup>®</sup>, due to the recent medical concerns relating to female hormone replacement therapies.

#### Gross Profit

Total gross profit increased \$2,748 or 16% to \$20,443 for the year ended December 31, 2004 from \$17,695 for the year ended December 31, 2003. Gross profit, as a percentage of revenues, declined to 73% for the year ended December 31, 2004 from 74% for the year ended December 31, 2003. This decrease in gross profit, as a percentage of sales, resulted primarily from a change in proportion of products sold for which the Company earns a distribution fee and consequently does not incur costs of sales related to these products.

#### Selling and Marketing Expense

Selling and marketing expense decreased \$3,602 or 32% to \$7,540 for the year ended December 31, 2004 from \$11,142 for the year ended December 31, 2003. Selling and marketing expense, as percentage of revenues, decreased to 27% for the year ended December 31, 2004 from 47% for the year ended December 31, 2003. This decrease was primarily attributed to decreased selling and marketing activities on Androderm<sup>®</sup>. It is expected that selling and marketing expense, as a percentage of revenues, will be between 35% and 40% for the year ended December 31, 2005.

#### General and Administrative Expense

General and administrative expense increased \$157 or 6% to \$2,784 for the year ended December 31, 2004 from \$2,627 for the year ended December 31, 2003. General and administrative expense, as a percentage of revenues, decreased to 10% for the year ended December 31, 2004 from 11% for the year ended December 31, 2003. It is expected that selling and marketing expense, as a percentage of revenues, will be between 10% and 12% for the year ended December 31, 2005.

#### Research and Development Expense

Research and development expense increased \$2,379 or 183% to \$3,681 for the year ended December 31, 2004 from \$1,302 for the year ended December 31, 2003. This increase in research and development expense related to the New Drug Submissions for Vantas<sup>™</sup> (Histrelin Hydrogel Implant) and GlucaGen<sup>®</sup>; an increased number of research and development projects in fiscal 2004; a provision related to prior year investment tax credits of \$557; and \$396 related to certain license payments for unapproved products.

## MANAGEMENT DISCUSSION AND ANALYSIS

(In thousands of Canadian dollars except for share and per share amounts)

### Amortization Expense

Amortization expense increased \$2,006 or 103% to \$3,952 for the year ended December 31, 2004 from \$1,946 for the year ended December 31, 2003. This increase in amortization expense is a result of the Company's decision to reduce the estimated useful life of the carrying value of the intellectual property associated with products which may be genericized as well as the impact of amortization expense related to the Company's acquisition of licenses, rights and intellectual property during the prior year.

### Interest Income

Interest income decreased \$279 or 20% to \$1,133 for the year ended December 31, 2004 from \$1,412 for the year ended December 31, 2003. This decrease reflects the impact of lower interest rates and a lower average cash balance during the year ended December 31, 2004 compared to the year ended December 31, 2003.

### Other Income

Other income was nil for the year ended December 31, 2004. Other income was \$421 for the year ended December 31, 2003. For the year ended December 31, 2003, other income included a one-time compensation payment for lost revenues of Dalacin® and other payments related to certain license and trademark license agreements.

### Write-Down of Intellectual Property

During 2003, the Company recorded write-downs and gains associated with the intellectual property described below.

- a) Management determined certain products were at a higher risk of generic competition than had been previously estimated. The Company prepared undiscounted cash flows related to these product sales and assessed that in some cases, the carrying value of the related intellectual property was in excess of its net recoverable amount. The Company then prepared discounted cash flows for these products and has written the carrying value down to the discounted value, resulting in a write-down of \$5,115.
- b) Management determined that certain products under development had a sufficiently high risk of not being approved for sale, and consequently, that there was a limited expectation of future cash flows. The Company has recorded an impairment charge of \$199.
- c) The Company entered into a license agreement for Oesclim®, a hormone replacement therapy (HRT) patch for women. Given the decline in sales of Oesclim® due to recent concerns relating to female HRT, the Company concluded that there was an impairment in the carrying value and recorded an impairment loss of \$1,725, representing the full carrying value of this license.
- d) The distribution agreement with Bioniche Life Sciences Inc. for Cystistat® was terminated for net proceeds of \$80. The net proceeds were recorded as a gain.

Effective January 1, 2003, the Company sold the MoiStir® trademark and assigned the licenses of Sialor® and the Baker Cummins line of dermatology products to a related party, a subsidiary of JODDES, and recorded a gain of \$278.

## MANAGEMENT DISCUSSION AND ANALYSIS

(In thousands of Canadian dollars except for share and per share amounts)

### Write-Down of Investments

During 2003, the Company recorded write-downs and gains associated with the investments described below.

- a) In June 2003, Anthra Pharmaceuticals, Inc. (“Anthra”) advised the Company that it had disposed of virtually all of its assets and was unable to determine when it would be able to resume production of its marketed product, Valtaxin™. The Company considers that there has been a permanent impairment in the carrying value of the investment in Anthra. Anthra is a private corporation based in the U.S. and it is not practicable within constraints of timeliness and cost to determine the fair value of the common shares. Consequently, the Company recorded a write-down of \$1,497, representing the full amount of its carrying value of its investment in Anthra.
- b) In December 2003, management determined that the decline in the market value of BioSante Pharmaceuticals, Inc. was other than temporary. Consequently, the Company recorded a write-down of \$526 related to this investment.

### Gain on Disposal of Investments

During 2004, the Company disposed all of its common shares of BioSante Pharmaceuticals, Inc. The Company recorded a gain of \$577 representing the difference between the proceeds received of \$1,021 and its carrying value of \$444. During 2003, the Company disposed all of its common shares of Connetics Corporation. The Company recorded a gain of \$225 representing the difference between the proceeds received of \$529 and its carrying value of \$304.

### Income Tax Expense

Income tax expense increased \$2,753 to \$957 for the year ended December 31, 2004 from a recovery of \$1,796 for the year ended December 31, 2003. The effective tax rate was 23% for the year ended December 31, 2004 compared to 30% for the year ended December 31, 2003.

### Net Income (Loss)

Due to the factors set forth above, net income was \$3,239 for the year ended December 31, 2004 compared to net loss of \$4,172 for the year ended December 31, 2003.

### LIQUIDITY AND CAPITAL RESOURCES

The Company believes that its existing cash and cash equivalents and short-term marketable securities, as well as cash generated from operations are sufficient to finance its current operations 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, and short-term and long-term marketable securities decreased \$2,423 to \$42,124 at December 31, 2004 from \$44,547 at December 31, 2003. Working capital decreased \$214 to \$39,709 at December 31, 2004 from \$39,923 at December 31, 2003. This decrease is primarily due to a decrease in short-term marketable securities and balance of license agreements payable offset by an increase in accounts receivable and inventory.

## MANAGEMENT DISCUSSION AND ANALYSIS

(In thousands of Canadian dollars except for share and per share amounts)

No dividend was declared or paid by Paladin on its Common Shares during the current financial year. In addition, the Company does not expect to pay dividends in the next financial year.

Effective February 1, 2004, the Company has amended its distribution agreement with its affiliate (see Related Party Transactions). As a result of this amendment, Paladin has taken ownership of inventory and accounts receivables related to products distributed by Paladin. The related party continues to provide logistics services, including customer service, warehousing and shipping and collection services.

Cash flows from operating activities were \$4,441 and \$5,446 for the years ended December 31, 2004 and 2003, respectively. Cash flows from operating activities represent the cash flows from net earnings, excluding revenues and expenses not affecting cash, principally amortization, gain on disposal of investments and intellectual property, write-down of intellectual property, future income taxes and imputed interest.

The Company's investing activities used cash of \$1,100 and \$9,531 for the years ended December 31, 2004 and 2003, respectively. During the year ended December 31, 2004, the Company invested \$4,053 in acquisitions of pharmaceutical product licenses and rights and intellectual property. The Company received proceeds of \$1,021 from the disposal of investments and pharmaceutical product licenses. In addition, the Company had a \$1,939 net decrease in short-term and long-term marketable securities. The principle uses of cash in fiscal 2003 were acquisitions of pharmaceutical product licenses and rights and intellectual property of \$9,969. In addition, the Company had a \$1,036 net decrease in short-term and long-term marketable securities.

Cash flows used in financing activities were \$3,787 for the year ended December 31, 2004. For the year ended December 31, 2003, cash flows from financing activities were \$4,058. For the year ended December 31, 2004, \$288 was provided from common stock option exercises and the issuance of common shares under the stock purchase plan. In addition, the Company had decrease of \$4,095 in accounts payable related pharmaceutical product licenses, of which \$596 was paid in January 2004. For the year ended December 31, 2003, \$86 was provided from common stock option exercises and the issuance of common shares under the stock purchase plan. Further, the Company had an increase of \$4,602 in accounts payable related to pharmaceutical product licenses.

On February 17, 2005, Paladin announced that it had received regulatory approval from the Toronto Stock Exchange (the "TSX") to carry out a normal course issuer bid effective February 22, 2005. Paladin has been authorized to purchase up to 630,000 of its common shares, or approximately 10% of its public float of 6,300,990 common shares, in the twelve-month period following the bid's effective date. As at February 17, 2005, Paladin has 14,858,469 common shares issued and outstanding.

### 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.

In June 1998, the Company entered into a number of ten-year agreements each with five-year renewal options with a wholly owned subsidiary of JODDES. Under these agreements, this affiliate provides manufacturing and logistics services including, customer service, warehousing and shipping, invoicing and collection services on behalf of the Company. 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 receivables and \$3.2 million of

## MANAGEMENT DISCUSSION AND ANALYSIS

(In thousands of Canadian dollars except for share and per share amounts)

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. On November 5, 2003, the Company purchased a three-year license and distribution agreement from PanGeo Pharmaceutical (Canada) Inc. (“PanGeo”). On November 6, 2003, PanGeo was purchased by JODDES.

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:

	2004	2003
Sales .....	<b>\$1,979</b>	\$1,075
Purchases .....	<b>9,595</b>	5,516
Sales and marketing .....	<b>1,592</b>	1,319
General and administrative .....	<b>281</b>	265
Research and development .....	<b>447</b>	241

### QUARTERLY INFORMATION

(In thousands of Canadian dollars except per share information)

	Q1 F2004	Q2 F2004	Q3 F2004	Q4 F2004	Q1 F2003	Q2 F2003	Q3 F2003	Q4 F2003
Sales .....	5,597	6,397	7,938	8,085	5,065	6,453	5,420	6,921
Income before write-downs and income taxes .....	501	875	1,510	1,310	715	1,631	463	285
Net income (loss) .....	344	681	1,038	1,176	573	(142)	357	(4,960)
Fully diluted EPS .....	\$0.02	\$0.05	\$0.07	\$0.08	\$0.04	\$(0.01)	\$0.03	\$(0.34)

### FOURTH QUARTER ANALYSIS

For the three month-period ended December 31, 2004, Paladin recorded revenues of \$8,085, gross profit of \$5,722; selling and marketing expenses of \$2,425; general and administrative expenses of \$660; research and development expense of \$1,229; amortization expense of \$942; interest income of \$247 and provision for income tax of \$134. During the fourth quarter the Company received assessments related to previously claimed investment tax credits and recorded a provision of \$557, which is included in research and development expense. In addition, during the fourth quarter, the Company disposed all of its

## MANAGEMENT DISCUSSION AND ANALYSIS

(In thousands of Canadian dollars except for share and per share amounts)

common shares of BioSante during 2004. The Company recorded a gain of \$577 representing the difference between the proceeds received of \$1,021 and its carrying value of \$444.

### PROPOSED TRANSACTIONS

The Company does not currently anticipate any material asset or business acquisition or disposal transaction.

### OFF BALANCE SHEET ARRANGEMENTS

The Company's off balance sheet arrangements consist of agreements for Canadian agreements for development, sales, marketing and distribution rights to innovative drug products which include contractual obligations. (See *Contractual Obligations* for additional details).

The Company does not issue guarantees contemplated by CICA Guidelines.

### PAYMENT OF DIVIDENDS

The Company has not paid dividends on its Common Shares and does not anticipate declaring any dividends in the near future. Paladin's current policy is to retain earnings to finance acquisition and development of new products and to reinvest in the Company.

### RECENT PRONOUNCEMENTS

During 2003, the Accounting Standards Board issued AcG-15 "Consolidation of Variable Interest Entities". AcG-15 requires certain variable interest entities, or VIE's, to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. AcG-15 is effective for all fiscal periods beginning on or after November 1, 2004. Effective January 31, 2005, Paladin will have to consider whether we are involved with any VIE's and if so determine the financial reporting impact of such involvement. As at December 31, 2004, Paladin has reviewed its investments in other companies and has determined that there are no investments which would require consolidation.

### 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.

## MANAGEMENT DISCUSSION AND ANALYSIS

(In thousands of Canadian dollars except for share and per share amounts)

### 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. The Company has the following contractual obligations related to product license, trademark and distribution agreements:

<u>Contractual Obligations</u>	<u>Total</u>	<u>Less than 1 year</u>	<u>1 – 3 years</u>	<u>4 – 5 years</u>	<u>After 5 years</u>
Purchase and service based commitments . . . . .	\$9,889	2,670	4,998	1,538	683

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 commitments related to product license, trademark and distribution agreements:

<u>Commitments</u>	<u>Total</u>	<u>Less than 1 year</u>	<u>1 – 3 years</u>	<u>4 – 5 years</u>	<u>After 5 years</u>
Milestone based commitments . . . . .	\$2,941	603	—	—	2,338
Revenue based commitments . . . . .	\$4,594	362	875	—	3,357



Jonathan Ross Goodman, B.A., LL.B., M.B.A.  
President & CEO



Samira Sakhia, CA, M.B.A.  
Chief Financial Officer

## MANAGEMENT REPORT

The accompanying financial statements of **Paladin Labs Inc.** and all of the information in this Annual Report are the responsibility of management and have been approved by the Board of Directors.

The financial statements have been prepared in accordance with Canadian generally accepted accounting principles. The most significant of these accounting principles are described in Note 2 to the financial statements. The financial statements include some amounts that are based on estimates and judgements. Management has determined such amounts on a reasonable basis in order to ensure that the financial statements are presented fairly in all material respects. The Company's accounting procedures and related systems of internal control are designed to provide reasonable assurance that its assets are safeguarded and its financial records are reliable. The financial information elsewhere in this Annual Report is consistent with the information presented in the financial statements.

The Board of Directors has appointed an Audit Committee consisting of three outside directors. The committee meets periodically during the year to review with management and the external auditors any significant accounting, internal control and auditing matters. They review and finalize the annual financial statements of the Company along with the external auditors' report prior to the submission of the financial statements to the Board of Directors for final approval.

The Company's external auditors, Ernst & Young LLP, Chartered Accountants, conduct an independent audit on behalf of the shareholders, in accordance with Canadian generally accepted auditing standards, and express their opinion on the financial statements. Their report outlines the scope of their audit and their opinion on the financial statements of the Company. The external auditors have full access to management and the Audit Committee of the Board.

Montreal, Canada,  
January 28, 2005



Jonathan Ross Goodman, B.A., LL.B., M.B.A.  
President & CEO



Samira Sakhia, CA, M.B.A.  
Chief Financial Officer

## AUDITORS' REPORT

To the Shareholders of  
**Paladin Labs Inc.**

We have audited the balance sheets of **Paladin Labs Inc.** as at December 31, 2004 and 2003 and the statements of operations and retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2004 and 2003 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

*Ernst & Young LLP*

Chartered Accountants

Montreal, Canada  
January 28, 2005

**BALANCE SHEETS**  
**As at December 31**  
(In thousands of Canadian dollars)

	2004	2003		2004	2003
<b>ASSETS</b>			<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Current</b>			<b>Current</b>		
Cash and cash equivalents . . . . .	\$ 1,507	\$ 1,991	Accounts payable and accrued liabilities . . . . .	\$ 4,723	\$ 4,546
Short-term marketable securities (note 3) . . . . .	36,039	42,556	Accounts payable to related parties (note 13) . . . . .	1,754	170
Accounts receivable . . . . .	5,878	248	Income taxes payable . . . . .	229	85
Inventory . . . . .	2,718	—	Balance of license agreements payable . . . . .	1,062	4,537
Other current assets (note 4) . . . . .	735	2,541	Deferred credit (note 15) . . . . .	—	300
Investment tax credits receivable (note 14) . . . . .	—	256	<b>Total current liabilities</b> . . . . .	<b>7,768</b>	<b>9,638</b>
Future income tax assets (note 15) . . . . .	600	1,969			
<b>Total current assets</b> . . . . .	<b>47,477</b>	<b>49,561</b>			
Long-term marketable securities (note 5) . . . . .	4,578	—	<b>Shareholders' equity</b>		
Property, plant and equipment (note 6) . . . . .	77	132	Capital stock (note 10) . . . . .	57,837	57,440
Intangible assets (note 7) . . . . .	11,065	12,359	Other paid-in capital (note 11) . . . . .	554	330
Deferred charges (note 8) . . . . .	4,176	2,781	Retained earnings . . . . .	4,801	1,562
Investments (note 9) . . . . .	1,433	1,877	<b>Total shareholders' equity</b> . . . . .	<b>\$63,192</b>	<b>\$59,332</b>
Future investment tax credits recoverable (note 15) . . . . .	439	659			
Future income tax assets (note 15) . . . . .	1,715	1,601			
	<b>\$70,960</b>	<b>\$68,970</b>		<b>\$70,960</b>	<b>\$68,970</b>

Commitments (note 17)

See accompanying notes

On behalf of the Board:



Jonathan Ross Goodman  
Director



Mark Beaudet  
Director

**STATEMENTS OF OPERATIONS AND RETAINED EARNINGS**  
**Years ended December 31**  
(In thousands of Canadian dollars except for share and per share amounts)

	2004	2003
Revenues ( <i>note 13</i> ) . . . . .	\$ 28,017	\$ 23,859
Cost of sales ( <i>note 13</i> ) . . . . .	7,574	6,164
<b>Gross profit</b> . . . . .	<b>20,443</b>	<b>17,695</b>
Selling and marketing ( <i>note 13</i> ) . . . . .	7,540	11,142
General and administrative ( <i>note 13</i> ) . . . . .	2,784	2,627
Research and development ( <i>notes 14 and 15</i> ) . . . . .	3,681	1,302
Amortization of intangible assets and deferred charges . . . . .	3,952	1,946
Interest income, net . . . . .	(1,133)	(1,412)
Gain on disposal of investment . . . . .	(577)	(225)
Write-down of intellectual property, net ( <i>note 12</i> ) . . . . .	—	6,681
Write-down of investments ( <i>note 9</i> ) . . . . .	—	2,023
Other income . . . . .	—	(421)
<b>Income (loss) before income taxes</b> . . . . .	<b>4,196</b>	<b>(5,968)</b>
Provision (recovery) for income taxes ( <i>note 15</i> )		
Current . . . . .	—	88
Future . . . . .	957	(1,884)
	957	(1,796)
<b>Net income (loss) for the year</b> . . . . .	<b>\$ 3,239</b>	<b>\$ (4,172)</b>
Retained earnings, beginning of the year . . . . .	1,562	5,734
<b>Retained earnings, end of the year</b> . . . . .	<b>\$ 4,801</b>	<b>\$ 1,562</b>
<b>Earnings (loss) per share</b>		
Basic and diluted . . . . .	\$ 0.22	\$ (0.28)
<b>Weighted average number of shares outstanding</b> ( <i>note 16</i> )		
Basic . . . . .	14,834,988	14,787,733
Diluted . . . . .	14,910,798	14,787,733

See accompanying notes

## STATEMENTS OF CASH FLOWS

Years ended December 31

(In thousands of Canadian dollars)

	<u>2004</u>	<u>2003</u>
<b>OPERATING ACTIVITIES</b>		
Net income (loss) for the year . . . . .	\$ 3,239	\$ (4,172)
Add items not affecting cash		
Amortization . . . . .	4,014	2,000
Compensation expense . . . . .	320	227
Future income taxes . . . . .	1,175	(1,991)
Gain on disposal of investment . . . . .	(577)	(225)
Unrealized foreign exchange (gain) loss . . . . .	17	—
Write-down of intellectual property . . . . .	—	7,039
Write-down of investments in other companies . . . . .	—	2,023
Imputed interest on balance of sale . . . . .	—	53
Gain on disposal of intellectual property . . . . .	—	(358)
	<u>8,188</u>	<u>4,596</u>
Net change in non-cash balances relating to operations . . . . .	<u>(3,747)</u>	<u>850</u>
<b>Cash flows from operating activities</b> . . . . .	<b>4,441</b>	<b>5,446</b>
<b>INVESTING ACTIVITIES</b>		
Additions to pharmaceutical product licenses and rights, and deferred charges . . . . .	(4,053)	(9,969)
Purchases of short-term marketable securities . . . . .	(42,839)	(52,608)
Maturities of short-term marketable securities . . . . .	54,116	61,580
Purchases of long-term marketable securities . . . . .	(9,338)	(7,936)
Proceeds from the disposal of investments . . . . .	1,021	529
Acquisition of property, plant and equipment . . . . .	(7)	(114)
Proceeds from the disposal of pharmaceutical license . . . . .	—	420
Acquisition of investments . . . . .	—	(1,433)
	<u>(1,100)</u>	<u>(9,531)</u>
<b>Cash flows used in investing activities</b> . . . . .	<b>(1,100)</b>	<b>(9,531)</b>
<b>FINANCING ACTIVITIES</b>		
Accounts payable related to the acquisition of intellectual property and deferred charges . . . . .	(4,095)	4,602
Common shares issued for cash . . . . .	288	86
Repayment of share purchase loan . . . . .	20	20
Payment of balance of sale . . . . .	—	(650)
	<u>(3,787)</u>	<u>4,058</u>
<b>Cash flows from (used in) financing activities</b> . . . . .	<b>(3,787)</b>	<b>4,058</b>
<b>Effect of exchange rate change on cash and cash equivalents</b> . . . . .	<b>(38)</b>	<b>(2)</b>
<b>Net change in cash and cash equivalents during the year</b> . . . . .	<b>(484)</b>	<b>(29)</b>
Cash and cash equivalents, beginning of year . . . . .	1,991	2,020
<b>Cash and cash equivalents, end of year</b> . . . . .	<b>\$ 1,507</b>	<b>\$ 1,991</b>
<b>Supplemental cash flow information</b>		
Interest paid . . . . .	\$ 34	\$ 12
Income taxes paid . . . . .	\$ 66	\$ 102

*See accompanying notes*

## NOTES TO FINANCIAL STATEMENTS

December 31, 2004

(In thousands of Canadian dollars except for share and per share amounts)

### 1. NATURE OF OPERATIONS

Paladin Labs Inc. (the “Company”) is a Canadian public company continued under the *Canada Business Corporations Act*. The Company’s shares are traded on the Toronto Stock Exchange. The Company’s business consists of in-licensing or acquiring, marketing, distributing and developing pharmaceutical products in Canada.

### 2. BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

The financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles, the most significant of which are described below:

#### Use of estimates

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates, and such differences could be material.

#### Cash and cash equivalents

Cash consists of bank deposits. Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of change in value, and consist primarily of bankers’ acceptances with maturities of three months or less.

#### Short-term and long-term marketable securities

Short-term marketable securities are recorded at the lower of cost and market value on a portfolio basis. Long-term marketable securities are recorded at their cost and are written down to their market value when a decline in market value is other than temporary.

#### Inventory

Inventory is valued at the lower of cost determined on a first-in, first-out basis, and net realizable value.

#### Investments

Investments in common shares of private and public companies, where the Company does not exercise significant influence, are accounted for by the cost method whereby earnings are recognized only to the extent that dividends are declared. Annually, or whenever events or changes in circumstances indicate, the Company performs a review of its investments to determine if there has been other than temporary impairment in value. Any impairment in the value of the investment results in a write-down which is charged to income during the year.

#### Property, plant and equipment

Property, plant and equipment are recorded at cost. Amortization is provided on a basis and at rates assigned to amortize the cost of the assets over their estimated useful lives as follows:

Computer equipment and software . . . . . Straight-line                    3 years

## NOTES TO FINANCIAL STATEMENTS

(In thousands of Canadian dollars except for share and per share amounts)

### **Intangible assets**

In the normal course of business, the Company secures Canadian development, sales, marketing and distribution rights to innovative drug products. Intellectual property acquired is recorded at cost and consists primarily of process know-how covered by certain patented and non-patented information. Pharmaceutical product licenses, rights and intellectual property are amortized on a straight-line basis over the lesser of the term of the agreement, the life of the patent or the expected useful life of the product. The terms generally range from 4 to 10 years, but may extend to 20 years. On January 1, 2003, the Company prospectively adopted the new CICA Section 3063 accounting recommendation on the impairment of long-lived assets. When the carrying value of a long-lived asset is less than its net recoverable value as determined on an undiscounted cash flow basis, an impairment loss is recognized. The impairment loss is recognized to the extent that its fair value measured on a discounted cash flow basis over the life of the asset, is below the asset's carrying value.

During the fourth quarter of 2003, the Company reduced the estimated useful life of intellectual property associated with products with no patent protection or protection under a license agreement. This intellectual property relates to products which may be genericized and whose estimated useful life has been reduced to five years from the date of acquisition.

### **Deferred charges**

Under a number of operating agreements, the Company has agreed to pay certain amounts over periods ranging from three to five years and has obtained the exclusive distribution rights to certain products. The deferred charges are amortized over the term of the distribution right. Management reviews the carrying value annually based on projected future cash flow or events or changes in circumstances indicate that the asset may be impaired. Any impairment in the carrying value of the deferred charge results in a write-down to fair value generally based on discounted cash flow which is charged to income.

### **Revenue recognition**

Revenue is recognized when the product is shipped to the Company's customers, provided the Company has not retained any significant risks of ownership or future obligations with respect to the product shipped. Revenue from product sales is recognized net of sales discounts and allowances. Revenue related to service arrangements, where the Company earns a distribution fee on net sales, is recognized when the service is provided. In certain circumstances, returns or exchange of products are allowed under the Company's policy and provisions are maintained accordingly. Sales are recorded net of these provisions.

### **Government assistance**

Amounts received or receivable resulting from government assistance programs, including grants and investment tax credits for research and development, are reflected as reductions to the cost of the assets or expenses to which they relate at the time the eligible expenditures are incurred, provided that there is reasonable assurance that benefits will be realized.

### **Research and development**

Research costs are charged to income in the year of expenditure. Milestones and other license payments paid prior to regulatory approval of the product are generally expensed when the event requiring payment of the milestone occurs. Development costs are charged against income in the year of expenditure unless a development project meets the criteria under generally accepted accounting principles for deferral and amortization. The Company has not deferred any such costs to date.

### **Interest income**

Interest income is recognized as it accrues to the Company.

## NOTES TO FINANCIAL STATEMENTS

(In thousands of Canadian dollars except for share and per share amounts)

### Income taxes

The Company provides for income taxes using the liability method. Under this method, future income tax assets and liabilities are determined based on the differences between the financial reporting and tax bases of assets and liabilities and are measured using substantively enacted tax rates and laws that are expected to be in effect in the period in which the future tax assets or liabilities are expected to be realized or settled. Future income tax assets are recognized to the extent that it is more likely than not that they will be realized.

### Deferred credit

The deferred credit results from the acquisition of future income tax benefits arising from a business combination. The deferred credits are charged to income tax expense, as these benefits are realized.

### Stock-based compensation plans

The Company has stock-based compensation plans, which are described in (note 10). Any consideration paid by employees on exercise of stock options or purchase of stock is credited to share capital. If stock or stock options are repurchased from employees, the excess of the consideration paid over the carrying amount of the stock or stock options cancelled is charged to retained earnings. In addition, options issued to consultants are recognized as an expense in the period they are granted using the Black-Scholes option-pricing model.

During the fourth quarter of 2003, the Company adopted the fair value method of accounting for stock-based compensation plans. The Company has selected the prospective method of adoption; accordingly, results from prior years have not been restated.

### Share issue costs

Share issue costs incurred by the Company are recorded as a reduction of capital stock.

### Earnings per share

Basic earnings per share are calculated using the weighted average number of shares outstanding during the year. Diluted earnings per share are calculated using the treasury stock method, giving effect to the exercise of all dilutive instruments. The treasury stock method assumes that any proceeds that could be obtained upon the exercise of options would be used to purchase common shares at the average market price during the year.

### Foreign currency translation

Transactions arising in foreign currencies are translated into Canadian dollars at the exchange rate prevailing at the transaction dates. At the balance sheet date, monetary assets and liabilities denominated in foreign currencies are translated at the year-end rates of exchange. Exchange gains and losses arising from the translation of foreign currency items are included in the determination of net income under general and administrative expenses.

## NOTES TO FINANCIAL STATEMENTS

(In thousands of Canadian dollars except for share and per share amounts)

### 3. SHORT-TERM MARKETABLE SECURITIES

	2004	2003
Corporate bonds, earning interest at rates ranging from 2.44% to 4.10% (2.41% to 3.77% in 2003) and maturing on various dates from March 2005 to November 2005 (February 2004 to June 2004 in 2003) . . . . .	\$18,978	\$ 7,094
Government bonds, earning interest at rates ranging from 2.25% to 4.10% (2.50% to 4.39% in 2003) and maturing on various dates from February 2005 to June 2005 (January 2004 to November 2004 in 2003) . . . . .	6,688	23,080
Discount notes, earning interest at rates ranging from 2.50% to 2.67% (3.40% to 3.60% in 2003) and maturing on various dates from January 2005 to April 2005 (January 2004 to June 2004 in 2003) . . . . .	6,648	7,531
Commercial paper, earning interest at rates ranging from 2.35% to 2.64% (2.48% to 2.60% in 2003) and maturing in April 2005 (January 2004 to April 2004 in 2003) . . . . .	3,725	4,851
	\$36,039	\$42,556

Short-term marketable securities are comprised of twelve investments (seven in 2003) in corporate bonds, three investments (eleven in 2003), in bonds issued by or guaranteed by various Canadian and Provincial governments, four in discount notes (two in 2003) issued by unrelated public corporations, and four in commercial paper (two in 2003) issued by unrelated public corporations.

Four corporations account for \$17,437 (2003 — \$10,859) and two crown corporations, whose bonds are guaranteed by the Federal government, account for \$6,688 (2003 — two crown corporations whose bonds are guaranteed by the Federal government — \$17,569) of the short-term marketable securities.

### 4. OTHER CURRENT ASSETS

	2004	2003
Receivable from an affiliated company (note 13) . . . . .	\$ —	\$ 401
Interest receivable . . . . .	418	332
Prepaid expenses . . . . .	171	88
Other receivables . . . . .	146	1,720
	\$ 735	\$ 2,541

Other receivables consist primarily of commodity taxes receivable of \$146 (2003 — \$1,694).

## NOTES TO FINANCIAL STATEMENTS

(In thousands of Canadian dollars except for share and per share amounts)

### 5. LONG-TERM MARKETABLE SECURITIES

	2004	2003
Corporate bonds, earning interest at rates ranging from 2.54% to 3.48% and maturing on various dates from January 2006 to February 2006 . . . . .	\$ 4,578	\$ —
	\$ 4,578	\$ —

Long-term marketable securities are comprised of two investments (none in 2003) in corporate bonds issued by unrelated public corporations.

### 6. PROPERTY, PLANT AND EQUIPMENT

	2004	2003
Computer equipment and software . . . . .	\$ 224	\$ 223
Less: accumulated amortization . . . . .	147	91
Net carrying value . . . . .	\$ 77	\$ 132

During 2004, the Company recorded amortization expense of \$62 (2003 — \$54) related to property, plant and equipment.

### 7. INTANGIBLE ASSETS

	2004	2003
Pharmaceutical product licenses and rights . . . . .	\$16,663	\$14,341
Less: accumulated amortization . . . . .	5,598	1,982
Net carrying value . . . . .	\$11,065	\$12,359

During 2004, the Company paid \$1,538 (2003 — \$3,332) for intangible assets and recorded amortization expense of \$3,143 (2003 — \$1,137).

### 8. DEFERRED CHARGES

	2004	2003
Deferred charges . . . . .	\$ 6,604	\$ 4,400
Less: accumulated amortization . . . . .	2,428	1,619
Net carrying value . . . . .	\$ 4,176	\$ 2,781

During 2004, the Company recorded amortization expense of \$809 (2003 — \$809) related to deferred charges.

## NOTES TO FINANCIAL STATEMENTS

(In thousands of Canadian dollars except for share and per share amounts)

### 9. INVESTMENTS

	2004	2003
Investment in common shares of BioSante Pharmaceuticals, Inc., (“BioSante”) a public company in the United States (2003 market value — \$444) (see note (i) and (ii) below) . . . . .	\$ —	\$ 444
Investment in Series B 10% Convertible Preferred Stock of Valera Pharmaceuticals, Inc. (“Valera”) (see note (ii) below) . . . . .	1,433	1,433
	<b>\$ 1,433</b>	<b>\$ 1,877</b>

Management’s review to determine if there has been other than a temporary decline in the market value of these investments below the carrying value may require the Company to recognize an impairment charge on the remaining value of its investments which could be material.

- (i) The Company disposed all of its common shares of BioSante during 2004. The Company recorded a gain of \$577 representing the difference between the proceeds received of \$1,021 and its carrying value of \$444.
- (ii) On May 28, 2003, the Company purchased 1,333,333 Series B convertible preferred voting shares of Valera representing less than 10% of the outstanding share capital on an issued and on a fully diluted basis. Valera is a private corporation based in the United States and it is not practicable within the constraints of timeliness and cost to determine the fair value of the preferred shares. The Company’s assessment of the carrying value of Valera indicates that there is no near-term impairment in the value of the Company’s investment. In December 2003, management determined that the decline in the market value of BioSante was other than temporary. Consequently, the Company recorded a write-down of \$526 related to this investment.
- (iii) In June 2003, Anthra advised the Company that it had disposed of virtually all of its assets and was unable to determine when it would be able to resume production of its marketed product, Valtaxin™. The Company considers that there has been a permanent impairment in the carrying value of the investment in Anthra. Anthra is a private corporation based in the United States and it is not practicable within constraints of timeliness and cost to determine the fair value of the common shares. Consequently, the Company recorded a write-down of \$1,497, representing the full amount of its carrying value of its investment in Anthra.

## NOTES TO FINANCIAL STATEMENTS

(In thousands of Canadian dollars except for share and per share amounts)

### 10. CAPITAL STOCK

#### Authorized

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

#### Issued and outstanding

	2004		2003	
	Number of shares	Amount	Number of shares	Amount
<b>Balance, beginning of year</b> . . . . .	<b>14,799,588</b>	<b>\$57,440</b>	14,780,205	\$7,334
Issued during the year:				
Exercise of stock options . . . . .	49,590	329	10,750	45
Employee share purchase plan . . . . .	9,286	48	8,633	41
Other . . . . .	5	—	—	—
Employee share purchase loan . . . . .	—	20	—	20
<b>Balance, end of year</b> . . . . .	<b>14,858,469</b>	<b>\$57,837</b>	14,799,588	\$7,440

At December 31, 2004, the amount of the share purchase loan to a former employee is \$20 (\$40 in 2003) collateralized by 3,000 common shares (6,000 in 2003), having a fair market value of \$15 (\$30 in 2003).

#### Shareholders Rights Plan

The Company has a Shareholders Rights Plan (“Rights Plan”). Under the Rights Plan, holders of voting shares are entitled to one share purchase right (“Right”) for each voting share held, if any person or group makes a take-over bid or acquires 20% or more of the Company’s outstanding voting shares without complying with the Rights Plan. Each Right entitles the registered holder, other than the acquiring person and parties related to the acquiror, to purchase five (5) common shares from treasury at its current market price.

#### Stock Option Plan

The Company has a Stock Option Plan (“Plan”) in place for the benefit of key employees, directors, officers and consultants of the Company to purchase an aggregate maximum of 1,497,000 common shares (2003 — 1,497,000). Options issued under the plan expire seven years from the grant date and vest equally over four years. The exercise price can not be less than the closing price per common share on the date of the grant. As at December 31, 2004, 433,886 (2003 — 398,813) common share options remain available under the Plan.

## NOTES TO FINANCIAL STATEMENTS

(In thousands of Canadian dollars except for share and per share amounts)

### 10. CAPITAL STOCK

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

	2004		2003	
	#	Weighted average exercise price \$	#	Weighted average exercise price \$
Balance, beginning of year . . . . .	873,984	5.57	706,524	6.18
Granted . . . . .	106,869	5.20	354,818	4.63
Exercised . . . . .	(49,590)	4.83	(10,750)	4.16
Forfeited . . . . .	(141,942)	5.76	(176,608)	6.22
Balance, end of year . . . . .	<u>789,321</u>	<u>5.53</u>	<u>873,984</u>	<u>5.57</u>
Options exercisable at end of year . . . . .	<u>505,464</u>	<u>5.60</u>	<u>412,001</u>	<u>5.74</u>

Additional information concerning stock options outstanding as at December 31, 2004 is as follows:

Exercise price	Options outstanding			Options exercisable	
	Number	Weighted average months to expiry	Weighted average exercise price \$	Number	Weighted average exercise price \$
\$3.16 – \$4.30 . . . . .	223,224	33	4.25	171,926	4.27
\$4.45 – \$4.97 . . . . .	127,056	70	4.65	46,431	4.74
\$5.00 – \$6.07 . . . . .	191,962	58	5.37	95,532	5.13
\$6.35 – \$7.00 . . . . .	211,344	39	6.83	166,210	6.84
\$9.60 – \$10.00 . . . . .	35,735	49	9.87	25,365	9.91
	<u>789,321</u>			<u>505,464</u>	

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

## NOTES TO FINANCIAL STATEMENTS

(In thousands of Canadian dollars except for share and per share amounts)

### 10. CAPITAL STOCK

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:

	2004	2003
Option compensation expense . . . . .	\$ 313	\$ 220
Weighted average fair value of options . . . . .	\$ 3.60	\$ 3.21
Weighted average risk-free interest rate . . . . .	3.97%	4.45%
Dividend yield . . . . .	nil	nil
Weighted average volatility factor . . . . .	66%	69%
Weighted average expected life . . . . .	7 years	7 years

For purposes of proforma disclosure, the fair value of option grants during 2002 was estimated at the date of grant using the following assumptions: weighted average risk-free interest rate of 5.02%; dividend yield of nil; weighted average volatility factor of the expected market price of the Company's common shares of 76%; and a weighted average expected life of the options of 7 years. For purposes of pro forma disclosures, the 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 for pro forma purposes. The weighted average fair value of stock options granted during 2002, under the Black-Scholes option-pricing model and above assumptions, was \$6.05.

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.

	2004	2003
Net income (loss) as reported . . . . .	\$ 3,239	\$(4,172)
Less:		
Amortization of fair value related to options granted in fiscal 2002 . . . . .	(40)	(117)
Amortization of fair value related to the option life amendment in 2002 . . . . .	(52)	(109)
Pro forma net (loss) income . . . . .	\$ 3,147	\$(4,398)
Basic earnings (loss) per share		
As reported . . . . .	0.22	(0.28)
Pro forma . . . . .	0.22	(0.30)
Diluted earnings (loss) per share		
As reported . . . . .	0.22	(0.28)
Pro forma . . . . .	0.21	(0.30)

## NOTES TO FINANCIAL STATEMENTS

(In thousands of Canadian dollars except for share and per share amounts)

### 10. CAPITAL STOCK

#### Stock Purchase Plan

The Company has a Stock Purchase Plan (“Purchase Plan”) allowing permanent employees to purchase up to 200,000 common shares at fair market value from treasury. During 2004, 8,065 (8,580 in 2003) shares were issued at fair market value under the purchase plan.

Under the Purchase Plan, the Company will contribute 25% of employees’ contributions to a maximum of 6% of the employees’ salary in the form of common shares. The Company will make its contribution if the employee remains employed by the Company and has held the original shares for two years from the original purchase date. During 2004, the Company issued 1,221 shares (53 in 2003) representing its 25% contribution and recorded a corresponding expense of \$7 (\$7 in 2003).

### 11. OTHER PAID-IN CAPITAL

The changes to other paid-in capital are as follows:

	2004	2003
<b>Balance, beginning of year</b> . . . . .	\$ 330	\$ 110
Options granted . . . . .	313	220
Options exercised (see (i)) . . . . .	(89)	—
Balance, end of year . . . . .	\$ 554	\$ 330

(i) During 2004, some options for which the Company had previously recorded a non-cash compensation expense were exercised.

### 12. GAIN ON DISPOSITION AND WRITE-DOWN OF INTELLECTUAL PROPERTY

	2003
Products with risk of genericization (i) . . . . .	\$5,115
Products under development (ii) . . . . .	199
Oesclim® (iii) . . . . .	1,725
Gain on disposal (iv) . . . . .	(358)
	\$6,681

The Company recorded write-downs and a gain associated with intellectual property as described below.

- (i) During 2003, management determined that certain products were at a higher risk of generic competition than had been previously estimated. The Company prepared undiscounted cash flows related to these product sales and assessed that, in some cases, the carrying value of the related intellectual property was in excess of its net recoverable amount. The Company then prepared discounted cash flows for these products and has written the carrying value down to the discounted value, resulting in a write-down of \$5,115.
- (ii) During 2003, management determined that certain products had a sufficiently high risk of not being approved for sale, and consequently, that there was a limited expectation of future cash flows. The Company has recorded an impairment charge of \$199.

## NOTES TO FINANCIAL STATEMENTS

(In thousands of Canadian dollars except for share and per share amounts)

### 12. GAIN ON DISPOSITION AND WRITE-DOWN OF INTELLECTUAL PROPERTY

- (iii) The Company entered into a License Agreement for Oesclim<sup>®</sup>, a hormone replacement therapy (HRT) patch for women. Given the decline in sales of Oesclim<sup>®</sup> due to recent concerns relating to female HRT, the Company concluded that there was an impairment in the carrying value and recorded an impairment loss of \$1,725, representing the full carrying value of this license.
- (iv) During 2003, the distribution agreement with Bioniche Life Sciences Inc. for Cystistat<sup>®</sup> was terminated for net proceeds of \$80. The net proceeds were recorded as a gain. Effective January 1, 2003, the Company sold the MoiStir<sup>®</sup> trademark and assigned the licenses of Sialor<sup>®</sup> and the Baker Cummins line of dermatology products to a related party, a subsidiary of JODDES, and recorded a gain of \$278.

### 13. 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.

In June 1998, the Company entered into a number of ten-year agreements each with five-year renewal options with a wholly owned subsidiary of JODDES. Under these agreements, this affiliate provides manufacturing and logistics services including, customer service, warehousing and shipping, invoicing and collection services on behalf of the Company. 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 receivable related to the products distributed by Paladin. Consequently, on February 1, 2004, Paladin purchased \$4.1 million of accounts receivable and \$3.2 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 annual payments of \$133. On November 5, 2003, the Company purchased a three-year license and distribution agreement from PanGeo Pharmaceutical (Canada) Inc. (“PanGeo”). On November 6, 2003, PanGeo was purchased by JODDES.

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:

	2004 \$	2003 \$
Revenues . . . . .	1,979	1,075
Purchases . . . . .	9,595	5,516
Selling and marketing . . . . .	1,592	1,319
General and administrative . . . . .	281	265
Research and development . . . . .	447	241

The Company paid \$170 to an affiliate relating to the purchase of a three-year license and distribution agreement in 2003.

## NOTES TO FINANCIAL STATEMENTS

(In thousands of Canadian dollars except for share and per share amounts)

### 14. RESEARCH AND DEVELOPMENT AND GOVERNMENT ASSISTANCE

The Company incurred research and development expenditures, which are eligible for investment tax credits. The investment tax credits recorded are based on management's estimates of amounts expected to be recovered and are subject to audit by taxation authorities. During 2004, the Company received assessments related to previously claimed investment tax credits and has provided for their repayment. The Company intends to actively contest these assessments.

The amounts can be summarized as follows:

	<b>2004</b>	<b>2003</b>
Research and development expenditures . . . . .	\$ 3,263	\$ 1,477
Investment tax credits related to prior years . . . . .	557	—
Investment tax credits . . . . .	(139)	(175)
	<b>\$ 3,794</b>	<b>\$ 1,302</b>

### 15. INCOME TAXES

Future income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's future tax assets and liabilities are as follows:

	<b>2004</b>	<b>2003</b>
<b>Future income tax assets</b>		
Current		
Tax basis of intangible and other assets in excess of carrying value . . . . .	\$ —	\$ 875
Scientific Research and Experimental Development expenditures not claimed for tax purposes . . . . .	507	845
Tax benefit of share issue costs . . . . .	93	211
Charitable donations . . . . .	—	38
	<b>\$ 600</b>	<b>\$ 1,969</b>

## NOTES TO FINANCIAL STATEMENTS

(In thousands of Canadian dollars except for share and per share amounts)

### 15. INCOME TAXES

	<u>2004</u>	<u>2003</u>
Long-term		
Tax basis of intangible and other assets in excess of carrying value . . . . .	\$ 1,599	\$ 1,520
Scientific Research and Experimental Development expenditures not claimed for tax purposes . . . . .	1,279	759
Tax benefit of share issue costs . . . . .	92	184
	<u>2,970</u>	<u>2,463</u>
<b>Total future income tax assets . . . . .</b>	<b><u>\$ 3,576</u></b>	<b><u>\$ 4,432</u></b>
<b>Future income tax liabilities</b>		
Long-term		
Tax basis of deferred charges less than carrying value . . . . .	<u>1,255</u>	862
<b>Total future income tax liabilities . . . . .</b>	<b><u>1,255</u></b>	<b><u>862</u></b>
<b>Net future income tax assets . . . . .</b>	<b><u>\$ 2,315</u></b>	<b><u>\$ 3,570</u></b>
The Company's income tax provision (recovery) consists of the following:		
	<u>2004</u>	<u>2003</u>
Provision (recovery) at Canadian statutory rates (31.02%) (2003 — 33.13%) . . . . .	\$ 1,266	\$(1,977)
Increase (decrease) resulting from:		
Non-deductible expense . . . . .	131	113
Net drawdown of deferred credit . . . . .	(300)	(513)
Large corporation tax . . . . .	—	88
Impact of change in tax rates . . . . .	—	170
Tax effect of capital items . . . . .	(163)	279
Other . . . . .	23	44
	<u>\$ 957</u>	<u>\$(1,796)</u>

As at December 31, 2004, the Company had Scientific Research and Experimental Development expenditures available for Federal and Provincial income tax purposes, amounting to approximately \$5,757 and \$7,012, respectively, which may be applied against taxable income of future years. The Company also has Federal investment tax credits from Scientific Research and Experimental Development expenditures amounting to \$439 which expire between 2010 and 2013. The benefit related to these items has been recognized in the financial statements.

## NOTES TO FINANCIAL STATEMENTS

(In thousands of Canadian dollars except for share and per share amounts)

### 15. INCOME TAXES

The Company has capital losses carried forward totalling \$198 which have not been recognized in the financial statements.

The Company recorded a gross reduction of current tax expense reflecting the claiming of Federal and Provincial losses carryforward and Scientific Research and Experimental Development expenditures in the current year in the amount of \$300 (2003 — \$813). The amount of the tax benefits claimed in the current and prior years, are subject to audit by the taxation authorities and could be reduced by a material amount in the future.

### 16. EARNINGS (LOSS) 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:

	2004 #	2003 #
Basic weighted average number of shares outstanding . . . . .	14,834,988	14,787,733
Dilutive effect of stock options . . . . .	75,810	—
Diluted weighted average number of shares outstanding . . . . .	14,910,798	14,787,733

There was no adjustment to net income for purposes of calculating diluted earnings per share. For 2003, the Company's diluted loss per share is equivalent to its basic loss per share, since all of the Company's potentially issuable options would have an anti-dilutive effect.

### 17. 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 and services based commitments.

#### Revenue based commitments

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

In addition, the Company may have to pay up to \$4,493 (US\$3,725) and \$100 if the Company achieves specific sales volumes on specific products in the future, over a maximum of 10 years.

#### Milestone based commitments

The Company has also committed to fund certain research and development expenditures of third parties for \$302 (US\$250) over the next two years. In addition, 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 \$2,554, including US\$2,117, over a maximum period of 15 years.

## NOTES TO FINANCIAL STATEMENTS

(In thousands of Canadian dollars except for share and per share amounts)

### 17. COMMITMENTS

#### 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 \$12,241, to retain exclusive distribution agreements for certain products. These commitments end in 2011 and annual commitments are as follows:

2005 . . . . .	\$3,472
2006 . . . . .	3,316
2007 . . . . .	2,376
2008 . . . . .	856
2009 . . . . .	861
2010 – 2011 . . . . .	1,360

### 18. FINANCIAL INSTRUMENTS

#### (i) Fair values

##### Short-term financial assets and liabilities

The carrying amounts of cash and cash equivalents, short-term marketable securities, accounts receivable and accounts payable are a reasonable estimate of their fair values because of the short maturity of these instruments. The effective rate of return on cash equivalents and marketable securities is approximately 2.9% (2003 — 3.2%).

##### Long-term financial assets

The carrying amount of long-term marketable securities are a reasonable estimate of their fair value because they were recently acquired at market value.

#### (ii) Concentration of credit risk and major customers

Investment tax credits receivable and research and development tax credits receivable are due from the Federal and Provincial governments.

The Company continually monitors its customers' credit. It establishes the provision for doubtful accounts based upon the credit risk applicable to each customer. For the year ended December 31, 2004, two customers, a major wholesale distributor and a major retail chain, represented 33% and 15% of revenues, respectively. As at December 31, 2004, two customers, a major wholesale distributor and a major retail chain, represented 60% and 19% of trade accounts receivable, respectively.

### 19. SEGMENTED INFORMATION

The Company operates in a single business segment focused on the in-licensing or acquiring, marketing, distributing and developing pharmaceutical products in Canada. In addition, the Company earns interest income from the investment of its excess cash. The Company operates out of its facilities in Canada and all of its assets are located in Canada.

### 20. COMPARATIVE FIGURES

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

## **CORRESPONDENCE**

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## **STOCK EXCHANGE LISTING**

Toronto Stock Exchange  
Trading symbol: PLB

## **SHARES OUTSTANDING**

14,858,469 Common Shares  
(at December 31, 2004)

## **FISCAL 2004 TRADING SUMMARY**

High: \$6.25  
Low: \$3.95  
Close: \$4.84  
Average daily volume: 6,838 shares

## **TRANSFER AGENT**

Computershare Trust Company of Canada  
1-800-564-6253

## **AUDITORS**

Ernst & Young LLP

## **ANNUAL GENERAL MEETING**

May 3, 2005, 5 p.m.  
6111 Royalmount Avenue  
Suite 102  
Montreal, QC H4P 2T4

This Report is also available on the Internet at [www.paladinlabs.com](http://www.paladinlabs.com).  
Ce document est aussi disponible en français.



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