

PALADIN LABS INC.
CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2006



Management Discussion And Analysis:

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

The following analysis explains the variations in the consolidated results of operations, financial position and cash flows for Paladin Labs Inc. (“Paladin” or the “Company”) and is current as at August 2, 2006. This discussion should be read in conjunction with the information contained in the Company’s interim and annual consolidated financial statements and the related notes to the consolidated financial statements. As at August 2, 2006, 14,921,173 shares were issued and outstanding.

Forward-Looking Statements

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

Overview

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

Second quarter highlights:

- Revenues reached \$11,241, an increase of 44% over the same period last year
- Net income was \$1,214, an increase of 108% over the same period last year
- Cash flows from operations reached \$2,856, a 44% increase over the same period last year
- Donated nearly \$300,000 in medication to Health Partners International of Canada destined for Nicaragua
- Won the prestigious Mercuriades Award for the best company in the Trade and Distribution Category demonstrating exceptional quality of performance in Quebec.

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 the timing and number of product launches. Each new product launch requires significant promotional investment during the first three to five years from launch. The level of patient and physician acceptance of Paladin’s products, the acceptance of Provincial government reimbursement on such products, market access, as well as the availability of similar therapies, impact Paladin’s revenues by driving the level and timing of prescriptions for its products.

Critical Accounting Estimates

Paladin’s consolidated financial statements are prepared in accordance with Canadian generally accepted accounting principles, applied in a consistent basis. Paladin’s critical accounting estimates include revenue recognition, the recording of research and development expenses, the fair value and useful lives of intangible assets, stock based compensation expense and future income tax asset recording. For a more detailed discussion of the Company’s critical accounting, please refer to the Management Discussion & Analysis included in the Company’s 2005 Annual Report. There have been no material changes to accounting estimates since December 31, 2005.

Results of Operations

Three-month period ended June 30, 2006 compared to three-month period ended June 30, 2005, and six-month period ended June 30, 2006 compared to six-month period ended June 30, 2005.

Revenues

Revenues increased \$3,433 or 44% to \$11,241 for the three-month period ended June 30, 2006 from \$7,808 for the three-month period ended June 30, 2005. For the six-month period ended June 30, 2006, revenues increased \$7,137 or 50% to \$21,373 from \$14,236 for the six-month period ended June 30, 2005. These increases are due primarily to strong performance from the Company's key promoted products, including Estring[®], Oxytrol[®], Plan B[®] and Twinject[®] which increased by 75% for the three-month period ended June 30, 2006 compared to the three-month period ended June 30, 2005 and by 239% for the six-month period ended June 30, 2006 compared to the six-month period ended June 30, 2005. The Company's acquisition of Pennsaid[®], contributed \$1,905 to the Company's revenues for the three-month period ended June 30, 2006 and \$3,308 for the six-month period ended June 30, 2006 (see note 5).

Gross Profit

Total gross profit increased \$2,890 or 51% to \$8,545 for the three-month period ended June 30, 2006 from \$5,655 for the three-month period ended June 30, 2005. For the six-month period ended June 30, 2006, gross profit increased \$5,678 or 54% to \$16,112 from \$10,434 for the six-month period ended June 30, 2005. Gross profit, as a percentage of revenues, increased to 76% for the three-month period ended June 30, 2006 from 72% for the three-month period ended June 30, 2005. Gross profit, as a percentage of revenues, increased to 75% for the six-month period ended June 30, 2006 from 73% for the six-month period ended June 30, 2005. This increase in gross profit, as a percentage of sales, resulted primarily from the launch of new products yielding a higher gross profit margin and a change in the proportion of products sold for which the Company earns a distribution fee and consequently does not incur cost of sales related to these products.

Selling and Marketing Expense

Selling and marketing expense increased \$804 or 27% to \$3,808 for the three-month period ended June 30, 2006 from \$3,004 for the three-month period ended June 30, 2005. For the six-month period ended June 30, 2006 selling and marketing expense increased \$2,099 or 42% to \$7,146 from \$5,047 for the six-month period ended June 30, 2005. The increase in selling and marketing expense was primarily attributed to the increased promotion activities relating to the launch of Twinject[®], the continued promotional expenses relating to the previous year's launch of Oxytrol[®], the re-launch of Plan B[®] as a non-prescription product and the co-promotion expenses relating to Pennsaid[®]. Selling and marketing expense, as percentage of revenues, decreased to 34% for the three-month period ended June 30, 2006 from 38% for the three-month period ended June 30, 2005. Selling and marketing expense, as percentage of revenues, decreased to 33% for the six-month period ended June 30, 2006 from 35% for the six-month period ended June 30, 2005.

General and Administrative Expense

General and administrative expense increased \$237 or 29% to \$1,057 for the three-month period ended June 30, 2006 from \$820 for the three-month period ended June 30, 2005. For the six-month period ended June 30, 2006 general and administrative expense increased \$710 or 43% to \$2,371 from \$1,661 for the six-month period ended June 30, 2005. General and administrative expense, as percentage of revenues, decreased to 9% for the three-month period ended June 30, 2006 from 11% for the three-month period ended June 30, 2005. Similarly, general and administrative expense, as percentage of revenues, decreased to 11% for the six-month period ended June 30, 2006 from 12% for the three-month period ended June 30, 2005.

Research and Development Expense

Research and development expense increased \$194 or 69% to \$476 for the three-month period ended June 30, 2006 from \$282 for the three-month period ended June 30, 2005. For the six-month period ended June 30, 2006 research and development expense increased \$175 or 29% to \$788 from \$613 for the six-month period ended June 30, 2005. This increase is primarily attributable to increased product submission fees related to certain product opportunities during the three-month and six-month periods ended June 30, 2006 which are currently awaiting regulatory response.

Amortization

Amortization expense increased \$683 or 58% to \$1,734 for the three-month period ended June 30, 2006 from \$1,096 for the three-month period ended June 30, 2005. For the six-month period ended June 30, 2006, amortization expense increased \$1,429 or 65% to \$3,611 from \$2,182 for the six-month period ended June 30, 2005. This increase in amortization expense is the result of the amortization related to the Company's newly acquired pharmaceutical product licenses and rights, and deferred charges.

Net Interest Income

Net interest income increased \$41 or 13% to \$366 for the three-month period ended June 30, 2006 from \$325 for the three-month period ended June 30, 2005 primarily as a result of higher interest rates. For the six-month period ended June 30, 2006, interest income decreased \$27 or 4% to \$600 from \$627 for the six-month period ended June 30, 2005. This decrease is primarily the result of certain interest payments the Company was required to disburse as well as lower average cash and marketable securities balances over the six-month period ended June 30, 2006 compared to the six-month period ended June 30, 2005, offset by higher interest rates.

Other Income

Other income was nil and \$724 for the three and six month periods ended June 30, 2006, compared to \$110 for the three and six month periods ended June 30, 2005, respectively. Other income for the three and six-month periods ended June 30, 2006 relates to a stock dividend received during the period from one of the Company's portfolio investments. Other income for the three and six-month periods ended June 30, 2005 relates to certain product marketing agreements under which the Company earns a service fee for marketing activities performed by the Company.

Income Tax Expense

Income tax expense increased \$319 to \$622 for the three-month period ended June 30, 2006 from \$303 for the three-month period ended June 30, 2005. For the six-month period ended June 30, 2006, income tax expense increased \$572 to \$1,156 from \$584 for the six-month period ended June 30, 2005. For the three and six-month periods ended June 30, 2006 the effective tax rate was 34% and 33%, respectively, compared to 34% and 35% for the three and six-month period ended June 30, 2005.

Net Income

Due to the factors set forth above, net income increased \$629 to \$1,214 for the three-month period ended June 30, 2006 compared to net income of \$585 for the three-month period ended June 30, 2005 and increased \$1,280 to \$2,364 for the six-month period ended June 30, 2006 from \$1,084 for the six-month period ended June 30, 2005.

Liquidity and Capital Resources

The Company believes that its existing cash and cash equivalents and short-term marketable securities, as well as cash generated from operations, are sufficient to finance its current operations 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 increased \$1,611 to \$43,930 at June 30, 2006 from \$42,319 at December 31, 2005. This increase is primarily due to positive cash-flows from operations in the amount of \$5,193 in excess of investing activities of \$3,850 in addition to cash received from financing activities in the amount of \$613.

Working capital increased \$3,219 to \$50,735 at June 30, 2006 from \$47,516 at December 31, 2005. This increase is primarily due to cash raised through positive operating cash-flows.

Cash flows from operating activities increased 44% to \$2,856 for the three-month period ended June 30, 2006 from \$1,980 for the three-month period ended June 30, 2005. Cash flows from operating activities for the six-month period ended June 30, 2006 were \$5,193 compared to \$4,070 for the six-month period ended June 30, 2005. Cash flows from operating activities represent the cash flows from net earnings, excluding revenues and expenses not affecting cash, principally amortization, future income taxes, stock based compensation expense and stock dividend income.

Cash flows used in investing activities were \$7,259 for the three-month period ended June 30, 2006 compared to cash flows from investing activities of \$88 for the three-month period ended June 30, 2005. During the three month period ended June 30, 2006, the Company invested \$202 towards the acquisition of pharmaceutical product licenses and rights, and deferred charges, \$27,133 towards the purchase of short-term marketable securities offset by cash generated by maturing marketable securities in the amount of \$20,076. For the three-month period ended June 30, 2005, the Company invested \$807 in acquisitions of pharmaceutical product licenses and rights, and deferred charges offset by cash generated from maturing marketable securities in the amount of \$907.

Cash flows used in investing activities were \$3,850 compared to cash flows from investing activities of \$1,455 for the six-month periods ended June 30, 2006 and 2005, respectively. During the six month period ended June 30, 2006, the Company invested \$3,654 in acquisitions of pharmaceutical product licenses and rights, and deferred charges, \$500 in the form of an investment in a portfolio company, \$39 towards the acquisition of property plant and equipment, offset by cash flows generated from maturing marketable securities in the amount of \$343. For the six-month period ended June 30, 2005, the Company had invested \$1,009 in acquisitions of pharmaceutical product licenses and rights, and deferred charges offset by cash flows generated from maturing marketable securities in the amount of \$4,466.

Cash flows used in financing activities were \$7 for the three-month period ended June 30, 2006 compared to cash flows used in financing activities of \$684 for the three-month period ended June 30, 2005. During the three-month period ended June 30, 2006, \$227 was generated from common stock option exercises and the issuance of common shares under the stock purchase plan offset by a payment related to the acquisition of intellectual property in the amount of \$234. For the three-month period ended June 30, 2005, under the terms of the normal course issuer bid, the Company repurchased 107,500 of its own shares for \$482. In addition, accounts payable related to the acquisition of intellectual property and deferred charges decreased by \$234, offset by \$12 generated by the issuance of common shares for cash and a repayment of a share purchase loan in the amount of \$20.

Cash flows from financing activities were \$613 for the six-month period ended June 30, 2006 compared to cash flows used in financing activities of \$1,035 for the six-month period ended June 30, 2005. During the six-month period ended June 30, 2006, \$847 was generated from common stock option exercises and the issuance of common shares under the stock purchase plan offset by a payment related to the acquisition of intellectual property in the amount of \$234. For the six-month period ended June 30, 2005, under the terms of the normal course issuer bid, the Company repurchased 107,500 of its own shares for \$482. In addition, accounts payable related to the acquisition of intellectual property and deferred charges decreased by \$598, offset by \$25 generated by the issuance of common shares for cash and a repayment of a share purchase loan in the amount of \$20.

Related Party Transactions

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

The Company engages this affiliate to provide logistics services, including customer service, warehousing and shipping, invoicing and collection services as well as to perform certain research and development services on a contractual pay-for-use basis. The Company also leases its office facilities from another wholly-owned subsidiary of JODDES. This lease is for a period of 3 years and includes annual minimum payments of \$159.

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

The table below reflects all transactions and services with affiliates which include those referred to in the agreements described above as well as revenues from a wholly-owned subsidiary of JODDES:

	Three-month period ended June 30		Six-month period ended June 30	
	2006	2005	2006	2005
	\$	\$	\$	\$
Revenues	162	174	332	375
Purchases	3,034	1,188	5,147	2,330
Research and development expenses	52	65	76	113
Sales and marketing expenses	663	449	1,234	820
General and administrative expenses	68	73	159	143

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.

Contractual Obligations and Commitments

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

	Contractual Obligations	Commitments	
	Purchase and service based commitments	Milestone based commitments	Revenue based commitments
	\$	\$	\$
July 1, 2006 – December 31, 2006	2,547	580	145
Fiscal 2007 – fiscal 2009	4,526	1,211	232
Fiscal 2010 – fiscal 2011	1,360	—	290
After fiscal 2012	—	2,168	10,530
Total	8,433	3,959	11,197

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

The consolidated financial statements of Paladin Labs Inc. (the “**Company**”) and the accompanying interim consolidated balance sheet as at June 30, 2006 and the interim consolidated statements of income, retained earnings and cash flows for the three-month period then ended are the responsibility of the Company’s management. These consolidated financial statements have not been audited or reviewed on behalf of the shareholders by the independent external auditors, Ernst & Young LLP.

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

(signed) Jonathan Ross Goodman
Jonathan Ross Goodman, B.A., LL.B, M.B.A.
President and Chief Executive Officer
Montreal, Canada
August 2, 2006

(signed) Samira Sakhia
Samira Sakhia C.A., M.B.A.
Chief Financial Officer
Montreal, Canada
August 2, 2006

CONSOLIDATED BALANCE SHEETS

[In thousands of Canadian dollars]

	June 30 2006 \$	December 31 2005 \$
	(unaudited)	
ASSETS		
Current		
Cash and cash equivalents	4,789	2,835
Marketable securities	39,141	39,484
Accounts receivable	8,341	8,128
Inventory	3,747	3,178
Other current assets	789	865
Investment tax credits receivable	827	827
Future income tax assets	2,949	3,158
Total current assets	60,583	58,475
Property, plant and equipment	102	96
Pharmaceutical product licenses and rights	9,395	9,135
Deferred charges	3,692	3,908
Investments	2,682	1,433
Future investment tax credits recoverable	153	153
Future income tax assets	3,848	4,479
	80,455	77,679
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Accounts payable and accrued liabilities	7,704	7,679
Accounts payable to related parties	892	1,044
Deferred revenue	426	903
Income taxes payable	135	408
Balance of license agreements payable	464	698
Balance of sale payable <i>[note 5]</i>	227	227
Total current liabilities	9,848	10,959
Long-term		
Balance of sale payable <i>[note 5]</i>	482	470
Future income tax liabilities	321	—
Total long-term liabilities	803	470
Shareholders' equity <i>[note 3]</i>		
Capital stock	58,341	57,378
Other paid-in capital	1,160	933
Retained earnings	10,303	7,939
Total shareholders' equity	69,804	66,250
	80,455	77,679

See accompanying notes

CONSOLIDATED STATEMENTS OF INCOME AND RETAINED EARNINGS

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

[unaudited]

	Three-month period ended		Six-month period ended	
	2006	June 30 2005	2006	June 30 2005
	\$	\$	\$	\$
Revenues	11,241	7,808	21,373	14,236
Cost of sales	2,696	2,153	5,261	3,802
Gross profit	8,545	5,655	16,112	10,434
Selling and marketing	3,808	3,004	7,146	5,047
General and administrative	1,057	820	2,371	1,661
Research and development	476	282	788	613
Amortization of intangible assets and deferred charges	1,734	1,096	3,611	2,182
Interest income, net	(366)	(325)	(600)	(627)
Other Income	—	(110)	(724)	(110)
Income before income taxes	1,836	888	3,520	1,668
Provision for income taxes				
Future	622	303	1,156	584
	622	303	1,156	584
Net income	1,214	585	2,364	1,084
Retained earnings, beginning of period	9,089	5,300	7,939	4,801
Purchase of common shares	—	(64)	—	(64)
Retained earnings, end of period	10,303	5,821	10,303	5,821
Earnings per share				
Basic	0.08	0.04	0.16	0.07
Diluted	0.08	0.04	0.16	0.07
Weighted average number of shares outstanding <i>[note 4]</i>				
Basic	14,891,946	14,846,483	14,830,676	14,852,728
Diluted	15,112,323	14,856,774	15,026,206	14,862,999

See accompanying notes

CONSOLIDATED STATEMENTS OF CASH FLOWS

[In thousands of Canadian dollars]

[unaudited]

	Three-month period ended		Six-month period ended	
	June 30		June 30	
	2006	2005	2006	2005
	\$	\$		
Operating activities				
Net income	1,214	585	2,364	1,084
Add items not affecting cash				
Amortization	1,750	1,111	3,644	2,212
Stock based compensation expense [note 3]	212	125	346	192
Future income taxes	620	302	1,166	567
Unrealized foreign exchange (gain) loss	(1)	(1)	(1)	(18)
Stock dividends	—	—	(724)	—
	3,795	2,122	6,795	4,037
Net change in non-cash balances relating to operations	(939)	(142)	(1,602)	33
Cash flows from operating activities	2,856	1,980	5,193	4,070
Investing activities				
Additions to pharmaceutical product licenses, rights, and deferred charges	(202)	(807)	(3,654)	(1,009)
Acquisition of property, plant and equipment	—	(12)	(39)	(19)
Purchases of short-term marketable securities	(27,133)	(18,722)	(29,712)	(19,918)
Maturities of short-term marketable securities	20,076	21,112	30,055	24,384
Investment in portfolio company	—	—	(500)	—
Purchases of long-term marketable securities	—	(1,483)	—	(1,983)
Cash flows (used in) from investing activities	(7,259)	88	(3,850)	1,455
Financing activities				
Common shares issued for cash	227	12	847	25
Accounts payable related to the acquisition of intellectual property and deferred charges	(234)	(234)	(234)	(598)
Repurchase of shares	—	(482)	—	(482)
Repayment of share purchase loan	—	20	—	20
Cash flows from (used in) financing activities	(7)	(684)	613	(1,035)
Effect of exchange rate change on cash and cash equivalents	(2)	3	(2)	(5)
Net change in cash and cash equivalents during the period	(4,412)	1,387	1,954	4,485
Cash and cash equivalents, beginning of period	9,201	4,605	2,835	1,507
Cash and cash equivalents, end of period	4,789	5,992	4,789	5,992
Cash and cash equivalents	4,789	5,992		
Short-term marketable securities	39,141	36,651		
Long-term marketable securities	—	1,483		
	43,930	44,126		

See accompanying notes

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

1. Basis of presentation

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

2. Accounting policies

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

3. Capital Stock

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

Issued and outstanding:

	Number of shares	Amount
Balance at beginning of year	14,732,368	\$57,378
Issued upon exercise of stock options	184,779	935
Issued under employee share purchase plan	4,026	28
Balance at June 30, 2006	14,921,173	\$58,341

Stock option plan

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

	2006		2005	
	#	Weighted average exercise price \$	#	Weighted average exercise price \$
Balance at beginning of year	915,743	5.57	789,321	5.53
Granted	145,500	6.87	130,250	4.35
Exercised	(184,779)	4.43	—	—
Expired or forfeited	(6,336)	5.29	(66,078)	5.77
Balance at June 30	870,128	5.84	853,493	5.33
Options exercisable at June 30	508,519	6.04	551,492	5.52

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

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

	Three-month period ended		Six-month period ended	
	2006	June 30 2005	2006	June 30 2005
Option compensation expense	210	123	342	187
Weighted average fair value of stock options	\$5.02	\$2.70	\$4.26	\$2.80
Weighted average risk-free interest rate	4.34%	3.83%	4.15%	3.86%
Dividend yield	nil	nil	Nil	nil
Weighted average volatility factor	58%	61%	58%	62%
Weighted average expected life	7 years	7 years	7 years	7 years

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

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

	Three-month period ended		Six-month period ended	
	2006	June 30 2005	2006	June 30 2005
	\$	\$	\$	\$
Net income as reported	1,214	585	2,364	1,084
Less: Amortization of fair value related to options granted in fiscal 2002	(2)	(10)	(8)	(21)
Amortization of fair value related to option life amendment in fiscal 2002	(2)	(4)	(4)	(11)
Pro-forma net income	1,210	571	2,352	1,052
Basic Earnings per share				
As reported	0.08	0.04	0.16	0.07
Pro-forma	0.08	0.04	0.16	0.07
Diluted Earnings per share				
As reported	0.08	0.04	0.16	0.07
Pro-forma	0.08	0.04	0.16	0.07

4. Earnings per share

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

Earnings per share	Three-month period ended		Six-month period ended	
	2006	June 30 2005	2006	June 30 2005
Basic weighted average number of shares outstanding	14,891,946	14,846,483	14,830,676	14,852,728
Dilutive effect of options	220,377	10,291	195,530	10,271
Diluted weighted average number of shares outstanding	15,112,323	14,856,774	15,026,206	14,862,999

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

5. Business acquisition

On August 16, 2005, Paladin acquired all the issued and outstanding shares of Dimethaid Health Care Ltd., subsequently renamed Squire Pharmaceuticals Inc. ("Squire"), a subsidiary of Nuvo Research Inc. (TSX: NRI), formerly Dimethaid Research Inc., for total consideration of \$8,445 consisting of \$5,748 in cash, \$2,000 for the assumption of a note payable in Squire, which was immediately repaid, and a \$827 non-interest bearing balance of sale payable of which \$227 is payable in the short term and \$600 is payable the earlier of meeting certain acquisition related conditions or December 31, 2010. Given the non-interest bearing nature of the \$827 balance of sale payable, the amount has been recorded in these financial statements at its discounted net present value of \$703 which will be accreted through charges to interest expense over the repayment term. Squire owns the Canadian license for Pennsaid[®], a lotion approved by Health Canada for the treatment of symptoms of knee osteoarthritis.

6. Related party transactions

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

The Company engages a wholly owned subsidiary of this affiliate to provide logistics services, including customer service, warehousing and shipping, invoicing and collection services as well as to perform certain research and development services on a contractual pay-for-use basis. The Company also leases its office facilities from another wholly owned subsidiary of JODDES. This lease is for a period of 3 years and includes minimum annual payments of \$159.

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

The table below reflects all transactions and services with affiliates which include those referred to in the agreements described above as well as revenues from a wholly-owned subsidiary of JODDES:

	Three-month period ended June 30		Six-month period ended June 30	
	2006	2005	2006	2005
	\$	\$	\$	\$
Revenues	162	174	332	375
Purchases	3,034	1,188	5,147	2,330
Research and development expenses	52	65	76	113
Sales and marketing expenses	663	449	1,234	820
General and administrative expenses	68	73	159	143

7. Commitments

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

Revenue based commitments

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

In addition, the Company may have to pay up to \$11,097 [US\$9,575] and \$100 if the Company achieves specific sales volumes on specific products in the future over a maximum of 10 years.

Milestone based commitments

The Company has also committed to fund certain research and development expenditures of third parties for \$1,449 [US\$1,250] over the next five years. In addition, additional payments maybe required under these agreements if milestones are met, such as regulatory approval in Canada. Based on the outcome of these milestones, the Company may have to pay up to \$2,510, including US\$2,093, over a maximum period of 15 years.

Purchase and service based commitments

The Company is committed to making minimum purchases of inventory, and minimum expenditures for regulatory, selling and marketing services in the amount of \$8,433, to retain exclusive distribution agreements for certain products. These commitments end in 2011 and annual commitments are as follows:

	\$
July 1, 2006 - December 31, 2006	2,547
2007	2,390
2008	1,275
2009	861
2010	677
2011-2012	683

8. Comparative figures

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

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