

PALADIN LABS INC.
CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2007



Management Discussion and Analysis:

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

This management's discussion and analysis provides our overview of the Company's operations, performance and financial condition for the quarter ended March 31, 2007 and compares these unaudited quarterly results to those of the quarter ended March 31, 2006. It is intended to complement and supplement financial information included in the interim and annual consolidated financial statements, related notes, other financial information found elsewhere in our annual report and in our annual information form or other documents filed on SEDAR at www.sedar.com. As a result, it should be read in conjunction with such financial information. This management's discussion and analysis is current as at May 9, 2007 and 14,998,889 shares were issued and outstanding as at this date. Reference to "Paladin" or the "Company" includes Paladin Labs Inc. and all its subsidiaries.

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.

Overview

Paladin is a specialty pharmaceutical company focused on developing, acquiring, in-licensing, marketing, and distributing innovative pharmaceutical products. Through a national sales force, the Company markets its pharmaceutical products to Canadian physicians.

First quarter highlights:

- Revenues reached \$12,893, an increase of 27% over the same period last year
- Net income was \$1,264, an increase of 10% over the same period last year
- Cash flows from operations reached \$4,503, a 95% increase over the same period last year
- EBITDA¹ was \$4,820, an increase of 70% over the same period last year
- Entered into a Canadian development, promotion and distribution agreement for Oralair™, Stallergenes' allergen extract immunotherapy sublingual tablets. Stallergenes and Paladin plan to submit the first product under this agreement, Oralair™ Grasses, for regulatory approval in 2007
- Approval by Health Canada for a new one-step dosing regimen for Plan B®
- Awarded the Biotechnology/Biopharmaceutical Entrepreneurship Award for outstanding growth and Jonathan Ross Goodman, President & CEO, awarded the BRIO Award for significant contribution to the development of the life sciences industry
- Announced a normal course issuer bid effective February 27, 2007
- Subsequent to the quarter end, acquired all the outstanding shares of BioEnvelop Inc., a wholly owned subsidiary of BioEnvelop Technologies Inc. (TSX-V:BIE), having expertise in developing and manufacturing rapidly dissolving edible films for the nutraceutical and pharmaceutical markets.
- Subsequent to the quarter end, entered into an agreement with Shire BioChem Inc., Shire US Inc. Shire US Manufacturing Inc. and Shire LLC to acquire the rights to a total of eight products currently marketed in Canada by Shire BioChem Inc.

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

¹ **EBITDA - Non-GAAP financial measures**

The term EBITDA (earnings before interest, taxes, depreciation and amortization) does not have any standardized meaning under Canadian Generally Accepted Accounting Principles ("GAAP") and therefore may not be comparable to similar measures presented by other companies. The Company defines EBITDA as earnings before interest expense, taxes, amortization, and unusual items; such as write-downs and gains (losses) on intellectual property and investments. EBITDA is calculated and presented consistently from period to period and agrees, on a consolidated basis, with the amount disclosed as earnings before under-noted items on the consolidated statement of income. The Company believes EBITDA to be an important measurement that allows it to assess the operating performance of its ongoing business on a consistent basis without the impact of depreciation and amortization expenses. The Company excludes depreciation and amortization expenses because their level depends substantially on non-operating factors such as the historical cost of capital assets. The Company's method for calculating EBITDA may differ from that used by other issuers and, accordingly, this measure may not be comparable to EBITDA used by other issuers.

Critical Accounting Estimates

Paladin's consolidated financial statements are prepared in accordance with Canadian GAAP, applied in a consistent basis. Paladin's critical accounting estimates include revenue recognition, inventory valuation, the recording of research and development expenses and related tax credits, the useful lives and fair value of intangible assets, stock based compensation expense and income taxes. For a more detailed discussion of the Company's critical accounting, please refer to the management's discussion & analysis included in the Company's 2006 Annual Report. There have been no material changes to accounting estimates since December 31, 2006.

Results of Operations

Three-month period ended March 31, 2007 compared to three-month period ended March 31, 2006.

Revenues

Revenues increased \$2,761 or 27% to \$12,893 for the three-month period ended March 31, 2007 from \$10,132 for the three-month period ended March 31, 2006. These increases are principally due to the strong sales performance of the Company's key promoted products, including Twinject[®], Oxytrol[®], Plan B[®], Trelstar[®], Pennsaid[®] and Metadol[®] which increased by 60% for the three-month period ended March 31, 2007 compared to the three-month period ended March 31, 2006.

Gross Profit

Total gross profit increased \$2,854 or 38% to \$10,421 for the three-month period ended March 31, 2007 from \$7,567 for the three-month period ended March 31, 2006. Gross profit, as a percentage of revenues, increased to 81% for the three-month period ended March 31, 2007 from 75% for the same period last year. This increase in gross profit as a percentage of sales, resulted primarily from the launch of new products yielding a higher gross profit margin, the effect of terminating a co-promotion agreement which previously shared Pennsaid[®] revenues and the 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. It is expected that gross profit, as a percentage of revenues, will approximate 76% to 78% for the year ending December 31, 2007.

Selling and Marketing Expense

Selling and marketing expense increased \$1,010 or 30% to \$4,348 for the three-month period ended March 31, 2007 from \$3,338 for the three-month period ended March 31, 2006. Selling and marketing expense, as percentage of revenues, increased to 34% for the three-month period ended March 31, 2007 from 33% for the same period last year. This increase was primarily attributed to increased promotional activities relating to Paladin's launch of Pennsaid[®], Metadol[®], Trelstar[®] and PravASA[®], as well as the continued promotion activities for Twinject[®], Plan B[®] and Oxytrol[®].

General and Administrative Expense

General and administrative expense decreased \$209 or 16% to \$1,105 for the three-month period ended March 31, 2007 from \$1,314 for the three-month period ended March 31, 2006. General and administrative expense, as percentage of revenues, decreased to 9% from 13% for the same period last year. This decrease is as a result of costs associated with a milestone corporate event for the period ended March 31, 2006, not occurring during the current period.

Research and Development Expense

Research and development expense increased \$219 or 70% to \$531 for the three-month period ended March 31, 2007 from \$312 for the three-month period ended March 31, 2006. During the three-month periods ended March 31, 2007 and 2006, Paladin's research and development efforts have been to search and explore potential product opportunities for internal development. This increase is primarily attributable to an increased head-count, certain payments for contractual clinical studies and product submission fees related to product opportunities.

Amortization

Amortization expense increased \$741 or 39% to \$2,618 for the three-month period ended March 31, 2007 from \$1,877 for the three-month period ended March 31, 2006. 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 \$149 or 64% to \$383 for the three-month period ended March 31, 2007 from \$234 for the three-month period ended March 31, 2006. This increase is due to the netting of certain interest payments the Company was required to disburse to interest income in 2006. The Company did not incur such interest expense for the period ended March 31, 2007. In addition, upon adoption of Section 3855- *Financial Instruments, Recognition and Measurement*, the Company has accreted interest income on the allocated loan portion of a secured convertible term note investment in a portfolio company, in the amount of \$17.

Unrealized Loss on Embedded Derivative Instrument

Upon adoption of Section 3855, as further described above, the Company using the Black-Scholes option pricing model determined the fair value of the conversion option on the secured convertible term note investment in a portfolio company as at January 1, 2007, and subsequently re-measured it as at March 31, 2007, and recognized an unrealized loss for the three-month period ended March 31, 2007 in the amount of \$210.

Gain on Disposal of Investment

During the three-month period ended March 31, 2007, the Company exercised its right to convert \$158 of a secured convertible term note in one of the Company's portfolio investments into common shares and subsequently sold such shares in the public market for \$232, representing a gain of \$74.

Other Income

Other income was nil for the three-month period ended March 31, 2007 compared to \$724 for the same period last year which related to a stock dividend received during the period from one of the Company's portfolio investments.

Income Tax Expense

Income tax expense increased \$268 to \$802 for the three-month period ended March 31, 2007 from \$534 for the three-month period ended March 31, 2006. The effective tax rate was 39% for the three-month period ended March 31, 2007 compared to 32% for the three-month period ended March 31, 2006. The Company has the following tax pools detailed below which may be applied against taxable income:

	Available \$	Recognized \$	Expires in
Non-capital tax losses			
Federal	10,710	5,940	2009-2026
Provincial	7,600	2,829	2009-2026
Scientific Research and Experimental Development expenditures			
Federal	9,759	1,421	N/A
Provincial	9,802	1,464	N/A
Capital losses			
Federal	198	-	N/A
Provincial	891	-	N/A
Investment tax credits			
Federal	2,471	-	2008-2015

Net Income

Due to the factors set forth above, net income increased \$114 to \$1,264 for the three-month period ended March 31, 2007 compared to net income of \$1,150 for the three-month period ended March 31, 2006.

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, except for those indicated in Note 10.

Paladin's cash, cash equivalents and marketable securities increased \$4,459 to \$40,533 at March 31, 2007 from \$36,074 at December 31, 2006. This increase is primarily due to cash flows generated from operating activities in the amount of \$4,503. The Company's Investment Policy regulates the investment activities relating to cash resources. An Investment Committee composed of representatives from management and the Board of Directors monitors compliance with said policy. The Company invests strictly in liquid, high-grade investment securities with varying terms to maturity, selected with regard to the expected timing of investments and expenditures for continuing operations and prevailing interest rates. Working capital (current assets less current liabilities) increased \$1,832 to \$45,504 at March 31, 2007 from \$43,672 at December 31, 2006 primarily due to cash flows generated from operating activities converted in the form of marketable securities during the quarter.

Cash flows from operating activities increased 95% or \$2,190 to \$4,503 from \$2,313 for the three-month period ended March 31, 2007 and 2006, respectively. Cash flows from operating activities represent the cash flows from net earnings, excluding revenues and expenses not affecting cash, principally amortization, future income taxes, stock based compensation expense, gains (losses) on investments and stock dividend income.

Cash flows used in investing activities were \$4,401 for the three-month period ended March 31, 2007 compared to cash inflows of \$3,411 for the three-month period ended March 31, 2006. During the three month period ended March 31, 2007, the Company invested \$4,594 towards short and long-term marketable securities and \$39 for the acquisition of property, plant and equipment partially offset by proceeds from the partial sale of the Company's investment in a portfolio company in the amount of \$232. For the three-month period ended March 31, 2006, the Company invested \$3,452 towards the acquisition of

pharmaceutical product licenses and rights, and deferred charges, \$500 in the form of a portfolio investment and \$39 for the acquisition of property, plant and equipment offset by cash generated through maturing marketable securities in the amount of \$7,402

Cash flows used in financing activities were \$276 for the three-month period ended March 31, 2007 compared to cash flows from financing activities of \$642 for the three-month period ended March 31, 2006. During the three-month period ended March 31, 2007, \$373 was used by the Company to repurchase 37,800 of its own shares under the terms of the normal course issuer bid and \$231 was used for an intellectual property payment offset by \$328 generated from stock option exercises and the issuance of common shares under the stock purchase plan for cash. For the three-month period ended March 31, 2006, \$642 was generated by the issuance of common shares for cash.

Related Party Transactions

Joddes Limited ["Joddes"], a private Canadian corporation, is a significant shareholder holding approximately 43% 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 Joddes to provide logistics services including: customer service, warehousing, shipping, invoicing, collection services and certain manufacturing services on behalf of the Company. The Company also engages this affiliate to perform certain research and development services on a contractual pay-for-use basis. The Company also leases its office facilities from another wholly owned subsidiary of Joddes. This lease is for a period of 10 years, ending in 2013 and includes minimum annual payments of \$136.

Effective November 1, 2006, the Company acquired the Canadian distribution rights to Metadol[®] from a wholly-owned subsidiary of Joddes for cash consideration of \$15,000. Under the terms of the agreement, the Company can purchase the Canadian license for Metadol[®] on the fourth anniversary of the agreement for \$1 and can receive a reimbursement of up to \$3,750 subject to certain acquisition related conditions.

All transactions with related parties are carried out in the normal course of operations, and are recorded at an agreed upon exchange amount. The accounts payable to related parties is on normal commercial terms and conditions and is non-interest bearing.

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

	Three-month period ended	
	2007	March 31 2006
	\$	\$
Revenues	139	170
Purchases	1,927	2,113
Research and development expenses	65	24
Sales and marketing expenses	787	571
General and administrative expenses	66	91

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
	\$	\$	\$
April 1, 2007 – December 31, 2007	3,720	1,418	-
Fiscal 2008 – fiscal 2010	9,081	2,216	494
Fiscal 2011 – fiscal 2012	2,642	760	1,401
After fiscal 2013	1,805	1,027	15,318
Total	17,248	5,421	17,213

New Accounting Standards

On January 1, 2007, the Company retroactively adopted, without restatement of prior periods, the recommendations of the following Sections of the Canadian Institute of Chartered Accountants Handbook: Section 1530, *Comprehensive Income*, Section 3251, *Equity*, Section 3855, *Financial Instruments – Recognition and Measurement*, and Section 3865, *Hedges*. These standards set out, among other things, at what point a financial instrument must be recognized in the balance sheet and in what amount, sometimes using fair value and other times using cost-based measures, in addition to specifying the basis of presentation for the gains and losses on the financial instruments. Based on their classification on the balance sheet, the gains and losses on the financial instruments are recognized in the statement of income or in the newly introduced financial statement, the statement of comprehensive income.

The impact of the adoption of these new standards, as at January 1, 2007, translated into a \$692 increase in accumulated other comprehensive income, a \$162 increase in marketable securities, a \$684 increase in investments in other companies, including the recognition through bifurcation of certain embedded derivatives in investments in secured convertible notes in a portfolio company in the amount of \$526, a \$19 increase in the opening balance of retained earnings, and a \$135 reduction in future income tax assets. Further, the adoption of these new standards has no impact on the Company's cash flows.

The Company refers the reader to note 3 of the Consolidated Interim Financial Statements for the first quarter ended March 31, 2007, for further details regarding the adoption of these standards.

Controls and procedures

In compliance with the Canadian Securities Administrators Multilateral Instrument 52-109, the Company has filed certificates signed by the President and Chief Executive Officer and the Chief Financial Officer that, among other things, report on the design of disclosure controls and procedures and the design of internal control over financial reporting.

Internal control over financial reporting ("ICFR") is designed to provide reasonable assurance regarding the reliability of the Company's financial reporting and its compliance with Canadian Generally Accepted Accounting Principles in its financial statements. The President and Chief Executive Officer and the Chief Financial Officer of the Company have evaluated whether there were changes to its ICFR during the three-month period ended March 31, 2007 that have materially affected, or are reasonably likely to materially affect, the ICFR. No such significant changes were identified through their evaluation.

**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 March 31, 2007 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 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
May 9, 2007

(signed) Samira Sakhia
Samira Sakhia C.A., M.B.A.
Chief Financial Officer
Montreal, Canada
May 9, 2007

CONSOLIDATED BALANCE SHEETS

[In thousands of Canadian dollars]

	March 31 2007 \$	December 31 2006 \$
	(unaudited)	
ASSETS		
Current		
Cash and cash equivalents	2,595	2,769
Marketable securities [notes 3 and 4]	35,772	33,305
Accounts receivable	9,645	9,495
Inventory	4,042	3,635
Other current assets	1,346	1,306
Investment tax credits receivable	831	831
Future income tax asset	1,563	2,550
Total current assets	55,794	53,891
Marketable securities [notes 3 and 4]	2,166	—
Property, plant and equipment	171	151
Pharmaceutical product licenses and rights	19,340	21,482
Deferred charges	3,000	3,476
Investments [notes 3 and 4]	3,596	3,217
Future income tax asset	3,612	3,634
Total assets	87,679	85,851
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Accounts payable and accrued liabilities	8,698	8,208
Accounts payable to related parties	932	1,274
Income taxes payable	433	279
Balance of license agreements payable	—	231
Balance of sale payable	227	227
Total current liabilities	10,290	10,219
Long-term		
Balance of sale payable	500	494
Future income tax liability	1,158	1,397
Total liabilities	11,948	12,110
Shareholders' equity [note 5]		
Capital stock	59,020	58,807
Other paid-in capital	1,318	1,223
Retained earnings	14,767	13,711
Accumulated other comprehensive income [notes 3 and 4]	626	—
Total shareholders' equity	75,731	73,741
Total liabilities and shareholders' equity	87,679	85,851

See accompanying notes

CONSOLIDATED STATEMENTS OF INCOME

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

[unaudited]

	Three-month period ended	
		March 31
	2007	2006
	\$	\$
Revenues	12,893	10,132
Cost of sales	2,472	2,565
Gross profit	10,421	7,567
Expenses (income)		
Selling and marketing	4,348	3,338
General and administrative	1,105	1,314
Research and development	531	312
Interest income	(383)	(234)
Earnings before under-noted items	4,820	2,837
Amortization of intangible assets and deferred charges	2,618	1,877
Unrealized loss on embedded derivative instrument <i>[note 4]</i>	210	—
Gain on disposal of investment	(74)	—
Other income	—	(724)
Income before income taxes	2,066	1,684
Provision for income taxes		
Current	154	—
Future	648	534
	802	534
Net income for the period	1,264	1,150
Earnings per share		
Basic	0.08	0.08
Diluted	0.08	0.08
Weighted average number of shares outstanding <i>[note 6]</i>		
Basic	15,003,709	14,768,726
Diluted	15,347,425	14,944,974

See accompanying notes

CONSOLIDATED STATEMENTS OF CASH FLOWS

[In thousands of Canadian dollars]

[unaudited]

	Three-month period ended	
	2007	March 31 2006
	\$	\$
Operating activities		
Net income	1,264	1,150
Add items not affecting cash		
Amortization	2,638	1,894
Stock based compensation expense [note 5]	129	112
Future income taxes	648	538
Gain on disposal of investment	(74)	—
Unrealized loss on embedded derivative instrument [note 4]	210	—
Accreted interest [note 4]	(11)	—
Other income	—	(724)
	4,804	2,970
Net change in non-cash balances relating to operations	(301)	(657)
Cash flows from operating activities	4,503	2,313
Investing activities		
Additions to pharmaceutical product licenses and rights, and deferred charges	—	(3,452)
Purchases of short-term marketable securities	(25,986)	(2,578)
Maturities of short-term marketable securities	31,770	9,980
Purchases of long-term marketable securities	(10,378)	—
Proceeds from the disposal of investment	232	—
Acquisition of investment	—	(500)
Acquisition of property, plant and equipment	(39)	(39)
Cash flows (used in) from investing activities	(4,401)	3,411
Financing activities		
Common shares issued for cash	328	642
Accounts payable related to the acquisition of intellectual property and deferred charges	(231)	—
Repurchase of shares	(373)	—
Cash flows (used in) from financing activities	(276)	642
Net change in cash and cash equivalents during the period	(174)	6,366
Cash and cash equivalents, beginning of period	2,769	2,835
Cash and cash equivalents, end of period	2,595	9,201
Cash and cash equivalents	2,595	9,201
Short-term marketable securities	35,772	32,083
Long-term marketable securities	2,166	—
	40,533	41,284

See accompanying notes

CONSOLIDATED STATEMENTS OF OTHER COMPREHENSIVE INCOME AND RETAINED EARNINGS

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

[unaudited]

	Three-month period ended	
	2007	March 31 2006
	\$	\$
Net income for the period	1,264	1,150
Other comprehensive income:		
Change in fair value of available-for-sale financial instruments (net of income taxes of \$14)	72	—
Reclassification adjustment for gains on available-for-sale financial instruments included in net income in the current period (net of income taxes of \$26)	(138)	—
	(66)	—
Comprehensive income for the period	1,198	1,150

Retained earnings, beginning of period	13,711	7,939
Net income for the period	1,264	1,150
Purchase of common shares	(227)	—
Cumulative impact of accounting changes relating to financial instruments (net of income taxes of \$3) [Note 3]	19	—
Retained earnings, end of period	14,767	9,089

See accompanying notes

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

1. Governing Statute and Nature of Operations

Paladin Labs Inc. is a specialty pharmaceutical public company continued under the Canada Business Corporations Act, focusing on developing, acquiring, marketing and distributing innovative pharmaceutical products. Paladin Labs Inc., together with its subsidiaries, is hereinafter referred to as the “Company”.

2. Basis of Presentation and Accounting policies

The unaudited interim consolidated financial statements have been prepared by the Company in accordance with Canadian generally accepted accounting principles (“GAAP”) applicable to interim financial statements and include the accounts of all its subsidiaries. Accordingly, they do not include all the information and disclosures required according to GAAP for annual financial statements and should be read in conjunction with the Company’s audited consolidated financial statements and notes thereto in the Company’s Annual Report for the year ended December 31, 2006.

Information with respect to the December 31, 2006 balance sheet is derived from the Company’s complete audited consolidated financial statements. The accounting policies underlying these interim financial statements are those set forth in note 2 of the audited financial statements for the year ended December 31, 2006 and those mentioned in note 3 to the interim financial statements.

3. Change in Accounting Policy

Effective January 1, 2007, the Company retroactively adopted, without restatement of prior periods, the recommendations included in the following sections of the Canadian Institute of Chartered Accountants (“CICA”) Handbook: Section 1530, *Comprehensive Income*, Section 3251, *Equity*, Section 3855, *Financial Instruments – Recognition and Measurement*, and Section 3865, *Hedges*.

Section 1530, *Comprehensive Income*, along with Section 3251, *Equity*, which amends Section 3250, *Surplus*, requires the presentation of comprehensive income and its components in a new financial statement. Further, they require companies to separately present changes in equity during the period as well as components of equity at the end of the period, including comprehensive income. Comprehensive income is the change in the net assets of a company arising from transactions, events and circumstances not related to shareholders. The impact of the adoption of this standard has been to incorporate other comprehensive income disclosures within the financial statements.

Section 3855, *Financial Instruments – Recognition and Measurement* sets out the standards for the recognition and measurement of financial assets, financial liabilities and derivatives. This standard prescribes when to recognize a financial instrument in the balance sheet and at what amount. Depending on their balance sheet classification, fair value or cost-based measures are used. This standard also prescribes the basis of presentation for gains and losses on financial instruments. Based on financial instrument classification, gains and losses on financial instruments are recognized in net income or other comprehensive income.

The following is a summary of the classifications the Company has elected to apply to each of its significant categories of financial instruments outstanding as of January 1, 2007:

- Marketable Securities are classified principally as “Assets held to maturity” with certain identified investments classified as “Available for sale”. The Marketable Securities classified as “Assets held to maturity” are initially recognized at their fair values, with any resulting premium or discount from the face value being amortized to income or expense using the effective interest method. After their initial fair value measurement, they are measured at amortized cost using the effective interest rate method. The Marketable Securities classified as “Available for sale” are initially recognized at their fair values, with any resulting changes in the fair value being charged or credited to other comprehensive income and when ultimately sold to net income. Fair values for marketable securities are obtained using quoted active market prices for such securities;
- Accounts receivable and other assets and Investment tax credits receivable are classified as “Loans and receivables”. They are recorded at cost, which upon their initial measurement is equal to their fair value. Subsequent measurements are recorded at amortized cost using the effective interest rate method;
- Investments in other companies are classified as “Available for Sale” except for the allocated conversion option of a secured convertible term note in a portfolio company, which is classified as a “Derivative” and the allocated loan portion on the same convertible term note which is classified as “Loans and receivables”. Derivatives are carried at fair value with changes in the fair value being charged or credited to the statement of income for the relevant period. Investments in other companies, consist of strategic investments in the form of equity in partner companies. The investments classified as “Available for Sale” are carried at fair value with changes in the fair value being charged or credited to other comprehensive income. In compliance with Section 3855, investments in private companies are carried at cost unless evidence of an other than temporary impairment exists in which case they are written down to their net recoverable amount. Fair values for investments in other companies classified as “Available for sale” are obtained using quoted prices in active markets for public companies, if such are available. Fair value for the allocated conversion option of a secured convertible term note in a portfolio company classified as a Derivative was obtained using the Black-Scholes option pricing valuation model; and,
- Accounts payable and accrued liabilities, Accounts payable to related parties and Balance of sale payable are classified as “Other financial liabilities”. They are initially measured at their fair value. Subsequent measurements are recorded at amortized cost using the effective interest rate method.

The impact of the adoption of these new standards translated into the following changes as at January 1, 2007: a \$692 increase in accumulated other comprehensive income; a \$162 increase in marketable securities; a \$684 increase in investments in other companies, including the recognition through bifurcation of certain embedded derivatives in investments (secured convertible notes in a portfolio company) in the amount of \$527; a \$19 increase in the opening balance of retained earnings; and, a \$135 reduction in future income tax assets. Further, the adoption of these new standards has no impact on the Company’s cash flows.

The impact of the adoption of this standard on the statement of income for the three-month period ended March 31, 2007 has been to record an unrealized loss on the allocated conversion option of a secured convertible term note in a portfolio company recognized as a derivative instrument, in the amount of \$210, which will subsequently be re-measured at each reporting period until ultimate settlement. In addition, accretive interest income on the allocated loan portion of the same convertible term note in the amount of \$17 was recorded.

Section 3865, “Hedges” allows optional treatment providing that hedges be designated as either fair value hedges, cash flow hedges or hedges of a self-sustaining foreign operation. Since the Company does not currently have any hedging programs in place, the adoption of this section did not have any impact on the Company’s financial statements.

4. Financial Instruments and Accumulated Other Comprehensive Income

	Carrying Value \$	Fair Value \$
Marketable Securities		
<i>Available for Sale</i>	17,621	17,621
<i>Held to Maturity</i>	20,317	20,288
Investments		
Investment in 8% Secured Convertible Term Notes in Nuvo Research Inc. [“Nuvo”], a public company listed on the Toronto Stock Exchange (Face Value \$500)		
• <i>Loans and receivables allocated amount</i>	163	457
• <i>Embedded derivative</i>	167	167
Investment in common shares of Valera Pharmaceuticals, Inc. [“Valera”], a public company in the United States	2,859	2,859
Investment in Series A 8% non-cumulative, convertible Preferred Shares of Verus Pharmaceuticals, Inc. [“Verus”], a private company in the United States	394	394¹
Investment in common shares of BioSante Pharmaceuticals, Inc. [“BioSante”], a public company in the United States	13	13

¹ In compliance with Section 3855, the Company’s investment in Verus, a private company, is carried at cost as there are no quoted market prices in an active market for such an equity instrument. Fair value has not been disclosed because fair value cannot be measured reliably.

The accumulated other comprehensive income as at March 31, 2007, and the net change in unrealized gains on available-for-sale investments are detailed as follows:

	2007
	\$
Balance, beginning of period	—
Cumulative impact of accounting changes relating to financial instruments [Note 3]	692
Adjusted balance, beginning of period	692
Other comprehensive income for the period	(66)
Balance, end of period	626

5. 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	14,980,131	\$58,807
Issued upon exercise of stock options	51,812	342
Issued under employee share purchase plan	1,746	18
Purchase of shares	(37,800)	(147)
Balance at March 31, 2007	14,995,889	\$59,020

During the three-month period ended March 31, 2007, under the terms of the normal course issuer bid, the Company repurchased 37,800 shares. As at March 31, 2007, the repurchased shares are in the process of being cancelled.

Stock option plan

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

	2007		2006	
	#	Weighted average exercise price \$	#	Weighted average exercise price \$
Balance at beginning of year	819,915	6.07	915,743	5.57
Granted	67,822	11.06	119,500	6.60
Exercised	(51,812)	6.66	(140,856)	4.30
Expired or forfeited	(5,559)	6.36	—	—
Balance at March 31	830,366	7.25	894,387	5.73
Options exercisable at March 31	574,636	5.91	521,619	5.88

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 March 31	
	2007	2006
Option compensation expense	127	132
Weighted average fair value of options	\$6.63	\$4.09
Weighted average risk-free interest rate	4.05%	4.11%
Dividend yield	Nil	Nil
Weighted average volatility factor	55%	58%
Weighted average expected life	7 years	7 years

6. 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 March 31	
	2007	2006
Basic weighted average number of shares outstanding	15,003,709	14,768,726
Dilutive effect of options	343,716	176,248
Diluted weighted average number of shares outstanding	15,347,425	14,944,974

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

7. Related party transactions

Joddes Limited [“Joddes”], a private Canadian corporation, is a significant shareholder holding approximately 43% 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 Joddes to provide logistics services including: customer service, warehousing, shipping, invoicing, collection services and certain manufacturing services on behalf of the Company. The Company also engages this affiliate to perform certain research and development services on a contractual pay-for-use basis. The Company also leases its office facilities from another wholly owned subsidiary of Joddes. This lease is for a period of 10 years, ending in 2013 and includes minimum annual payments of \$136.

Effective November 1, 2006, the Company acquired the Canadian distribution rights to Metadol[®] from a wholly-owned subsidiary of Joddes for cash consideration of \$15,000. Under the terms of the agreement, the Company can purchase the Canadian license for Metadol[®] on the fourth anniversary of the agreement for \$1 and can receive a reimbursement of up to \$3,750 subject to certain acquisition related conditions.

All transactions with related parties are carried out in the normal course of operations, and are recorded at an agreed upon exchange amount. The accounts payable to related parties is on normal commercial terms and conditions and is non-interest bearing.

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

	Three-month period ended	
	2007	2006
	\$	\$
Revenues	139	170
Purchases	1,927	2,113
Research and development expenses	65	24
Sales and marketing expenses	787	571
General and administrative expenses	66	91

8. 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 3% to 20% of sales, or require payments for products at rates ranging from 20% to 40% of the net selling price.

A certain pharmaceutical product license agreement requires that the Company make royalty payments ranging from 75% to 90% of the excess of a defined contribution amount above certain established minimums and requires payments of 50% of the excess of certain established internal rates of return for a product.

In addition, the Company may have to pay up to \$17,212, including US\$14,843 if it achieves specific sales volumes on certain 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 \$4,370, including US\$1,050 over the next six years. In addition, certain 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 \$1,051 (US\$911), 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 \$17,248, including US\$7,239, to retain exclusive distribution agreements for certain products. These commitments end in 2014 and annual commitments are as follows:

	\$
April 1, 2007 - December 31, 2007	3,720
2008	3,987
2009	2,719
2010	2,375
2011	1,661
2012-2014	2,786

9. Comparative figures

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

10. Subsequent Events

On April 30, the Company acquired BioEnvelop Inc., a wholly owned subsidiary of BioEnvelop Technologies Inc. (TSX-V:BIE). BioEnvelop Inc. has expertise in developing and manufacturing rapidly dissolving edible films for the nutraceutical and pharmaceutical markets. Under the terms of the agreement, the Company has acquired all of the issued and outstanding shares of BioEnvelop Inc. for cash consideration of \$645 plus 114,355 common shares of Paladin. Of these amounts, \$175 in cash and 15,900 in shares are payable should certain post-closing conditions be met.

On May 2, 2007 the Company entered into an agreement with Shire BioChem Inc., Shire US Inc. Shire US Manufacturing Inc. and Shire LLC to acquire the rights to a total of eight products currently marketed in Canada by Shire BioChem Inc. for cash consideration of \$9,520.

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