

Here today.
Here for **life.**



2ND QUARTER RESULTS 2004

Here today. Here for life.

Dear Shareholders,

We continue to make solid progress with the three principal drivers of our growth strategy: i) growing sales of our key promoted brands; ii) advancing our pipeline products; and, iii) expanding our product portfolio through acquisitions.

Sales of our key promoted brands, which include Androderm[®], Dalacin[®], Dostinex[®], Estring[®] and Plan B[®], were up a healthy 13% for the first half of 2004, compared to the corresponding periods in 2003. Sales of Plan B[®] grew 44% in the first half of the period and achieved record market share during the second quarter of 2004. We continue to make significant strides with Dostinex[®], Estring[®], and Dalacin[®] which had year-over-year growth of 20%, 11% and 2% respectively, and each brand continues to grow in terms of prescriptions and market share. Sales of Androderm[®] declined year-over-year as a result of increased competition in the testosterone replacement market.

In terms of advancing our pipeline products, during the second quarter, we received Health Canada approval for OXYTROL[®], a novel transdermal patch for the treatment for overactive bladder. We in-licensed OXYTROL[®] from Watson Pharmaceuticals in the first quarter of this year and now expect to launch the product in Canada during the fourth quarter.

OXYTROL[®] significantly strengthens our growing urology franchise. According to IMS Canada, the total Canadian market for the treatment of overactive bladder exceeded \$46 million in 2003. We expect that OXYTROL[®] could become our largest urology product and we have a tremendous opportunity to leverage our established network of high prescribing physicians in this therapeutic area to achieve high margin growth.

Also during the quarter, Health Canada announced that it is moving forward with a proposal to amend regulations, which if approved, would allow Plan B[®], to be sold in Canada on a "behind-the-counter" (BTC) basis without a physician prescription. We initially applied to Health Canada for Plan B[®] non-prescription status in March 2002. We believe that BTC status may result in improved sales performance of Plan B[®].

Subsequent to the end of the second quarter, we filed new drug submissions with Health Canada for GlucaGen[®] and Histrelin Hydrogel Implant. Pending Health Canada approvals, the timeline for Paladin's Canadian market launch of these two products is approximately two years.

GlucaGen[®] (recombinant glucagon) 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 \$4.1 million in 2003 and grew by 28% over the prior year. There is only one other pharmaceutical company in the recombinant glucagon market and it is not promoting its product due to the small size of the market. We feel that with our superior packaging and focused promotion to endocrinologists, an audience we already service, Paladin will be able to capture significant market share in this growing market.

Histrelin Hydrogel Implant is a unique, once-yearly luteinizing hormone-releasing hormone (LHRH) implant indicated for the treatment of prostate cancer, the most prevalent form of cancer afflicting Canadian men. The once-yearly implant represents an alternative to other LHRH agonists, which are administered via injection every one, three or four months. Histrelin provides an excellent strategic fit with our strong and growing urology franchise. The Canadian LHRH agonist market is highly concentrated in terms of the number of high prescribing physicians. There are currently 320 Canadian urologists that account for 63% of all prescriptions in this \$108 million market. Paladin's sales force is already calling on these high prescribing physicians to promote Androderm[®], Muse[®] and soon OXYTROL[®]. Histrelin has been submitted by Valera, our partner, to the FDA in the United States for regulatory approval in December 2003.

On the acquisition front, we entered into an exclusive Canadian distribution agreement with U.S. based Ovation Pharmaceuticals for Sabril[®] and Frisium[®], two central nervous system pharmaceutical products. Both brands are currently available in Canada.

Financial Review

While revenue for the three-month period ended June 30, 2004 decreased slightly to \$6.4 million, compared to a record \$6.5 million in the second quarter a year ago, our \$12.0 million in revenue for the six months ended June 30, 2004, represents the highest first half total in Company history.

Net income for the second quarter was \$681,000 or \$0.05 per fully diluted share, compared to a net loss of \$142,000 or (\$0.01) per share in the second quarter a year ago.

Our balance sheet remains strong with \$38.5 million in cash, cash equivalents and marketable securities as at June 30, 2004. From this strong cash position, we continue to pursue opportunities to acquire additional promotion-sensitive brands from large pharmaceutical companies and in support of our longer-term growth, products in late-stage clinical development.

As a result of our planned fourth quarter launch for OXYTROL[®] we are revising our financial guidance for 2004. Given the scope of market opportunity for the product, we expect to incur significantly higher selling and marketing expenses starting in the third quarter of 2004. As a result, we are revising our 2004 EBITDA target to \$6.4 million to \$7 million, from \$9.0 million, and our 2004 net income target to \$1.9 million to \$2.1 million, from \$3.6 million. We maintain our guidance for \$26.5 million in revenue for fiscal 2004.

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

Sincerely,



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

Management Discussion And Analysis:

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

The following analysis explains the variations in the results of operations, financial position and cash flows for Paladin Labs Inc. ("Paladin" or the "Company") and is current as at July 28, 2004. This discussion should be read in conjunction with the information contained in the Company's interim and annual financial statements and the related notes to these financial statements.

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. Investors should consult the Company's ongoing quarterly filings, annual reports and Annual Information Form for additional information on risks and uncertainties relating to these forward-looking statements.

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.

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.

Second quarter highlights:

- Revenues reached \$6,397, a decrease of 1% over the same period last year.
- Net income was \$681, an increase of \$823 from a loss of \$142 in the same period last year.
- Obtained Health Canada approval for OXYTROL® (oxybutinin transdermal system).
- Signed distribution agreement with Ovation Pharmaceuticals, Inc. for Sabril® and Frisium®.

Paladin's annual and quarterly operating results are primarily affected by: (1) the level of acceptance of Paladin's products by physicians and their patients; and, (2) wholesaler buying patterns. The level of patient and physician acceptance of Paladin's products, as well as the availability of similar thera-

pies, 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. To ensure that Paladin maintains good relations with wholesalers, Paladin typically gives wholesalers prior notice of price increases to enable them to purchase products that they will later sell at higher prices.

Critical Accounting Estimates

Paladin's financial statements are prepared in accordance with Canadian generally accepted accounting principles, applied on a consistent basis. Paladin's critical accounting estimates include revenue recognition, the recording of research and development expenses, the useful lives and fair value of intangible assets and stock based compensation expense. For a more detailed discussion of the Company's critical accounting, please refer to the Management Discussion & Analysis included in the Company's 2003 Annual Report. There have been no material changes to accounting estimates since December 31, 2003.

Results of Operations

Three-month period ended June 30, 2004 compared to three-month period ended June 30, 2003, and six-month period ended June 30, 2004 compared to six-month period ended June 30, 2003.

Revenues

Revenues decreased \$56 or 1% to \$6,397 for the three-month period ended June 30, 2004 from \$6,453 for the three-month period ended June 30, 2003. For the six-month period ended June 30, 2004, revenues increased \$476 or 4% to \$11,994 from \$11,518 for the six-month period ended June 30, 2003. The decrease in revenues for the three-month period ended June 30, 2004 was due to a decrease in net revenues from the Company's generic product line where the Company had certain back orders. This decrease was partially offset by growth from the Company's key promoted products, including Androderm[®], Dostinex[®], Dalacin[®], Estring[®] and Plan B[®], which increased by 2% compared to the three-month period ended June 30, 2003. The increase in revenues for the six-month period ended June 30, 2004 was due to growth from the Company's key promoted products including Androderm[®], Dostinex[®], Dalacin[®], Estring[®] and Plan B[®], which increased by 13% compared to the six-month period ended June 30, 2003. The increase in revenues of promoted products was offset by continued declines in sales of Urispas[®], due to generic competition; a decline in sales of Oesclim[®], due to the recent medical concerns relating to female hormone replacement therapies; and short-term supply issues related to certain generic products.

Gross Profit

Total gross profit decreased \$157 or 3% to \$4,763 for the three-month period ended June 30, 2004 from \$4,920 for the three-month period ended June 30, 2003. For the six-month period ended June 30, 2004, gross profit increased \$294 or 3% to \$9,042 from \$8,748 for the six-month period June 30, 2003.

Gross profit, as a percentage of revenues, declined to 74% for the three-month period ended June 30, 2004 from 76% for the three-month period ended June 30, 2003. Gross profit, as a percentage of revenues, declined to 75% for the six-month period ended June 30, 2004 from 76% for the six-month period ended June 30, 2003.

Selling and Marketing Expense

Selling and marketing expense decreased \$935 or 34% to \$1,784 for the three-month period ended June 30, 2004 from \$2,719 for the three-month period ended June 30, 2003. For the six-month period ended June 30, 2004, selling and marketing expense decreased \$2,156 or 40% to \$3,217 from \$5,373 for the six-month period June 30, 2003. Selling and marketing expense, as percentage of revenues, decreased to 28% for the three-month period ended June 30, 2004 from 42% for the three-month period ended June 30, 2003. Selling and marketing expense, as percentage of revenues, decreased to 27% for the six-month period ended June 30, 2004 from 47% for the six-month period ended June 30, 2003. This decrease was primarily attributed to decreased promotion activities on Androderm[®]. It is expected that selling and marketing expense, as a percentage of revenues, will be between 33% and 37% for the year ended December 31, 2004.

General and Administrative Expense

General and administrative expense increased \$155 or 25% to \$764 for the three-month period ended June 30, 2004 from \$609 for the three-month period ended June 30, 2003. For the six-month period ended June 30, 2004, general and administrative expense increased \$212 or 17% to \$1,469 from \$1,257 for the six-month period June 30, 2003. General and administrative expense, as a percentage of revenues, was 12% for the three-month period ended June 30, 2004 and 9% for the three-month period ended June 30, 2003. General and administrative expense, as a percentage of revenues, was 12% for the six-month period ended June 30, 2004 and 11% for the six-month period ended June 30, 2003.

Research and Development Expense

Research and development expense increased \$355 or 245% to \$500 for the three-month period ended June 30, 2004 from \$145 for the three-month period ended June 30, 2003. For the six-month period ended June 30, 2004, research and development expense increased \$1,196 or 248% to \$1,678 from \$482 for the six-month period June 30, 2003. This increase in research and development expense for the three-month and six-month periods ended June 30, 2004 was due to: expenses related to preparation of New Drug Submissions for Histrelin Hydrogel Implant and GlucaGen[®]; an increased number of research and development projects in fiscal 2004; and, \$353 related to certain license payments for unapproved products.

Amortization Expense

Amortization expense increased \$617 or 125% to \$1,110 for the three-month period ended June 30, 2004 from \$493 for the three-month period ended June 30, 2003. For the six-month period ended June 30, 2004, amortization

expense increased \$966 or 103% to \$1,901 from \$935 for the six-month period June 30, 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 generalized as well as the impact of amortization expense related to the Company's acquisitions of licenses, rights and intellectual property during fiscal 2003.

Interest Income

Interest income decreased \$95 or 26% to \$270 for the three-month period ended June 30, 2004 from \$365 for the three-month period ended June 30, 2003. For the six-month period ended June 30, 2004, interest income decreased \$102 or 15% to \$599 from \$701 for the six-month period June 30, 2003. This decrease reflects the impact of lower interest rates and lower average cash balance during the three and six-month period ended June 30, 2004 compared to the three and six-month period ended June 30, 2003.

Other Income

Other income was \$0 for the three and six-month periods ended June 30, 2004. For the three and six-month periods ended June 30, 2003, other income was \$27 and \$381, respectively. Other income in the three and six-month periods ended June 30, 2003 includes a one-time compensation payment for lost revenues of Dalacin[®] and other payments related to certain license and trademark license agreements.

Gain on Disposal

Gain on disposal was \$0 for the three and six-month periods ended June 30, 2004. During the three-month period ended June 30, 2003, the Company recorded a gain on disposal of \$226 related to the sale of its investment in Connetics Corporation. During the six-month period ended June 30, 2003, the Company recorded a gain on disposal of \$504 related to assignment and sale of licenses to certain over-the-counter products to a related party and the sale of its investment in Connetics Corporation.

Write-down of Investments

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 will be able to resume production of its marketed product, Valtaxin[™]. The Company determined that there had 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.

Income Tax Expense

Income tax expense decreased \$23 or 11% to \$194 for the three-month period ended June 30, 2004 from \$217 for the three-month period ended June 30, 2003. For the six-month period ended June 30, 2004, income tax expense decreased \$8 or 2% to \$351 from \$359 for the six-month period June 30,

2003. For the three and six-month periods ended June 30, 2003, the Company did not record any tax benefit related to the write-down of its investment in Anthra. The effective tax rate was 22% for the three-month period ended June 30, 2004 compared to 289% for the three-month period ended June 30, 2003. The effective tax rate was 26% for the six-month period ended June 30, 2004 compared to 45% for the six-month period ended June 30, 2003.

Net Income

Due to the factors set forth above, net income increased \$823 to a net income of \$681 for the three-month period ended June 30, 2004 from a net loss of \$142 for the three-month period ended June 30, 2003 and increased \$594 or 138% to \$1,025 for the six-month period ended June 30, 2004 from \$431 for the six-month period ended June 30, 2003.

Liquidity and Capital Resources

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

Paladin's cash, cash equivalents, and short-term and long-term marketable securities decreased \$6,049 to \$38,498 at June 30, 2004 from \$44,547 at December 31, 2003. This decrease in cash, cash equivalents, and short-term and long-term marketable securities was primarily due to an increase in accounts receivable and inventory. On February 1, 2004, the Company 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. Consequently, on February 1, 2004, Paladin purchased \$4.1 million of accounts receivables and \$2.9 million of inventory from this affiliate.

Working capital decreased \$683 to \$39,240 at June 30, 2004 from \$39,923 at December 31, 2003. This decrease is primarily due to an increase in long-term marketable securities and a decrease in short-term liabilities.

Cash flows from operating activities were \$552 and \$1,936 for the three-month periods ended June 30, 2004 and 2003, respectively. Cash flows used in operating activities was \$1,896 for the six-month period ended June 30, 2004. For the six-month period ended June 30, 2003, cash flows from operating activities were \$2,662. Cash flows from operating activities represent the cash flows from net earnings, excluding revenues and expenses not affecting cash, principally amortization, future income taxes, option compensation expense and imputed interest.

Cash flows from investing activities were \$4,734 for the three-month period ended June 30, 2004 and cash flows used in investing activities were \$10,603

for the three-month period ended June 30, 2003. During the three-month period ended June 30, 2004, the Company invested \$519 in acquisitions of pharmaceutical product licenses and rights and intellectual property. In addition, the Company had a \$5,255 net decrease in short-term and long-term marketable securities. For the three-month period ended June 30, 2003, the Company invested \$569 in acquisitions of pharmaceutical product licenses and rights and intellectual property and \$1,434 in other companies. In addition, the Company received \$529 related to the sale of its investment in Connetics Corporation and had a \$9,105 net increase in short-term and long-term marketable securities.

Cash flows from investing activities were \$7,194 for the six-month period ended June 30, 2004 and cash flows used in investing activities were \$3,132 for the six-month period ended June 30, 2003. During the six-month period ended June 30, 2004, the Company invested \$1,942 in acquisitions of pharmaceutical product licenses and rights and intellectual property. In addition, the Company had a \$9,138 net decrease in short-term and long-term marketable securities. For the six-month period ended June 30, 2003, the Company invested \$1,087 in acquisitions of pharmaceutical product licenses and rights and intellectual property and \$1,434 in other companies. In addition, the Company received \$869 related to the sale of its investment in Connetics Corporation and certain over-the-counter products and had a \$1,611 net increase in short-term and long-term marketable securities.

Cash flows used in financing activities were \$802 for the three-month period ended June 30, 2004. For the three-month period ended June 30, 2003, cash flows from financing activities were \$51. For the three-month period ended June 30, 2004, \$217 was provided from common stock option exercises and the issuance of common shares under the stock purchase plan. In addition, the Company had a decrease of \$1,039 in accounts payable related to pharmaceutical product licenses. For the three-month period ended June 30, 2003, cash was provided from the issuance of common shares under the stock purchase plan.

Cash flows used in financing activities were \$2,209 for the six-month period ended June 30, 2004. For the six-month period ended June 30, 2003, cash flows from financing activities were \$61. For the six-month period ended June 30, 2004, \$254 was provided from common stock option exercises and the issuance of common shares under the stock purchase plan. In addition, the Company had a decrease of \$2,483 in accounts payable related to pharmaceutical product licenses. For the six-month period ended June 30, 2003, cash was provided from the issuance of common shares under the stock purchase plan.

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.

Here today. Here for life.

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 receivables and has taken title to the inventory and accounts receivables related to the products distributed by Paladin. Consequently, on February 1, 2004, Paladin purchased \$4.1 million of accounts receivable and \$2.9 million of inventory from this affiliate. The related party will continue to provide logistics services, including customer service, warehousing and shipping, invoicing and collection services.

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

	Three-month period ended		Three-month period ended	
	June 30		June 30	
	2004	2003	2004	2003
	\$	\$	\$	\$
Revenues	14	897	503	1,452
Purchases	702	1,358	4,183	2,607
Research and development expenses	118	40	222	98
Sales and marketing expenses	379	321	679	611
General and administrative expenses	86	67	148	137

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. The Company will receive no further consideration for these products.

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

	Contractual Obligations	Commitments	
	Purchase and service based commitments	Milestone based commitments	Revenue based commitments
	\$	\$	\$
July 1, 2004 –			
December 31, 2004	1,673	—	—
Fiscal 2005 – fiscal 2006	6,788	1,761	402
Fiscal 2007 – fiscal 2008	3,232	—	737
After fiscal 2009	2,221	2,168	4,121
Total	13,914	3,929	5,260

Notice to Reader of the Interim Financial Statements

The financial statements of Paladin Labs Inc. (the "**Company**") and the accompanying interim balance sheet as at June 30, 2004 and the interim statements of income, retained earnings and cash flows for the three and six month periods then ended are the responsibility of the Company's management. These financial statements have not been audited or reviewed on behalf of the shareholders by the independent external auditors, Ernst & Young LLP.

The interim 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 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
July 28, 2004

(signed) Samira Sakhia

Samira Sakhia,
C.A., M.B.A.
Chief Financial Officer
Montreal, Canada
July 28, 2004

BALANCE SHEET

[In thousands of Canadian dollars]

	June 30 2004	December 31 2003
	\$ (unaudited)	\$
ASSETS		
Current		
Cash and cash equivalents	5,080	1,991
Short-term marketable securities	30,801	42,556
Accounts receivable	4,755	248
Inventories	3,066	—
Other current assets	551	2,541
Investment tax credits receivable	169	256
Future income tax assets	1,969	1,969
Total current assets	46,391	49,561
Long-term marketable securities	2,617	—
Property, plant and equipment	102	132
Intangible assets	11,638	12,359
Deferred charges	3,543	2,781
Investments	1,877	1,877
Future income tax credits recoverable	659	659
Future income tax assets	1,170	1,601
	67,997	68,970
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Accounts payable and accrued liabilities	3,424	4,546
Accounts payable to related parties	908	170
Income taxes payable	126	85
Balance of license agreements payable	2,674	4,537
Deferred credit	19	300
Total current liabilities	7,151	9,638
Shareholders' equity [note 4]		
Capital stock	57,713	57,440
Contributed surplus	87	87
Other paid-in capital	459	243
Retained earnings	2,587	1,562
Total shareholders' equity	60,846	59,332
	67,997	68,970

See accompanying notes

STATEMENTS OF INCOME AND RETAINED EARNINGS

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

	Three-month period ended June 30		Three-month period ended June 30	
	2004	2003	2004	2003
	\$	\$	\$	\$
		(restated – see note 3)		(restated – see note 3)
Revenues	6,397	6,453	11,994	11,518
Cost of sales	1,634	1,533	2,952	2,770
Gross profit	4,763	4,920	9,042	8,748
Selling and marketing	1,784	2,719	3,217	5,373
General and administrative [note 3]	764	609	1,469	1,257
Research and development	500	145	1,678	482
Amortization	1,110	493	1,901	935
Interest income, net	(270)	(365)	(599)	(701)
Other income	—	(27)	—	(381)
Income before under noted items	875	1,346	1,376	1,783
Gain on disposal of license [note 6]	—	(226)	—	(504)
Write-down of long-term investments [note 7]	—	1,497	—	1,497
Income before income taxes	875	75	1,376	790
Provision for income taxes				
Current	25	30	50	60
Future	169	187	301	299
	194	217	351	359
Net income (loss) [note 3]	681	(142)	1,025	431
Retained earnings, beginning of period	1,906	6,307	1,562	5,734
Retained earnings, end of period	2,587	6,165	2,587	6,165
Earnings per share				
Basic	0.05	(0.01)	0.07	0.03
Diluted	0.05	(0.01)	0.07	0.03
Weighted average number of shares outstanding [note 5]				
Basic	14,829,954	14,784,725	14,916,400	14,782,677
Diluted	14,935,709	14,800,111	14,908,438	14,791,495

See accompanying notes

STATEMENTS OF CASH FLOWS

[In thousands of Canadian dollars]

	Three-month period ended June 30 2003		Three-month period ended June 30 2004	
	2004	2003	2004	2003
	\$	\$	\$	\$
		(restated – see note 3)		(restated – see note 3)
Operating activities				
Net income (loss) [note 3]	681	(142)	1,025	431
Add items not affecting cash				
Amortization	1,125	509	1,933	964
Stock based compensation expense [note 3]	82	59	218	158
Future income taxes	75	173	150	227
Write-down of long-term investment	—	1,497	—	1,497
Imputed interest on balance of sale	—	14	—	27
Gain on disposal of license	—	(226)	—	(504)
	1,963	1,884	3,326	2,800
Net change in non-cash balances relating to operations	(1,411)	52	(5,222)	(138)
Cash flows from (used in) operating activities	552	1,936	(1,896)	2,662
Investing activities				
Additions to pharmaceutical product licenses and rights and intellectual property and deferred charges	(519)	(569)	(1,942)	(1,087)
Investment in other companies	—	(1,434)	—	(1,434)
Acquisition of property, plant and equipment	(2)	(24)	(2)	(49)
Purchases of short-term marketable securities	(14,016)	(26,416)	(16,769)	(30,836)
Maturities of short-term marketable securities	20,092	18,564	28,524	30,478
Purchases of long-term marketable securities	(1,902)	(1,253)	(3,698)	(1,253)
Maturities of long-term marketable securities	1,081	—	1,081	—
Proceeds from disposal of assets	—	529	—	869
Cash flows from (used in) investing activities	4,734	(10,603)	7,194	(3,312)
Financing activities				
Common shares issued for cash	217	31	254	41
Account payable related to the acquisition of intellectual property	(1,039)	—	(2,483)	—
Repayment of share purchase loan	20	20	20	20
Cash flows from (used in) financing activities	(802)	51	(2,209)	61
Net change in cash and cash equivalents during the period	4,484	(8,616)	3,089	(589)
Cash and cash equivalents, beginning of period	596	10,047	1,991	2,020
Cash and cash equivalents, end of period	5,080	1,431	5,080	1,431
Cash and cash equivalents	5,080	1,431		
Short-term marketable securities	30,801	43,950		
Long-term marketable securities	2,617	1,253		
	38,498	46,634		

See accompanying notes

NOTES TO FINANCIAL STATEMENTS

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

1. Basis of presentation

Information with respect to the December 31, 2003 balance sheet is derived from the Company's complete audited financial statements. These unaudited interim financial statements should be read in conjunction with the audited financial statements and the notes thereto in the Company's Annual Report for the year ended December 31, 2003.

2. Accounting policies

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, 2003.

3. Restatement

As reported in note 3 of the audited financial statements for the year ended December 31, 2003, the Company changed its accounting policy for the stock-based compensation plans in the fourth quarter of 2003. Consequently, the Company has applied fair value based method to expense employee options awarded since January 1, 2003. This change in accounting policy has resulted in restatement of general and administrative expenses and net income for the three-month and six-month periods ended June 30, 2003.

4. 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	14,799,588	\$57,440
Issued on exercise of stock options	47,590	230
Issued under employee share purchase plan	4,125	23
Other	5	—
Balance at June 30, 2004	14,851,308	\$57,713

Stock option plan

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 at beginning of year	873,984	5.57	706,524	6.18
Granted	98,369	4.21	163,318	4.23
Exercised	(47,590)	4.84	(5,000)	4.25
Expired or forfeited	(64,186)	6.28	(59,056)	6.43
Balance at June 30	860,577	5.51	805,786	5.78
Options exercisable at June 30	439,140	5.62	353,352	5.64

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

The Company recorded option compensation expense and determined the fair value of stock options as follows:

	Three-month period ended June 30		Three-month period ended June 30	
	2004	2003	2004	2003
Option compensation expense	80	59	216	158
Weighted average fair value of stock options	\$3.90	\$2.87	\$3.47	\$3.00
Weighted average risk-free interest rate	4.15%	4.58%	3.94%	4.67%
Dividend yield	nil	nil	nil	nil
Weighted average volatility factor	66%	71%	66%	71%
Weighted average expected life	7 years	7 years	7 years	7 years

For purposes of pro forma disclosures, the estimated fair value of the options granted prior to 2003 will continue to be disclosed as an expense on

Here today. Here for life.

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

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

	Three-month period ended		Three-month period ended	
	2004	2003	2004	2003
	June 30	June 30	June 30	June 30
	\$	\$	\$	\$
Net income (loss) as reported	681	(142)	1,025	431
Less: Amortization of fair value related to option grants	(19)	(32)	(38)	(71)
Amortization of fair value related option life amendment in fiscal 2002	(11)	(28)	(37)	(55)
Pro-forma net income	651	(202)	950	305
Basic Earnings per share				
As reported	0.05	(0.01)	0.07	0.03
Pro-forma	0.04	(0.01)	0.06	0.02
Diluted Earnings per share				
As reported	0.05	(0.01)	0.07	0.03
Pro-forma	0.04	(0.01)	0.06	0.02

5. 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		Three-month period ended	
	2004	2003	2004	2003
	June 30	June 30	June 30	June 30
	\$	\$	\$	\$
Basic weighted average number of shares outstanding	14,829,954	14,784,725	14,816,400	14,781,677
Dilutive effect of options	105,755	15,386	92,038	8,818
Diluted weighted average number of shares outstanding	14,935,709	14,800,111	14,908,438	14,791,495

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

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.

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 receivable and \$2.9 million of inventory from this affiliate. The related party will continue to provide logistics services, including customer service, warehousing and shipping, invoicing and collection services.

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

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:

	Three-month period ended June 30		Three-month period ended June 30	
	2004 \$	2003 \$	2004 \$	2003 \$
Revenues	14	897	503	1,452
Purchases	702	1,358	4,183	2,607
Research and development expenses	118	40	222	98
Sales and marketing expenses	379	321	679	611
General and administrative expenses	86	67	148	137

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. The Company will receive no further consideration for these products.

7. Write-down of investments

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 will be able to resume production of its marketed product, Valtaxin[™]. The Company determined that there had 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.

8. Commitments

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

Revenue based commitments

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

In addition, the Company may have to pay up to \$5,161 [US\$3,850] and \$100 if the Company achieves specific sales volumes on specific products in the future. Payments related to sales volume may be due over the next 10 years.

Milestone based commitments

The Company has also committed to fund certain research and development expenditures of third parties for \$335 [US\$250] over the next two years. 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 \$3,594, including US\$2,618, over a maximum period of 15 years.

Purchase and service based commitments

The Company is committed to making minimum spending related to inventory purchases, regulatory, sales and marketing expenditures in the amount of \$13,914 including US\$250 in order to retain exclusive distribution agreements for certain products. These commitments end in 2011 and annual amounts are as follows:

	\$
July 1, 2004-December 31, 2004	1,673
2005	3,472
2006	3,316
2007	2,376
2008	856
2009-2011	2,221

9. Comparative figures

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

Stock Exchange Listing

Toronto Stock Exchange

Trading Symbol: PLB

Transfer Agent

Computershare Trust Company of Canada

1500 University St.

Suite 700

Montreal, Quebec

H3A 3S8

Investor Relations

Samira Sakhia

Chief Financial Officer

Tel.: (514) 340-5067

Fax: (514) 344-4675

E-mail: info@paladin-labs.com

Bruce Wigle

Investor Relations

Tel.: (416) 815-0700, Ext. 228

Fax: (416) 815-0080

E-mail: bwigle@equicomgroup.com



Paladin Labs Inc.
6111 Royalmount Avenue
Suite 102
Montreal, Quebec
Canada H4P 2T4
www.paladinlabs.com