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MANAGEMENT'S DISCUSSION AND ANALYSIS

FOR THE THREE-MONTH AND SIX-MONTH PERIODS ENDED JUNE 30, 2008

The following information should be read in conjunction with our unaudited interim consolidated financial statements as at June 30, 2008 and related notes thereto as well as the audited consolidated financial statements and Management's Discussion and Analysis as at December 31, 2007 and related notes thereto. Our unaudited interim consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP"). The Management's Discussion and Analysis provides a review of the performance of the Company for the three-month period ended June 30, 2008, as compared to the three-month period ended June 30, 2007 and for the six-month periods then ended. This review was performed by management with information available as at August 7, 2008. Additional information relating to the Company, including its Annual Information Form, can be found on SEDAR on www.sedar.com.

Certain statements in this document are forward-looking and prospective. Forward-looking statements generally can be identified by the use of forward-looking terminology such as "may", "will", "expect", "intend", "estimate", "anticipate", "plan", "foresee", "believe" or "continue" or the negatives of these terms or variations of them or similar terminology. By their nature, forward-looking statements require us to make assumptions and are subject to inherent risks and uncertainties. There is significant risk that predictions and other forward-looking statements will not prove to be accurate. Readers of this document are cautioned not to place undue reliance on our forward-looking statements as a number of factors could cause future results, conditions, actions or events to differ materially from the operating targets, expectations, estimates or intentions expressed in the forward-looking statements.

Factors that could cause actual results to differ materially include but are not limited to:

- our plans to develop and commercialize product candidates and the timing of these development programs;
- whether we will receive, and the timing and costs of obtaining, regulatory approvals;
- clinical development of our product candidates, including the results of current and future clinical trials;
- the benefits of our drug delivery technologies and product candidates as compared to others;
- our ability to maintain and establish intellectual property rights in our drug delivery technologies and product candidates;
- our need for additional financing and our estimates regarding our capital requirements and future revenues and profitability;
- our estimates of the size of the potential markets for our product candidates;
- our selection and licensing of product candidates;
- our ability to attract distributors and collaborators with acceptable development, regulatory and commercialization expertise and the benefits to be derived from such collaborative efforts;
- sources of revenues and anticipated revenues, including contributions from distributors and collaborators, product sales, license agreements and other collaborative efforts for the development and commercialization of product candidates;
- our ability to create an effective direct sales and marketing infrastructure for products we elect to market and sell directly;
- the rate and degree of market acceptance of our products;
- the timing and amount of reimbursement for our products;
- the success and pricing of other competing therapies that may become available;
- our ability to hire and retain qualified employees;
- the manufacturing capacity of third-party manufacturers for our product candidates; and
- other risk factors discussed herein and listed from time to time in our reports, public disclosure documents and other filings with the securities commissions in Canada and the United States.

A detailed list of the risks and uncertainties affecting us can be found in our Annual Information Form for the year ended December 31, 2007 filed on SEDAR.

In some cases, you can identify forward-looking statements by terms such as “may”, “will”, “should”, “could”, “would”, “expect”, “plan”, “anticipate”, “believe”, “estimate”, “project”, “predict”, “intend”, “potential”, “continue” and similar expressions intended to identify forward-looking statements. Forward-looking statements reflect our current views with respect to future events and are based upon what we believe are reasonable assumptions and subject to risks and uncertainties. Given these risks and uncertainties, the forward-looking events and circumstances discussed in this Management's Discussion and Analysis may not transpire, and you should not place undue reliance on these forward-looking statements since actual future results, conditions, actions or events may vary from the forward-looking information. Also, these forward-looking statements represent our estimates and assumptions only as of the date of this Management's Discussion and Analysis. We undertake no obligation and do not intend to update or revise these forward-looking statements, unless required by law. We qualify all of the information presented in this Management's Discussion and Analysis, and particularly our forward-looking statements, with these cautionary statements.

Where we say “we”, “us”, “our”, or the “Company” we mean Labopharm Inc. and its subsidiaries unless otherwise indicated. All amounts are presented in Canadian dollars unless otherwise indicated.

OVERVIEW

We are an international, specialty pharmaceutical company focused on optimizing the performance of existing drugs by incorporating our proprietary, advanced controlled-release technologies. We have multiple products in development. Our lead product, a once-daily formulation of the analgesic tramadol, designed to address the worldwide market for moderate to severe pain products, is being commercialized globally, which may include the U.S. market in the near future following the recent confirmation by the Food and Drug Administration (FDA) of a January 2, 2009 action date on our recently submitted complete response. Our second product, a once-daily formulation of trazodone, a novel serotonin antagonist reuptake inhibitor (SARI) antidepressant, is in New Drug Application (NDA) preparation for U.S. and Canadian submission in the second half of 2008, while our third product, a novel twice-daily formulation of the analgesic tramadol plus acetaminophen, is in a pivotal Phase III study with results expected in the first quarter of 2009. Additionally, we have other products in development utilizing both our Contramid® and Misuse Preventive technologies, as well as our polymeric nano-delivery system™ (PNDS™) technology. Our products address large market opportunities and we are in active discussion, in several product areas, with interested commercialization partners.

Our global commercialization program for once-daily tramadol recognizes three markets: Europe, the United States, and the rest of the world. We intend to successfully market our once-daily tramadol product primarily through a series of licensing and distribution arrangements. To date, we have entered into agreements for the distribution of our product in 29 European countries and some of their overseas territories, the United States, Canada, South Korea, Australia, Israel, Turkey, Mexico and 20 other Latin American and Caribbean countries. We are also in discussions with potential partners to commercialize our once-daily tramadol product in other jurisdictions. We have either obtained regulatory approval, submitted applications for regulatory approval or are preparing to submit regulatory applications in more than 30 countries. During the second quarter of 2008, we initiated shipments to South Korea and subsequent to the quarter ended June 30, 2008, we initiated shipments to Australia. Our partners in both these countries launched our once-daily tramadol product in July 2008.

In Europe, our product was launched initially in Germany in November 2005 and has since been launched in ten additional European countries: Czech Republic, Slovakia, Italy, Spain, the United Kingdom, France, Belgium, Poland, Austria and in July 2008, in Romania. In Canada, our product has been launched by our marketing partner, Paladin Labs Inc. (Paladin). During the first quarter of 2008, Paladin entered into a co-promotion agreement with Nycomed Canada Inc., doubling the number of primary care sales representatives promoting our once-daily tramadol product in Canada. We plan to continue to launch our once-daily tramadol product in other countries throughout 2008 and 2009.

Obtaining regulatory approval for our once-daily tramadol formulation in the United States remains a top priority. We have received two approvable letters from the FDA, the first in September 2006 and the second in May 2007. Based on our belief that we have met the statutory standards for approval of our once-daily tramadol formulation, we appealed the FDA's decision regarding our once-daily formulation of tramadol using the FDA's Formal Dispute Resolution (FDR) process. Through

the FDR process, the FDA suggested we submit additional statistical analysis of existing data as a means to satisfy its requirements. As a result, on July 2, 2008, we submitted a complete response to the FDA, which centers on the additional analysis of existing data using the methodology suggested by the FDA. Our response has been accepted by the FDA as a complete, Class 2 response. We believe that the additional analysis confirms the conclusions of efficacy of our once-daily tramadol formulation consistent with previous analyses that were included in our NDA and additional submissions thereafter. The action date assigned by the FDA under the Prescription Drug User Fee Act (PDUFA) is January 2, 2009.

Our once-daily formulation of the SARI antidepressant trazodone is designed to address an unmet need in the US\$20 billion global market for drugs treating depression. It is recognized that a major challenge in treating depression is early remission due to poor patient compliance in taking their medication, due to slow onset of action and exacerbation of sleep disturbance and agitation. We believe that our once-daily trazodone formulation can not only treat depression but also reduce agitation and improve quality of sleep, thus improving compliance and reducing the need for add-on therapies. Earlier this year we completed a North American Phase III clinical trial (04ACL3-001) for our formulation. The study demonstrated that our formulation of trazodone achieved statistical significance for the primary endpoint in the reduction of depression, and also demonstrated significantly improved patient sleep patterns. We are preparing an NDA, which we expect to submit both in the U.S and Canada during the second half of 2008. We have begun planning for commercialization which includes initiating the transfer of the manufacturing process to a third-party commercial manufacturing site and initiating discussions with potential distributors in the U.S.

We are developing a twice-daily formulation that combines the analgesics tramadol and acetaminophen which is designed to provide both immediate and sustained relief of moderate to severe pain. Based on its potential efficacy, safety and convenience, we believe that our formulation could compete in the US\$7 billion global market for prescription drugs that address acute pain. During the first half of 2008, we initiated a pivotal Phase III clinical trial (06CCL3-001) in North America for our formulation, and expect to be able to announce results in the first quarter of 2009.

We are developing a platform for the controlled release of high potency, orally administered drugs that is intended to minimize the potential for unintentional misuse and/or abuse. Misuse and/or deliberate abuse of opioid analgesics is particularly problematic, resulting in an increasing economic and public health burden and becoming an important concern for physicians when treating pain. We completed a pharmacokinetic study on a misuse prevention formulation of once-daily tramadol as proof of principle which achieved positive results. In addition to once-daily tramadol, we are evaluating the use of our misuse prevention platform on other compounds, including high potency pain relief products, and we are preparing to initiate pharmacokinetic studies on two of the most widely misused pain drugs.

The pharmacokinetic study for our twice-daily tramadol and acetaminophen combination formulation demonstrated that the acetaminophen component of the formulation rapidly achieved blood plasma levels associated with efficacy in the currently marketed product, followed by controlled release characteristics. Consequently, we initiated development of a twice-daily formulation of acetaminophen for the sustained relief of mild to moderate pain. We are currently in the process of evaluating the commercial opportunity.

In addition to those products based on our Contramid® technology, we are developing product candidates based on our PNDS™ technology for the delivery of water-insoluble and poorly bioavailable drugs. Our research and development activities to date include proof of concept studies that have been completed for a novel, lipid- and preservative-free formulation of the intravenous anaesthetic propofol using our PNDS™ intravenous platform, as well as for SN-38, a currently intravenously administered colon cancer drug that we have formulated for oral administration using our PNDS™ oral platform.

Our Goal

Our goal is to become a specialty pharmaceutical company, with the expertise and infrastructure to develop and commercialize proprietary therapeutics by taking them from the formulation stage through clinical development and regulatory approval to marketing and sales. We believe that full integration should maximize the value inherent in our technology and product candidates by allowing greater control over the development and commercialization process and generating higher returns on investment.

Revenue

Revenue from product sales, corresponding gross margin, and royalties will be the key drivers of our performance as we pursue our activities. Through our license and distribution agreements, we expect to continue to launch our once-daily tramadol product in various markets throughout 2008 and beyond. The contribution of our once-daily tramadol product will vary for each country because of specific market conditions and/or pricing policies. It is difficult to estimate the timing of product launches in various countries because of the regulatory and/or pricing approval processes required before we can market our once-daily tramadol in each jurisdiction. Since 2002, we have secured license agreements for marketing and distribution of our once-daily tramadol product that cover more than 50 countries, and which have generated \$38.3 million to date in licensing payments. We believe that revenue growth should also be sustained by the additional products in our pipeline as we move them to commercialization. Our once-daily trazodone product could generate significant licensing payments in the near term as we move forward to secure a license and distribution agreement for the U.S. market.

Research and Development Expenses

Our research and development expenses to date consist primarily of fees paid to outside parties to conduct our clinical studies, manufacturing process validation, analytical testing or other services, salaries and related personnel expenses, materials and laboratory supplies and costs for our facilities and equipment. Our research and development expenses have fluctuated significantly from period to period in the past and are likely to do so in the future as they are impacted by the progress related to our development efforts.

Selling, General and Administrative Expenses

As we expand our operations in order to become a global commercial organization with significant product sales, our selling, general and administrative expenses should increase as we build our infrastructure for our sales, marketing, manufacturing, and product support efforts. These incremental costs to support commercial operations and product sales are necessary in order for us to remain a global organization with increasingly diverse operations, moving away from a primary focus on research and development activities.

CHANGES IN ACCOUNTING POLICIES

Details of the Handbook Sections, released by the Canadian Institute of Chartered Accountants ("CICA"), and which were adopted on January 1, 2008, are presented in note 3 of our unaudited interim consolidated financial statements for the quarter ended June 30, 2008.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our critical accounting policies and estimates remain substantially the same as reported in our Management's Discussion and Analysis for the year ended December 31, 2007, as included in our annual report, except for the following estimates:

Impairment of Long-term Investment

At June 30, 2008, we held Canadian third-party asset-backed commercial paper ("ABCP") in Aurora Trust Series A with a principal value at maturity of \$5,751,000. At the date we acquired this investment in May 2007, it was rated R1 (High) by DBRS Limited ("DBRS"), the highest credit rating issued for commercial paper by DBRS. This investment matured on October 15, 2007 but, as a result of illiquidity in the Canadian ABCP market, it did not settle on maturity. As a result, we have classified our ABCP investment as long-term after initially classifying it as an available-for-sale marketable security. The ABCP in which we have invested has not traded in an active market since mid-August 2007 and there are currently no market quotations available.

On August 16, 2007, an announcement was made by a group representing banks, asset providers and major investors on an agreement in principle to a long-term proposal and interim agreement to convert the ABCP into long-term floating rate notes maturing no earlier than the scheduled maturity of the underlying assets. On September 6, 2007, a pan-Canadian restructuring committee consisting of major investors was formed. The committee was created to propose a solution to the liquidity problem affecting the ABCP and has retained legal and financial advisors to oversee the proposed restructuring process.

On March 20, 2008, the pan-Canadian restructuring committee issued an information statement ("the Information Statement") containing details about the proposed restructuring. Based on this and other public information it is estimated that we will, on restructuring, receive Class A-1, Class A-2, Class B and Class C long-term floating rate notes with par values of \$1,767,000, \$3,252,000, \$560,000, and \$172,000, respectively, and having maturities of approximately eight years. The Class A-1 and A-2 notes are expected by the restructuring committee to obtain an AA credit rating while the Class B and Class C notes are likely to be unrated. On April 25, 2008, a majority of the ABCP holders voted in favour of the restructuring proposal. On June 5, 2008, a court order sanctioning the restructuring of the ABCP was made pursuant to the *Companies' Creditors Arrangement Act*. The sanction order remains subject to appeals by certain ABCP holders, and the restructuring is not expected to be implemented until all appeals have been resolved.

The valuation technique we used to estimate the fair value of our investment in ABCP as at June 30, 2008, incorporates probability weighted discounted cash flows considering the available public information regarding market conditions and other factors that a market participant would consider for such investments. The assumptions used in determining the estimated fair value reflect the details included in the Information Statement and the risks associated with the long-term floating rate notes. We assume that the notes will generate a weighted average interest rate of 3.4%. One of the cash flow scenarios modeled is a liquidation scenario whereby, if the restructuring is not successfully completed, recovery of our investment is through the liquidation of the underlying assets of the ABCP trusts.

Discount rates vary dependent upon the credit rating of the replacement long-term floating rate notes. Discount rates have been estimated using average yield of AA rated corporate bonds having similar maturities, adjusted for consideration of additional risk for the lack of information, lack of liquidity and uncertainty with respect to the exact nature of the resulting instrument. A weighted average discount rate of 8.5% was used in our fair-value estimate of our ABCP. An increase in the estimated discount rates of 1 percent would reduce the estimated fair value of our investment in ABCP by approximately \$288,000.

The recalibration of the valuation model as at June 30, 2008 based on current available information did not result in a significant change in the estimated fair value of the ABCP. This fair value represents approximately 65% of the principal value.

Continuing uncertainties regarding the value of the assets which underlie the ABCP, the amount and timing of cash flows and the outcome of the restructuring process could give rise to a further material change in the value of our investment in this ABCP which could impact our near term earnings.

RESULTS OF OPERATIONS

Fluctuations in Operating Results

Our results of operations have fluctuated significantly from period to period in the past and are likely to do so in the future. We anticipate that our quarterly and annual results of operations will be impacted for the foreseeable future by several factors, including the timing of approvals to market our products in various jurisdictions and resulting product sales, the timing and amount of payments received pursuant to our current and future collaborations with third-parties, and the progress and timing of expenditures related to our research, development and commercialization efforts. Due to these fluctuations, we presently believe that the period-to-period comparisons of our operating results are not a reliable indication of our future performance.

Revenue

For the three-month and six-month periods ended June 30, 2008, total revenue amounted to \$4,923,000 and \$8,142,000, respectively compared to \$5,856,000 and \$11,269,000 for the corresponding periods in 2007.

For the three-month and six-month periods ended June 30, 2008, product sales of our once-daily tramadol were \$3,859,000 and \$6,017,000, respectively compared to \$4,149,000 and \$7,541,000, respectively for the corresponding periods last year. While our product sales to our partners are lower in 2008 than in 2007, end-user market sales are significantly higher. The reason this is not reflected in our year over year product sales is that in 2007, a large portion of our sales were for initial launch quantities in new markets. Lower volumes in 2008 were partly offset by higher average selling prices per tablet compared to 2007, due primarily to a more favorable product mix. During the second quarter of 2008, we initiated shipments to South Korea.

During the three-month period ended June 30, 2008, we recognized licensing revenue of \$1,064,000, representing a portion of the licensing payments received from our marketing and distribution partners under our license and distribution agreements for once-daily tramadol. Licensing revenue for the three-month period ended June 30, 2007 was \$1,707,000. For the six-month period ended June 30, 2008, licensing revenue amounted to \$2,125,000 compared to \$3,728,000 for the corresponding period last year. For both the quarter and the six-month periods ended June 30, 2008, the decrease in licensing revenue recognized is attributable to the extension of the estimated term over which we are recognizing the up-front payment of US\$20 million previously received from Purdue Pharma, following receipt of the second FDA approvable letter in May 2007. This up-front payment is recognized on a straight-line basis over the estimated term during which we will be maintaining substantive contractual obligations to Purdue Pharma, namely pursuing regulatory approval in the U.S., and supplying product for an initial eighteen-month period post launch, as per our agreement.

Subsequent to June 30, 2008, we announced that we had reached an agreement with Recordati Ireland Ltd. (Recordati) to reacquire the sales and marketing rights to our once-daily tramadol product for the United Kingdom. Under this agreement, we received a payment of \$1,118,000 from Recordati, of which \$106,000 was in consideration of an account receivable related to a portion of a milestone payment previously recognized, and re-purchased finished goods inventory from Recordati for a cash consideration of \$269,000.

Prior to the conclusion of this agreement, we were recognizing as licensing revenue \$102,000 per quarter on a straight-line basis for licensing payments previously received from Recordati. Following the conclusion of this agreement, we will have no further substantive contractual obligations towards Recordati and the balance of the deferred licensing payments previously received and amounting to \$3,411,000 as at June 30, 2008, will be recognized as licensing revenue in the third quarter of 2008, together with the unrecognized portion of the \$1,118,000 payment amounting to \$1,012,000.

Cost of Goods Sold

For the three-month and six-month periods ended June 30, 2008, our cost of goods sold (which excludes depreciation) was \$1,683,000 and \$2,634,000 respectively, compared to \$4,003,000 and \$5,704,000 for the corresponding periods last year. Our cost of goods sold consists primarily of raw materials, third-party bulk tablet manufacturing costs, third-party packaging costs and a royalty expense for our once-daily tramadol product. During the second quarter of 2007, following the receipt of the second approvable letter from the FDA for our once-daily tramadol product, we recorded a provision of \$1,742,000 for previously capitalized inventory costs and related deposits to manufacturers, which we had incurred in anticipation of U.S. approval in June 2007, and our plan to launch as quickly as possible thereafter. These costs had been capitalized prior to regulatory approval, based on our best estimate of the timing of the launch.

[in thousands of Canadian dollars]	FOR THE THREE MONTHS ENDED:		FOR THE SIX MONTHS ENDED:	
	JUNE 30, 2008	JUNE 30, 2007	JUNE 30, 2008	JUNE 30, 2007
Product sales	3,859	4,149	6,017	7,541
Cost of goods sold	1,683	4,003	2,634	5,704
Gross margin	2,176	146	3,383	1,837
Gross margin %	56%	4%	56%	24%
Adjusted gross margin %	56%	46% ¹	56%	47% ¹

¹ Adjusted to exclude the inventory provision of \$1,742,000

For the three-month and six-month periods ended June 30, 2008, gross margin as a percentage of product sales revenue is 56% compared to an adjusted gross margin (which excludes the aforementioned provision) of 46% and 47% for the corresponding periods in 2007. In 2008, the increase in our gross margin percentage compared to 2007 reflects primarily lower packaging costs, combined with higher average selling prices per tablet, resulting from a more favorable product mix. The reduction in our packaging costs is the result of pricing negotiations with our vendor, and reflects our continued efforts to reduce our costs of goods sold to improve our gross margin. Our gross margin will vary primarily as a result of selling prices in various jurisdictions, currency fluctuations, inventory write-offs, as well as the effect of packaging formats and the size of packaging runs on our cost of goods sold.

Research and Development Expenses

Research and development expenses (before government assistance) for the three-month period ended June 30, 2008 were \$6,993,000 compared to \$6,521,000 for the three-month period ended June 30, 2007. This increase is primarily the result of the timing and progress of our clinical trial programs, as well as a general increase in our research and development workforce to support the development of our growing product pipeline. In the second quarter of 2008, our Phase III clinical trial for our twice-daily formulation that combines the analgesics tramadol and acetaminophen (06CCL3-001) was ongoing, as well as several pharmacokinetic and other studies for various products in our pipeline. The second quarter of 2007 primarily included costs related to the Phase III clinical trial for our once-daily formulation of trazodone.

For the six-month period ended June 30, 2008, research and development expenses (before government assistance) were \$13,844,000 compared with \$11,800,000 for the six-month period ended June 30, 2007. This increase is primarily the result of higher clinical trial activity in the current period, as well as an increase in our research and development workforce as we advance the development of our multiple product candidates. In the first half of 2008 clinical trial costs were considerably higher, as we completed the Phase III clinical trial for our once-daily formulation of trazodone (04ACL3-001), we initiated the Phase III clinical trial for our twice-daily formulation that combines the analgesics tramadol and acetaminophen (06CCL3-001), and we conducted several pharmacokinetic and other studies for various products in our pipeline. The six-month period ended June 30, 2007 primarily included costs related to the initiation of the Phase III clinical trial for our once-daily formulation of trazodone.

Research and development tax credits for the quarter ended June 30, 2008 were \$687,000 compared to \$840,000 in the corresponding quarter of 2007. For the six-month period ended June 30, 2008, research and development tax credits amounted to \$1,847,000 compared to \$1,649,000 for the corresponding period last year. During the first quarter of 2008, we released reserves of \$450,000 following the favourable audit by the tax authorities of our provincial research and development tax credit claims for the years 2004 to 2006.

The research and development tax credits by jurisdiction are as follows:

[in thousands of Canadian dollars]	FOR THE THREE MONTHS ENDED:		FOR THE SIX MONTHS ENDED:	
	JUNE 30, 2008	JUNE 30, 2007	JUNE 30, 2008	JUNE 30, 2007
Canadian federal research and development tax credits	350	675	800	1,200
Provincial research and development tax credits	337	165	1,047	449
	687	840	1,847	1,649

Selling, General and Administrative Expenses

Selling, general and administrative expenses for the quarter ended June 30, 2008 were \$6,062,000 compared to \$6,047,000 for the quarter ended June 30, 2007. During the quarter ended June 30, 2008, we accrued patent litigation costs of US\$903,000 as disclosed in note 11 of our unaudited interim consolidated financial statements. These costs, together with increased compensation costs, were offset primarily by lower consulting and other legal fees, and lower non-cash stock-based compensation expense. A higher number of options was granted in 2008, however the fair value of the options granted was significantly lower, due primarily to the relatively lower average stock price during the current period. For the six-month period ended June 30, 2008, selling, general and administrative expenses amounted to \$10,878,000 compared to \$11,218,000 for the corresponding period last year. The decrease is primarily a result of lower non-cash stock-based compensation, partially offset by the increase in the items noted above for the quarter.

Financial Expenses

Financial expenses for the quarter ended June 30, 2008 were \$709,000 compared to \$491,000 for the quarter ended June 30, 2007. For the six-month period ended June 30, 2008, financial expenses amounted to \$1,420,000 compared to \$1,040,000 for the corresponding period in 2007. The increase is primarily attributable to the higher average outstanding long-term debt balance in the three-month and six-month periods ended June 30, 2008.

Impairment of Long-term Investment

During the first quarter of 2008 we recorded an additional impairment loss on our long-term investment of \$691,000, to consider our revision of the estimate of the fair-value of the ABCP as at March 31, 2008. No further impairment losses were recorded in the second quarter of 2008. It is reasonably possible that the amount ultimately recovered may differ materially from the estimated fair value of this long term investment.

Interest Income

Interest income for the quarter ended June 30, 2008 was \$551,000 compared to \$925,000 for the quarter ended June 30, 2007. For the six-month period ended June 30, 2008 interest income totalled \$1,203,000 compared to \$1,897,000 in the corresponding period in 2007. The decrease is primarily attributable to a lower average balance of cash and investment balances, combined with lower average rates of return earned on our investments in 2008.

Foreign Exchange (Gain) Loss

For the quarter ended June 30, 2008, we recorded a foreign exchange gain of \$20,000, compared to a loss of \$393,000 for the quarter ended June 30, 2007. The foreign exchange loss in the quarter ended June 30, 2007 resulted from the relative strengthening of the Canadian currency versus the Euro and the unfavourable impact this had on cash held in Euros. For the six-month period ended June 30, 2008, the foreign exchange gain amounted to \$292,000 compared to a loss of \$387,000 for the corresponding period in 2007. The gain realized during the six-month period ended June 30, 2008 resulted primarily from the favourable impact of the strengthening of the Euro against the Canadian dollar, on our cash balances held in Euros.

Income Taxes

For the quarter ended June 30, 2008, income tax expense amounted to \$350,000 compared to \$675,000 for the quarter ended June 30, 2007. For the six-month period ended June 30, 2008, income tax expense amounted to \$800,000 compared to \$1,202,000 for the corresponding period of the previous year. For both 2008 and 2007, we have not deducted certain discretionary research and development expenses, in order to record sufficient Canadian Federal taxable income to allow us to utilize our non refundable Canadian Federal research and development tax credits. These Canadian Federal research and development tax credits have a limited carryforward period, whereas the discretionary research and development expenses have an unlimited carryforward period.

Net Loss and Net Loss Per Common Share

Net loss for the three-month period ended June 30, 2008 was \$10,140,000 or \$0.18 per common share, compared to \$11,009,000 or \$0.19 per common share, for the three-month period ended June 30, 2007. The decrease in net loss is primarily the result of our improved gross margin. For the six-month period ended June 30, 2008, net loss was \$19,832,000 or \$0.35 per common share, compared with \$17,508,000, or \$0.31 per common share for the corresponding period last year and increased primarily as a result of higher research and development expenses.

QUARTERLY INFORMATION

The following selected financial information is derived from our unaudited quarterly financial statements for each of the last eight quarters.

[in thousands of Canadian dollars, except per share data]	FOR THE THREE MONTHS ENDED:							
	JUNE 30, 2008	MARCH 31, 2008	DEC. 31, 2007	SEPT. 30, 2007	JUNE 30, 2007	MARCH 31, 2007	DEC. 31, 2006	SEPT. 30, 2006
Product sales	3,859	2,158	1,576	2,818	4,149	3,392	2,819	1,097
Licensing and other	1,064	1,061	1,060	2,275	1,707	2,021	2,339	2,229
Total Revenue	4,923	3,219	2,636	5,093	5,856	5,413	5,158	3,326
Net loss	(10,140)	(9,692)	(10,036)	(9,031)	(11,009)	(6,499)	(7,165)	(4,361)
Basic and diluted net loss per common share	(0.18)	(0.17)	(0.18)	(0.16)	(0.19)	(0.11)	(0.13)	(0.08)

LIQUIDITY AND CAPITAL RESOURCES

Sources of Liquidity and Funding Requirements

We have incurred substantial operating losses since our inception due in large part to expenditures for our research and development activities. At June 30, 2008, we had an accumulated deficit of \$224,756,000. To date, we have financed our cash requirements primarily through share issuances, debt financing, licensing payments, investment tax credits, collaborative research contracts and interest income.

On December 21, 2007, we entered into an agreement for a US\$25,000,000 term loan, maturing in December 2011. Under the terms of the new term loan agreement, we received US\$15,000,000 (Tranche A) upon signing of the agreement, with the remaining US\$10,000,000 available beginning May 15, 2008 through November 15, 2008 (Tranche B).

Cash, cash equivalents and available-for-sale marketable securities totalled \$55,319,000 as at June 30, 2008 compared to \$71,899,000 as at December 31, 2007, a decrease of \$16,580,000, primarily as a result of funds used in operating activities. In addition, we hold an investment in ABCP having a principal value of \$5,751,000 and an estimated fair value as at June 30, 2008, of \$3,739,000 which has been classified as a long-term investment. The investment of these funds is governed by our corporate investing policy. As at June 30, 2008, our marketable securities included guaranteed investment certificates, and bonds issued by government agencies and Canadian corporations.

As at June 30, 2008, working capital¹ was \$48,168,000. Accounts receivable totalled \$1,870,000 as at June 30, 2008 and primarily included trade receivables and sales taxes receivable. Research and development tax credits receivable totalled \$1,797,000 and included the estimated tax credits for the year ended December 31, 2007 and for the six-month period ended June 30, 2008. Inventories totalled \$1,918,000 and consisted of raw materials, intermediate finished product (primarily bulk tablets) and finished packaged goods, for ongoing commercialization. Accounts payable and accrued liabilities totalled \$9,038,000 as at June 30, 2008 and included trade payables and accrued payroll and related expenses and other payables. Deferred revenue totalled \$19,376,000 as at June 30, 2008 and included the unrecognized portion of the licensing fees received from the various licensees of once-daily tramadol. These licensing fees are generally recognized as revenue over the term during which we maintain substantive contractual obligations to the licensee.

Under our current operating plan, we believe that our current cash, cash equivalents and marketable securities, potential proceeds from our term loan agreement, and research and development tax credits should be sufficient to finance our operations and capital needs beyond the next eighteen months. Potential funding from additional license agreements for our most advanced products should extend our cash autonomy further. However, in light of the inherent uncertainties associated with research and development programs, the scale-up and commercialization of products, the results of clinical testing, receipt of regulatory approval of certain products and the ability to secure licensing agreements, it may be necessary for us to either (i) raise additional funds for the continuing development and marketing of our products, or (ii) delay or scale-back our development programs. Furthermore, additional financing may also be required for business acquisitions or to acquire additional products or technologies.

¹ Working capital is not a measure defined by GAAP and is here calculated as total current assets less total current liabilities. Working capital, as calculated by us, may not be comparable to similar measures presented by other issuers.

Cash Flows

Funds used in operating activities prior to net changes in non-cash operating items amounted to \$8,844,000 for the quarter ended June 30, 2008, compared to \$8,604,000 for the quarter ended June 30, 2007. The lower net loss in 2008 was offset by lower non-cash items, primarily stock-based compensation and unrealized foreign exchange. The net change in non-cash operating items represented a use of cash of \$213,000 for the three-month period ended June 30, 2008, compared to \$1,060,000 for the corresponding period in 2007, a decrease primarily due to the timing of collection of our accounts receivable. For the six-month period ended June 30, 2008, funds used in operating activities prior to net changes in non-cash operating items amounted to \$16,568,000, compared to \$13,022,000 for the six-month period ended June 30, 2007, increasing primarily as a result of our higher net loss in the current six-month period. Net changes in non-cash operating items provided funds of \$717,000 for the six-month period ended June 30, 2008, compared to \$108,000 for the corresponding period in 2007, an increase due primarily to the timing of the receipt of various amounts receivable.

Funds generated from or used by investing activities primarily reflect the proceeds from maturities of marketable securities net of their reinvestment. In addition, capital expenditures for the current quarter were \$808,000 compared to \$375,000 for the three-month period ended June 30, 2007. For the six-month period ended June 30, 2008, capital expenditures were \$1,425,000 compared to \$1,269,000 for the corresponding period in 2007. Capital expenditures for the first half of 2008 were primarily related to the acquisition of laboratory equipment, office and information technology equipment, building improvements and patents and trademarks. During the quarter ended June 30, 2008, we established our U.S. headquarters in Princeton, New Jersey.

For the quarter ended June 30, 2008, funds used by our financing activities amounted to \$162,000 compared to \$929,000 for the quarter ended June 30, 2007. For the six-month period ended June 30, 2008, funds used by our financing activities amounted to \$185,000 compared to \$1,879,000 for the six-month period ended June 30, 2007. The lower use of funds in 2008 is primarily due to the fact that no principal repayments are payable in 2008 on our new term loan agreement completed in December 2007, while in 2007 the amortization schedule of our former term loan did include principal repayments.

OFF-BALANCE SHEET ARRANGEMENTS

To date, we have not had any relationships with unconsolidated entities or financial partnerships, such as entities referred to as structured finance or special purpose entities, which are established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

OUTSTANDING SHARE DATA

The number of common shares outstanding as of August 7, 2008 is 56,824,063 and has increased by 1,700 since June 30, 2008, due to the exercise of stock options. The number of stock options outstanding as of August 7, 2008 is 4,458,050 and has decreased by 25,200 since June 30, 2008, due to the exercise of 1,700 stock options and the expiry of 43,500 stock options, net of the grant of 20,000 stock options.

QUANTITATIVE AND QUALITATIVE DISCLOSURES OF MARKET RISKS

Disclosure of the fair value of the financial instruments, foreign currency risk, interest rate risk, credit risk and liquidity risk is presented in note 10 of our unaudited interim consolidated financial statements.

RECENT ACCOUNTING PRONOUNCEMENTS

In February 2008, the CICA issued Section 3064, *Goodwill and Intangible Assets*. Section 3064, which replaces Section 3062, *Goodwill and Other Intangible Assets* and Section 3450, *Research and Development Costs*, establishes standards for the recognition, measurement, presentation and disclosure of goodwill and intangible assets. This standard is effective for our interim and annual financial statements beginning on January 1, 2009. We are currently assessing the impact of the adoption of this new Section on our consolidated financial statements.

The CICA will converge Canadian GAAP with International Financial Reporting Standards ["IFRS"] over a transition period to end in 2011. We are currently assessing the impact of the transition to IFRS on our consolidated financial statements.

CONTROLS AND PROCEDURES

In accordance with the Canadian Securities Administrators Multilateral Instrument 52-109, the Company has filed certificates signed by the President and Chief Executive Officer and the Senior Vice-President and 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.

The Company has designed disclosure controls and procedures to provide reasonable assurance that material information relating to the Company is made known to the President and Chief Executive Officer and the Senior Vice-President and Chief Financial Officer, particularly during the period in which the interim filings are being prepared.

The Company has designed internal controls over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with the Company's GAAP.

All control systems, no matter how well designed, have inherent limitations, including the possibility of human error and the circumvention or overriding of the controls or procedures. As a result, there is no certainty that our disclosure controls and procedures or internal control over financial reporting will prevent all errors or all fraud.

There were no changes in our internal controls over financial reporting that occurred during the quarter ended June 30, 2008 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

CONSOLIDATED BALANCE SHEETS

[Unaudited]

[Thousands of Canadian dollars]	AS AT JUNE 30, 2008 \$	AS AT DECEMBER 31, 2007 \$
ASSETS <i>[note 10]</i>		
Current		
Cash and cash equivalents	32,557	17,173
Available-for-sale marketable securities	22,762	54,726
Accounts receivable	1,870	1,972
Research and development tax credits receivable	1,797	1,197
Income taxes receivable	120	161
Inventories <i>[note 5]</i>	1,918	2,875
Prepaid expenses and other assets	783	1,460
Total current assets	61,807	79,564
Restricted long-term investments	133	1,277
Long-term investment <i>[note 6]</i>	3,739	4,329
Property, plant and equipment	10,905	10,800
Intangible assets	3,596	3,453
Future income tax assets	119	116
	80,299	99,539
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Accounts payable and accrued liabilities	9,038	8,719
Current portion of deferred revenue	4,339	4,325
Current portion of obligations under capital leases	262	203
Total current liabilities	13,639	13,247
Deferred revenue	15,037	17,083
Obligations under capital leases	5,482	5,613
Long-term debt	14,318	13,647
Total liabilities	48,476	49,590
Shareholders' equity		
Share capital		
Unlimited authorization of common shares, voting, without par value; issued and outstanding 56,822,363 and 56,817,963 as at June 30, 2008 and as at December 31, 2007, respectively <i>[note 7]</i>	241,962	241,955
Warrants	541	541
Contributed surplus <i>[note 7]</i>	14,096	12,527
Deficit	(224,756)	(205,024)
Accumulated other comprehensive loss	(20)	(50)
Total shareholders' equity	31,823	49,949
	80,299	99,539

Contingent liability *[note 11]*

Subsequent event *[note 12]*

See accompanying notes to interim consolidated financial statements

INTERIM CONSOLIDATED STATEMENTS OF OPERATIONS

[Unaudited]

	FOR THE THREE MONTHS ENDED:		FOR THE SIX MONTHS ENDED:	
	JUNE 30, 2008	JUNE 30, 2007	JUNE 30, 2008	JUNE 30, 2007
[Thousands of Canadian dollars, except share and per share amounts]	\$	\$	\$	\$
REVENUE				
Product sales	3,859	4,149	6,017	7,541
Licensing	1,064	1,707	2,125	3,728
	4,923	5,856	8,142	11,269
EXPENSES				
Cost of goods sold (excluding depreciation) <i>[note 5]</i>	1,683	4,003	2,634	5,704
Research and development, net <i>[note 8]</i>	6,306	5,681	11,997	10,151
Selling, general and administrative	6,062	6,047	10,878	11,218
Financial costs	709	491	1,420	1,040
Impairment loss on long-term investment <i>[note 6]</i>	—	—	691	—
Depreciation and amortization	524	500	1,049	972
Interest income	(551)	(925)	(1,203)	(1,897)
Foreign exchange (gain) loss	(20)	393	(292)	387
	14,713	16,190	27,174	27,575
Loss before income taxes	(9,790)	(10,334)	(19,032)	(16,306)
Provision for income taxes - current	350	675	800	1,202
Net loss for the period	(10,140)	(11,009)	(19,832)	(17,508)
Net loss per share basic – diluted	(0.18)	(0.19)	(0.35)	(0.31)
Weighted average number of common shares outstanding	56,821,651	56,795,490	56,819,919	56,784,151

See accompanying notes to interim consolidated financial statements

INTERIM CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS

[Unaudited]

[Thousands of Canadian dollars]	FOR THE THREE MONTHS ENDED:		FOR THE SIX MONTHS ENDED:	
	JUNE 30, 2008 \$	JUNE 30, 2007 \$	JUNE 30, 2008 \$	JUNE 30, 2007 \$
Net loss for the period	(10,140)	(11,009)	(19,832)	(17,508)
Changes in unrealized (losses) gains on available-for-sale marketable securities	(39)	(146)	30	(227)
Comprehensive loss for the period	(10,179)	(11,155)	(19,802)	(17,735)

INTERIM CONSOLIDATED STATEMENTS OF DEFICIT

[Unaudited]

FOR THE SIX MONTHS ENDED: [Thousands of Canadian dollars]	JUNE 30, 2008 \$	JUNE 30, 2007 \$
Balance, beginning of period	(205,024)	(168,449)
Change in accounting policy <i>[note 3]</i>	100	—
Net loss for the period	(19,832)	(17,508)
Balance, end of period	(224,756)	(185,957)

See accompanying notes to interim consolidated financial statements

INTERIM CONSOLIDATED STATEMENTS OF CASH FLOWS

[Unaudited]

[Thousands of Canadian dollars]	FOR THE THREE MONTHS ENDED:		FOR THE SIX MONTHS ENDED:	
	JUNE 30, 2008 \$	JUNE 30, 2007 \$	JUNE 30, 2008 \$	JUNE 30, 2007 \$
OPERATING ACTIVITIES				
Net loss for the period	(10,140)	(11,009)	(19,832)	(17,508)
Items not affecting cash:				
Depreciation of property, plant and equipment	460	442	915	856
Amortization of intangible assets	64	58	134	116
Amortization of premium or discounts on marketable securities	13	76	27	150
Impairment loss on long-term investment <i>[note 6]</i>	—	—	691	—
Non-cash financial costs	92	36	187	77
Unrealized foreign exchange (gain) loss	(20)	400	(261)	388
Stock-based compensation	687	1,393	1,571	2,899
	(8,844)	(8,604)	(16,568)	(13,022)
Net change in non-cash operating items <i>[note 5]</i>	(213)	(1,060)	717	108
	(9,057)	(9,664)	(15,851)	(12,914)
INVESTING ACTIVITIES				
Acquisition of marketable securities	—	(10,224)	(23,553)	(53,247)
Proceeds from maturities of marketable securities	21,758	4,971	55,819	66,385
Acquisition of restricted long-term investment	—	—	(45)	—
Acquisition of property, plant and equipment	(629)	(326)	(1,148)	(1,146)
Acquisition of intangible assets	(179)	(49)	(277)	(123)
	20,950	(5,628)	30,796	11,869
FINANCING ACTIVITIES				
Repayment of obligations under capital leases	(47)	(25)	(72)	(47)
Repayment of long-term debt	—	(1,014)	—	(2,057)
Transaction costs	(118)	—	(118)	—
Proceeds from issuance of common shares <i>[note 7]</i>	3	110	5	225
	(162)	(929)	(185)	(1,879)
Foreign exchange gain (loss) on cash and cash equivalents held in foreign currencies	(175)	(831)	624	(914)
Net increase (decrease) in cash and cash equivalents during the period	11,556	(17,052)	15,384	(3,838)
Cash and cash equivalents, beginning of period	21,001	26,936	17,173	13,722
Cash and cash equivalents, end of period	32,557	9,884	32,557	9,884
Cash flows include the following items:				
Interest paid	622	368	1,145	779
Income taxes received	43	—	43	472

See accompanying notes to interim consolidated financial statements

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS [Unaudited]

JUNE 30, 2008

[Thousands of Canadian dollars, except share and per share amounts]

1. DESCRIPTION OF BUSINESS

Labopharm Inc. (the “Company”), incorporated under the *Companies Act (Québec)* is an international, specialty pharmaceutical company focused on improving existing drugs by incorporating its proprietary, advanced controlled-release technologies. The Company develops products internally in order to enter into strategic alliances or license agreements with national or international pharmaceutical companies that have the necessary resources and distribution networks to market and sell its pharmaceutical products.

2. BASIS OF PRESENTATION AND ACCOUNTING POLICIES

These unaudited interim consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles (“GAAP”) for interim financial statements. Accordingly, they do not include all of the information and notes required by GAAP for annual financial statements and should be read in conjunction with the audited consolidated financial statements for the year ended December 31, 2007 and the accompanying notes, included in the Company’s annual report. All adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation of the interim consolidated financial statements have been included.

The accounting policies used in the preparation of these unaudited interim consolidated financial statements are the same as those used in the preparation of the Company’s most recent annual consolidated financial statements, and are set forth in notes 2 and 3 of the audited consolidated financial statements for the year ended December 31, 2007 included in the Company’s annual report, except as described in note 3 hereafter.

3. CHANGES IN ACCOUNTING POLICIES

The following Handbook Sections, released by the Canadian Institute of Chartered Accountants (“CICA”), were adopted by the Company on January 1, 2008:

Section 1535, *Capital Disclosures*, establishes standards for disclosing information about an entity’s capital and how it is managed. It describes the disclosure of the entity’s objectives, policies and processes for managing capital, the quantitative data about what the entity regards as capital, whether the entity has complied with any capital requirements, and, if it has not complied, the consequences of such non-compliance. Disclosure requirements pertaining to Section 1535 are contained in note 9.

Section 3862, *Financial Instruments – Disclosures*, describes the required disclosure for the assessment of the significance of financial instruments for an entity’s financial position and performance and of the nature and extent of risks arising from financial instruments to which the entity is exposed and how the entity manages those risks. Disclosure requirements pertaining to Section 3862 are contained in note 10.

Section 3863, *Financial Instruments – Presentation*, establishes standards for presentation of the financial instruments and non-financial derivatives. It carries forward the presentation related requirements of Section 3861, *Financial Instruments – Disclosure and Presentation*. The adoption of this section had no impact on the Company’s interim consolidated financial statements.

Section 3031, *Inventories*, replaces the previous standard for inventories, Section 3030. The new section is the Canadian equivalent to International Financial Reporting Standards IAS 2, *Inventories*. The application of this new section had an impact on the Company’s measurement of inventories. Under the new section, inventories should be measured at the lower of cost and net realizable value, while prior to the adoption of the new section, the Company valued its raw materials at the lower of cost and replacement cost. The transitional provision of the section required that the standard be applied to the opening inventory of the period, with any resulting adjustment recorded to the opening deficit. This change in the measurement method of raw materials resulted in an increase of \$100 to the carrying value of raw materials as at January 1, 2008 and consequently the opening balance of deficit was reduced by \$100. Prior periods were not restated. The adoption of this section had no other impact on the Company’s interim consolidated financial statements.

Section 1400, *General Standards of Financial Statement Presentation* has been amended to include requirements to assess and disclose an entity’s ability to continue as a going concern. The adoption of this section had no impact on the Company’s interim consolidated financial statements.

4. RECENT ACCOUNTING PRONOUNCEMENT

In February 2008, the CICA issued Section 3064, *Goodwill and Intangible Assets*. Section 3064, which replaces Section 3062, *Goodwill and Other Intangible Assets* and Section 3450, *Research and Development Costs*, establishes standards for the recognition, measurement, presentation and disclosure of goodwill and intangible assets. This standard is effective for the Company’s interim and annual financial statements beginning on January 1, 2009. The Company is currently assessing the impact of the adoption of this new section on its consolidated financial statements.

5. INVENTORIES

	JUNE 30, 2008	DECEMBER 31, 2007
	\$	\$
Raw materials	717	827
Intermediate finished goods	1,083	1,899
Finished goods	118	149
	1,918	2,875

During the three-month and six-month periods ended June 30, 2008, inventories in the amount of \$1,546 and \$2,532, respectively [2007 – \$3,859 and \$5,420, respectively] were recognized as cost of goods sold. For the three-month and six-month periods ended June 30, 2008, cost of goods sold includes an inventory write-down of nil and \$152, respectively [2007 – \$1,742 and \$1,742, respectively].

6. LONG-TERM INVESTMENT

At June 30, 2008, the Company held Canadian third-party asset-backed commercial paper (“ABCP”) in Aurora Trust Series A with a principal value at maturity of \$5,751. At the date the Company acquired this investment in May 2007, it was rated R1 (High) by DBRS Limited (“DBRS”), the highest credit rating issued for commercial paper by DBRS. This investment matured on October 15, 2007 but, as a result of illiquidity in the Canadian ABCP market, it did not settle on maturity. As a result, the Company has since classified its ABCP investment as long-term after initially classifying it as an available-for-sale marketable security. The ABCP in which the Company has invested has not traded in an active market since mid-August 2007 and there are currently no market quotations available.

On August 16, 2007, an announcement was made by a group representing banks, asset providers and major investors on an agreement in principle to a long-term proposal and interim agreement to convert the ABCP into long-term floating rate notes maturing no earlier than the scheduled maturity of the underlying assets. On September 6, 2007, a pan-Canadian restructuring committee consisting of major investors was formed. The committee was created to propose a solution to the liquidity problem affecting the ABCP and has retained legal and financial advisors to oversee the proposed restructuring process.

On March 20, 2008, the pan-Canadian restructuring committee issued an information statement (the “Information Statement”) containing details about the proposed restructuring. Based on this and other public information it is estimated that the Company will, on restructuring, receive Class A-1, Class A-2, Class B and Class C long-term floating rate notes with par values of \$1,767, \$3,252, \$560, and \$172, respectively, and having maturities of approximately eight years. The Class A-1 and Class A-2 notes are expected by the restructuring committee to obtain an AA credit rating while the Class B and Class C notes are likely to be unrated. On April 25, 2008, a majority of the ABCP holders voted in favour of the restructuring proposal. On June 5, 2008, a court order sanctioning the restructuring of the ABCP was made pursuant to the *Companies’ Creditors Arrangement Act*. The sanction order remains subject to appeals by certain ABCP holders, and the restructuring is not expected to be implemented until all appeals have been resolved.

The valuation technique used by the Company to estimate the fair value of its investment in ABCP as at June 30, 2008, incorporates probability weighted discounted cash flows considering available public information regarding market conditions and other factors that a market participant would consider for such investments. The assumptions used in determining the estimated fair value reflect the details included in the Information Statement and the risks associated with the long-term floating rate notes. The Company assumes that the notes will generate a weighted average interest rate of 3.4%. One of the cash flow scenarios modeled is a liquidation scenario whereby, if the restructuring is not successfully completed, recovery of the Company’s investment is through the liquidation of the underlying assets of the ABCP trusts.

6. LONG-TERM INVESTMENT [CONT'D]

Discount rates vary dependent upon the credit rating of the replacement long-term floating rate notes. Discount rates have been estimated using average yield of AA rated corporate bonds having similar maturities, adjusted for consideration of additional risk for the lack of information, lack of liquidity and uncertainty with respect to the exact nature of the resulting instrument. A weighted average discount rate of 8.5% was used in the Company's fair-value estimate of its ABCP. An increase in the estimated discount rates of 1 percent would reduce the estimated fair value of the Company's investment in ABCP by approximately \$288.

The recalibration of the valuation model as at June 30, 2008 based on current available information did not result in a significant change in the estimated fair value of the ABCP. This estimated fair value, which represents approximately 65% of the principal value as at June 30, 2008, is detailed as follows:

	JUNE 30, 2008 \$	DECEMBER 31, 2007 \$
Investment cost	5,640	5,640
Accrued interest	264	163
Impairment charge	(2,165)	(1,474)
Estimated fair market value	3,739	4,329

Subsequent to the quarter-end, the Company entered into an agreement with the parent company of the broker through which the Company had purchased its ABCP. Under this agreement, the Company can borrow an amount up to 45% of the principal value of the ABCP at a favourable borrowing rate for a three-year period. At the end of the three-year period, the value of the ABCP is guaranteed to be at least 45% of the principal value of the ABCP, such that the Company's potential loss on the ABCP is limited, should market conditions substantially change unfavourably. This agreement is conditional on the definitive approval of the restructuring plan as sanctioned by the court on June 5, 2008.

Continuing uncertainties regarding the value of the assets which underlie the ABCP, the amount and timing of cash flows and the outcome of the restructuring process could give rise to a further material change in the value of the Company's investment in this ABCP which could impact the Company's near term results.

7. SHARE CAPITAL AND CONTRIBUTED SURPLUS

Share capital transactions

During the six-month period ended June 30, 2008, 4,400 [2007 – 70,000] options were exercised for a total cash consideration of \$5 [2007 – \$225]. In addition, share capital was increased by \$2 [2007 – \$142] and contributed surplus reduced by the same amount.

Stock option plan

The changes in the number of stock options granted by the Company and their weighted average exercise prices, for the six-month periods ended June 30, 2008 and 2007 are as follows:

	2008		2007	
	#	\$	#	\$
Balance, beginning of period	3,670,750	5.89	3,556,425	6.03
Granted	1,260,000	2.30	1,026,700	7.06
Exercised	(4,400)	0.96	(70,000)	3.22
Forfeited	(20,400)	3.39	—	—
Expired	(422,700)	5.66	(471,500)	10.26
Balance, end of period	4,483,250	4.93	4,041,625	5.85
Options eligible to be exercised, end of period	3,088,650	5.52	3,011,825	5.50

During the three-month period ended June 30, 2008, the Company undertook in favour of an institutional shareholder to limit annually the number of options granted under the stock option plan. The foregoing undertaking shall expire at the earliest of the institutional shareholder owning less than 3% of the Company's outstanding shares, and the stock option plan being amended and such amendment(s) being approved and ratified by the shareholders at a duly called meeting.

The fair value of options granted was estimated at the date of grant using the Black-Scholes option pricing model, resulting in the following weighted average assumptions and weighted average grant date fair value of stock options:

	FOR THE THREE MONTHS ENDED:		FOR THE SIX MONTHS ENDED:	
	JUNE 30, 2008	JUNE 30, 2007	JUNE 30, 2008	JUNE 30, 2007
Expected volatility	0.75	0.62	0.76	0.62
Expected life	5.0 years	5.0 years	5.0 years	4.9 years
Risk-free interest rate	3.39%	4.18%	3.46%	4.11%
Dividend yield	Nil	Nil	Nil	Nil
Weighted average grant date fair value (per option)	\$1.24	\$4.12	\$1.47	\$3.95

8. RESEARCH AND DEVELOPMENT EXPENSES, NET

Research and development expenses are presented net of estimated government assistance of \$687 and \$840 for the three-month periods ended June 30, 2008 and 2007, respectively, and net of estimated government assistance of \$1,847 and \$1,649 for the six-month periods ended June 30, 2008 and 2007, respectively.

9. MANAGEMENT OF CAPITAL

The Company's capital management objectives are to safeguard its ability to continue as a going concern and to provide returns for shareholders and benefits for other stakeholders, by ensuring it has sufficient cash resources to fund its research and development activities, to pursue its commercialization efforts and to maintain its ongoing operations. To secure the additional capital necessary to pursue these plans, the Company may attempt to raise additional funds through the issuance of debt or equity, or by entering into distribution and license agreements.

The Company includes shareholders' equity (excluding accumulated other comprehensive loss), long-term debt and deferred revenue in the definition of capital, which, as at June 30, 2008 and as at December 31, 2007, included:

	JUNE 30, 2008	DECEMBER 31, 2007
	\$	\$
Shareholders' equity (excluding accumulated other comprehensive loss)	31,843	49,999
Total deferred revenue	19,376	21,408
Long-term debt	14,318	13,647
	65,537	85,054

The Company is subject to certain non-financial covenants related to its long-term debt and the Company complied with these covenants as at June 30, 2008. There has been no change with respect to the overall capital risk management strategy during the six-month period ended June 30, 2008.

10. FINANCIAL INSTRUMENTS

Classification of financial instruments

Financial assets and financial liabilities are measured on an ongoing basis at fair value or amortized cost. The disclosures in the “Financial Instruments – Recognition and Measurement” section of note 3 to the Company’s 2007 consolidated financial statements describe how the categories of financial instruments are measured and how income and expenses, including fair value gains and losses, are recognized. As at June 30, 2008, the classification of the financial instruments, as well as their carrying values and fair values, are shown in the table below:

	AVAILABLE- FOR-SALE \$	LOANS AND RECEIVABLES \$	OTHER FINANCIAL LIABILITIES \$	TOTAL CARRYING VALUE \$	FAIR VALUE \$
Financial assets					
Cash and cash equivalents	32,557	—	—	32,557	32,557
Available-for-sale marketable securities	22,762	—	—	22,762	22,762
Accounts receivable (excluding sales tax receivable)	—	1,664	—	1,664	1,664
Restricted long-term investments	133	—	—	133	133
Long-term investment	3,739	—	—	3,739	3,739
	59,191	1,664	—	60,855	60,855
Financial liabilities					
Accounts payable and accrued liabilities ¹	—	—	8,695	8,695	8,695
Obligations under capital leases	—	—	5,744	5,744	5,537
Long-term debt	—	—	14,318	14,318	14,199
	—	—	28,757	28,757	28,431

¹ This amount excludes capital tax and certain reserves

Fair value of financial instruments

The Company has determined the estimated fair values of its financial instruments based on appropriate valuation methodologies; however, considerable judgment is required to develop these estimates. Accordingly, the estimated fair values are not necessarily indicative of the amounts the Company could realize in a current market exchange. The estimated fair value amounts can be materially affected by the use of different assumptions or methodologies. The methods and assumptions used to estimate the fair value of financial instruments are described below:

- The fair values of the available-for-sale marketable securities have been determined by reference to published price quotation.
- Given their short-term maturity, the fair value of cash and cash equivalents, accounts receivable, restricted long-term investments and accounts payable and accrued liabilities approximates their carrying value.
- The long-term investment is recorded at its estimated fair value using the methods and assumptions described in note 6.
- The estimated fair value of long-term debt was determined by discounting expected cash flows at rates the Company would expect in the market place for similar debt.

Management of risks arising from financial instruments

The Company does not use financial derivatives. There has been no change with respect to the Company’s overall risk exposure during the six-month period ended June 30, 2008.

Market risks

a) Foreign exchange risk

The Company operates internationally and a substantial portion of the Company's revenue from licensing and distribution agreements and product sales is denominated in U.S. dollars or Euros. This results in financial risk due to fluctuations in the value of the Canadian dollar relative to the U.S. dollar and Euro. The Company has a natural hedge for a portion of this risk, in that many of its expenditures are in U.S. dollars and Euros. Fluctuations in payments made for the Company's products could cause unanticipated fluctuations in the Company's consolidated operating results.

In December 2007, the Company contracted a term loan denominated in U.S. currency, the outstanding balance of which was US\$15,000 as at June 30, 2008. To reduce the impact on the Company's consolidated results of operations, financial position or cash flows which would result from a significant adverse change in foreign currency exchange rate between the Canadian dollar relative to the U.S. dollar and the effect it would have on the carrying value of its term loan, the Company typically maintains cash and cash equivalents denominated in U.S. dollars. The significant balances in foreign currencies as at June 30, 2008 are as follows:

	U.S. DOLLARS \$	EUROS €	BRITISH POUNDS £
Cash and cash equivalents	10,014	3,149	—
Accounts receivable	17	991	—
Restricted long-term investments	47	53	—
Accounts payable and accrued liabilities	(1,663)	(718)	(534)
Long-term debt	(15,033)	—	—
	(6,618)	3,475	(534)

Based on the aforementioned net exposure as at June 30, 2008, and assuming that all other variables remain constant, a 10% rise or fall in the Canadian dollar against the other currencies would have resulted in decreases (increases) in net loss and comprehensive loss as follows:

	CANADIAN DOLLAR	
	APPRECIATES 10% \$	DEPRECIATES 10% \$
Against U.S. dollar	669	(669)
Against Euro	(555)	555
Against British pound	107	(107)

b) Interest rate risk

Financial instruments that potentially subject the Company to significant cash flow interest rate risk are financial assets with variable interest rates and consist of cash and cash equivalents.

Financial assets and financial liabilities that bear interest at fixed rates are subject to fair value interest rate risk. The Company's available-for-sale marketable securities and the restricted long-term investments are the only financial assets bearing fixed interest rates, and the long-term debt and obligations under capital leases are the financial liabilities bearing a fixed interest rate. The risk that the Company will realize a loss as a result of a decline in the fair value of its marketable securities is limited because these investments, although available for sale, are generally held to maturity. The Company does not believe that the results of operations or cash flows would be affected to any significant degree by a sudden change in market interest rates relative to fixed interest rates on the marketable securities, owing to their relative short-term nature.

10. FINANCIAL INSTRUMENTS [CONT'D]

Market risks [Cont'd]

b) Interest rate risk [Cont'd]

A portion of cash and cash equivalents bear interest at a variable rate. Accounts receivable, accounts payable and accrued liabilities bear no interest. Based on the value of variable interest-bearing cash and cash equivalents during the six months ended June 30, 2008, an assumed 10% increase in interest rates during such period would have decreased the net loss by \$21, with an equal but opposite effect for an assumed 10% decrease in interest rates.

Risks inherent to the long-term investment are disclosed in note 6.

To manage the interest rate risk, the Company's investments are made to achieve the highest rate of return while complying with the two primary objectives for its investment portfolio: liquidity and capital preservation.

Credit risk

The maximum exposure to credit risk of the Company as at June 30, 2008, is the carrying value of its financial assets. The Company manages credit risk by maintaining bank accounts with reputable banks and financial institutions and investing only in highly rated Canadian corporations or government-backed institutions with securities that are traded on active markets and are capable of prompt liquidation. Cash and cash equivalents are held as follows:

	JUNE 30, 2008 \$	DECEMBER 31, 2007 \$
Two Canadian chartered banks	17,637	1,563
Two European banks	14,238	3,637
One U.S. bank	649	11,934
Other bank	33	39

The Company's cash and cash equivalents are not subject to any external restrictions. The Company has an investment policy that monitors the safety and preservation of principal and investments, which limits the amount invested by issuer.

Also, the Company provides credit to its clients in the normal course of operations. It carries out on a continuing basis, credit evaluations of its customers. Revenue from product sales is primarily from established pharmaceutical companies. As at June 30, 2008, 93% of the Company's trade receivables are aged as current and 6% are aged between one and thirty days past due. As at June 30, 2008, 89% [December 31, 2007 – 59%] are due from two customers [December 31, 2007 – two customers].

Liquidity risk

The Company is exposed to the risk of being unable to honour its financial commitments by the deadlines set out under the terms of such commitments and at a reasonable price. The Company manages its liquidity risk by forecasting cash flows from operations and anticipated investing and financing activities. Senior management of the Company is actively involved in the review and approval of planned expenditures. The following are the contractual maturities of the undiscounted cash flows of financial liabilities as at June 30, 2008:

	LESS THAN 1 YEAR \$	1-3 YEARS \$	3-5 YEARS \$	MORE THAN 5 YEARS \$
Accounts payable and accrued liabilities	8,695	—	—	—
Obligations under capital leases	1,037	2,045	2,035	5,602
Long-term debt	1,684	13,925	3,520	—
	11,416	15,970	5,555	5,602

The long-term debt is collateralized by all of the Company's assets except for its intellectual property.

11. CONTINGENT LIABILITY

At the initiation of a generic challenge to intellectual property protecting one of its products, the Company and one of its licensees, together with a third party, initiated discussions with respect to the joint defence of this intellectual property and sharing of the litigation costs thereof. These discussions have not yet been satisfactorily completed. An amount of US\$2,493 has been claimed as the Company's share of patent defence litigation costs incurred up to June 30, 2008. As a good faith gesture, on July 30, 2008, the Company paid an amount of US\$903. Should the cost-sharing discussions not lead to a satisfactory resolution, the Company will be entitled to claim reimbursement of the US\$903, as under the license agreement the Company believes that no amounts are due. Such reimbursement claim may need to be settled by the dispute resolution mechanism provided for in the license agreement. The ultimate outcome of these discussions is currently not determinable. The amount of US\$903 was recorded in accounts payable and accrued liabilities as at June 30, 2008, and as a selling, general and administrative expense in the three-month period then ended.

12. SUBSEQUENT EVENT

On July 7, 2008, the Company announced that it had reached an agreement with Recordati Ireland Ltd. ("Recordati") to reacquire the sales and marketing rights to its once-daily tramadol product for the United Kingdom. Under this agreement, the Company received a payment of \$1,118 from Recordati, of which \$106 was in consideration of an account receivable related to a portion of a milestone payment previously recognized, and re-purchased finished goods inventory for a cash consideration of \$269.

Prior to the conclusion of this agreement, the Company was recognizing as licensing revenue \$102 per quarter on a straight-line basis for licensing payments previously received from Recordati. Following the conclusion of this agreement, the Company will have no further substantive contractual obligations towards Recordati and the balance of the deferred licensing payments previously received and amounting to \$3,411 as at June 30, 2008, will be recognized as licensing revenue in the third quarter of 2008, together with the unrecognized portion of the \$1,118 payment amounting to \$1,012.

13. COMPARATIVE FIGURES

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

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All amounts in this report
are in Canadian dollars,
unless otherwise stated.

Ce rapport trimestriel est disponible
en français sur demande.

Printed in Canada

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