

Quarterly Report

FIRST QUARTER - FISCAL 2004

Q1

Labopharm

Management's Discussion & Analysis

The following information should be read in conjunction with our unaudited interim consolidated financial statements as at March 31, 2004, and related notes thereto, which are prepared in accordance with Canadian generally accepted accounting principles ("GAAP") for interim financial statements, as well as the audited consolidated financial statements and Management's Discussion and Analysis for the year ended December 31, 2003. The Management's Discussion and Analysis provides a review of the performance of the Company for the quarter ended March 31, 2004, as compared to the quarter ended March 31, 2003. This review was performed by management with information available as at May 7, 2004. Additional information relating to the Company, including its Annual Information Form, can be found on SEDAR on www.sedar.com.

To the extent any statements made in this document contain information that is not historical, these statements are essentially forward-looking and are subject to risks and uncertainties. Actual results, levels of activity, performance, or achievements could differ materially from those projected herein and depend on a number of factors, including the successful and timely completion of clinical studies, the uncertainties related to the regulatory process, and the commercialization of product candidates thereafter. The risks and uncertainties related to our activities are enumerated in the RISK FACTORS section of our Annual Information Form.

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 developing novel drug products using our proprietary drug delivery technologies. We currently have nine products at various stages of development, including five in clinical development. Our lead product candidate is a once-daily formulation of tramadol, a currently available analgesic for moderate to moderately severe pain. In Europe, we have filed for regulatory approval under the mutual recognition procedure, or MRP, and in the United States we are in Phase III clinical development and have completed two Phase III trials. Our existing product candidates are based on our proprietary technology, Contramid®. We use Contramid® to develop new branded products that improve on existing drugs by providing the benefits of controlled-release drug delivery. We believe Contramid® can be applied to a wide variety of drugs in solid oral dosage form to improve their administration and performance.

Our Goal

Our goal is to become a fully integrated, international, specialty pharmaceutical company developing and commer-

cializing our own pharmaceutical products. By applying our reformulation expertise and delivery technologies to existing compounds with proven efficacy and safety, we believe that we can accelerate drug development and lower development risk as compared to traditional pharmaceutical and biotechnology companies.

Liquidity and Going Concern Uncertainty

We have incurred substantial operating losses since our inception due in large part to expenditures for our research and development activities. At March 31, 2004, we had an accumulated deficit of \$91.6 million. We expect our operating losses to decrease over the next several years as we pursue the commercialization of our lead product candidate, once-daily tramadol, while continuing to advance our other product candidates and expand our development pipeline. However, our committed sources of funds and our cash and cash equivalents on hand are expected to be sufficient to meet our committed cash obligations and expected level of expenses into the third quarter of 2004. Our ability to continue as a going concern is dependent upon us raising additional funds.

Subsequent to quarter end, we entered into an agreement to issue 6,122,449 common shares on a bought deal basis to a syndicate of underwriters. The shares will be publicly offered in Canada under a short-form prospectus at a price of \$4.90 per common share, for gross proceeds of \$30,000,000. The completion of this offering is expected to close on or about May 26, 2004 and will significantly improve our liquidity position.

Revenue

We have not generated any revenue from product sales to date. Revenue to date has been generated substantially from our research collaboration agreements and interest income generated on excess funds. To date, we have entered into a number of research collaboration agreements for a variety of products. These agreements generally include up-front fees upon initiation of the services, payments upon completion of feasibility and formulation stage of development and/or other milestones, and could include royalties upon successful commercialization of the product candidates. The most recent research collaboration agreement was confirmed in February 2004, under which we will develop a once-daily formulation of the anti-depressant trazodone hydrochloride (trazodone) for Gruppo Angelini.

We have also entered into two distribution and license agreements and three letters of intent in Europe for once-daily tramadol, including the letter of intent with Hexal AG for Germany signed on March 31, 2004. The terms of these agreements include up-front payments upon signature, and additional payments upon market and/or price approval in the respective European countries. Under these agreements, we are primarily responsible for supplying finished packaged goods.

Research and Development Expenses

Our research and development expenses consist primarily of salaries and related personnel expenses, fees paid to external service providers, laboratory supplies and costs for facilities and equipment. In the first quarter of fiscal 2004, fees paid to external service providers consisted primarily of costs associated with our Phase III clinical trials of once-daily tramadol.

We expect our research and development expenses to moderate as we conclude our clinical trials on tramadol and advance our other product candidates. However, we are unable to estimate the specific timing and future costs of our research and development programs.

CHANGES IN ACCOUNTING POLICIES

Stock-Based Compensation

In 2003, the Canadian Institute of Chartered Accountants ("CICA") amended its pronouncement relating to stock-based compensation requiring companies to measure and expense all equity instruments awarded to employees starting in fiscal years beginning on or after January 1, 2004. The transitional provisions provide for a prospective treatment to this change in accounting policy for those companies who adopt this new pronouncement in fiscal years beginning before January 1, 2004 and a retroactive treatment for those companies adopting on or after January 1, 2004. We chose to adopt the retroactive treatment without restatement for our fiscal year starting January 1, 2004. We incurred a non-cash compensation expense of \$411,000 for the first quarter of 2004 in relation to this new accounting policy for stock options issued to employees and directors since March 1, 2002. In addition, the opening deficit balance for 2004 increased by \$2,976,000.

Impairment of Long-Lived Assets

Effective January 1, 2004, we adopted the new recommendations of CICA related to Handbook Section 3063, *Impairment of Long-lived Assets*. Section 3063 establishes standards for the recognition, measurement and disclosure of the impairment of long-lived assets held for use by us. It requires that an impairment loss be recognized when the carrying amount of an asset to be held and used exceeds the sum of the undiscounted cash flows expected from its use and disposal. The impairment loss to be recognized is measured as the amount by which the carrying amount of the asset exceeds its fair value. Prior to January 1, 2004, any impairment loss to be recognized was measured by the amount by which the carrying amount of the assets exceeded its net recoverable value. The adoption of this standard did not have any effect on our results, financial position or cash flows.

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 and amount of payments received pursuant to our current and future collaborations, and the progress and timing of expenditures related to our development and commercialization efforts. Due to these fluctuations, we believe that the period-to-period comparisons of our operating results are not a good indication of our future performance.

Revenue

For the first quarter ended March 31, 2004, total revenue, which includes investment income, amounted to \$199,000 compared to \$306,000 for the quarter ended March 31, 2003.

Revenue from research and development contracts for the quarter ended March 31, 2004 totaled \$81,000, the entire amount of which was derived from the Gruppo Angelini agreement, under which we will formulate a once-daily version of the anti-depressant trazodone for global commercialization. Revenue from research and development contracts of \$78,000 for the quarter ended March 31, 2003 was generated entirely from the MedPointe agreement for progress made on the formulation of DDS-2001.

During the quarter, we recognized \$12,000 as licensing revenue, representing a portion of the up-front payments received from Gruppo Angelini and Esteve S.A in conjunction with our license and distribution agreements for once-daily tramadol. These up-front payments are being recognized on a straight-line basis over the term of the respective agreements with these companies. In addition, if we continue to make progress on the commercialization of our once-daily tramadol product and satisfy the milestones under our license and distribution agreements in Europe, additional milestone payments will be received and recognized. Milestones for the European market relate to market and price approvals in France and other countries.

Investment income for the quarter ended March 31, 2004 was \$106,000 compared with \$228,000 for the quarter ended March 31, 2003. The decrease results from lower cash and investment balances in the current quarter compared to the quarter ended March 31, 2003, and a result of lower rates of return on invested funds caused by a general decrease in market interest rates.

Research and Development Expenses

Research and development expenses (net of tax credits) for the first quarter ended March 31, 2004 were \$4,974,000 compared with \$6,161,000 for the quarter ended March 31, 2003, a decrease of \$1,187,000. Approximately \$3.9 million of research and development expenses during the first quarter ended March 31, 2004 were in relation to our continued development of a once-daily tramadol product, compared to approximately \$5.0 million in the comparative quarter. The lower expenses were primarily the result of the timing and the

amount of the milestone payments and purchase of clinical trial material related to the clinical studies for our tramadol program. Significant costs were incurred upon initiation of the two Phase III studies in the U.S. in the quarter ended March 31, 2003. The decrease in costs related to our clinical trial program was partially offset by increased fixed costs related to our research and development group and infrastructure, and an amount of \$162,000 in stock compensation expense as a result of the new requirement to expense all stock-based compensation which we adopted as of January 1, 2004.

Selling, General and Administrative Expenses

Selling, general and administrative expenses for the quarter ended March 31, 2004 were \$2,141,000 compared to \$1,797,000 for quarter ended March 31, 2003. The increase is due primarily to the expensing of stock-based compensation which amounted to \$411,000, of which \$249,000 was included in selling, general and administrative expenses in the current quarter as a result of the new accounting policy adopted by the Company discussed previously. Subsequent to quarter end, we incurred approximately \$1,000,000 of additional financing costs which may need to be expensed during 2004, if the financing which led to these costs is not finalized.

Depreciation and Amortization

Depreciation and amortization expense increased to \$398,000 in the quarter ended March 31, 2004 from \$126,000 in the quarter ended March 31, 2003 as a result of the depreciation of the significant additions to property, plant and equipment, including our new GMP pilot plant and the additional laboratory equipment purchased or put to use after March 31, 2003.

Interest Expense

Interest expense increased to \$212,000 in the quarter ended March 31, 2004 from \$10,000 in the quarter ended March 31, 2003, because of interest on capital leases obligations. Last year's additions of property, plant and equipment through capital leases after March 31, 2003 were a contributing factor to this increase, the most significant capital lease being for our new facilities.

Net Loss

Net loss for the quarter ended March 31, 2004 was \$7,569,000, or \$0.21 per share, compared with \$7,817,000, or \$0.25 per share, for the quarter ended March 31, 2003. The decrease in net loss is the result of lower expenses related to the clinical trial program for our once-daily tramadol which was partially offset by the total stock-based compensation expense of \$411,000 for the current quarter and an increase in depreciation, amortization, and interest expense, as described previously.

QUARTERLY INFORMATION (UNAUDITED)

The following selected financial information is derived from our unaudited quarterly financial statements for each of the last eight quarters, all of which cover periods of three months.

\$000s except per share data	Three months ended							
	March 31, 2004	March 31, 2003	June 30, 2003	Sept. 30, 2003	Dec. 31, 2003	May 31, 2002	August 31, 2002	Nov. 30, 2002
Revenue	199	306	678	217	212	372	436	1,007
Net loss	(7,569)	(7,817)	(8,827)	(7,889)	(9,388)	(3,538)	(3,491)	(4,212)
Basic and diluted net loss per share	(0.21)	(0.25)	(0.28)	(0.22)	(0.27)	(0.11)	(0.11)	(0.14)

LIQUIDITY AND CAPITAL RESOURCES

As at March 31, 2004, working capital was \$8,196,000. Our sources of funds and our cash and cash equivalents on hand are expected to be sufficient to meet our committed cash obligations and expected level of expenses into the third quarter of 2004. Our ability to continue as a going concern is dependent upon raising additional financing through borrowings or equity financing, receiving funds through collaborative research contracts or product licensing agreements and achieving future profitable operations. The outcome of these matters is dependent on a number of items outside of our control. As a result, there is significant uncertainty as to whether we will have the ability to continue as a going

concern. However, we expect to raise additional funds by issuing equity during 2004 and believe this should be supplemented by up-front and milestone payments in relation to existing and additional product distribution and licensing agreements in 2004. However, there can be no assurance that, if required, we would be able to raise such capital on favourable terms, or that commercial agreements will be concluded or that we will receive payments under existing agreements.

On May 6, 2004, we entered into an agreement to issue 6,122,449 common shares on a bought deal basis to a syndicate of underwriters. The shares will be publicly offered in Canada under a short-form prospectus at a price of \$4.90 per

common share for gross proceeds of \$30,000,000. The share issue expense related to this offering is estimated at \$2,300,000. We have also granted the underwriters an over-allotment option to purchase up to an additional 15% of the issue, exercisable on the same terms and conditions at any time until 30 days following the date of closing. The transaction is subject to the receipt of all necessary regulatory and stock exchange approvals. The completion of this offering is expected to close on or about May 26, 2004 and will improve significantly our liquidity position.

Funds applied to operating activities in the quarter ended March 31, 2004 amounted to \$8,654,000 compared to \$6,239,000 for the comparative quarter, and were used primarily to develop our in-house product portfolio, principally our once-daily tramadol product.

Funds provided from investing activities for the quarter ended March 31, 2004 amounted to \$9,475,000 compared to \$5,625,000 for the quarter ended March 31, 2003. Capital expenditures for the quarter were \$372,000 compared to \$1,319,000 for the quarter ended March 31, 2003. Capital expenditures for the first quarter of 2004 were principally related to our information technology infrastructure and to the acquisition of laboratory equipment. The net proceeds from acquisitions, disposals and maturities of investments in the quarter ended March 31, 2004 were \$2,903,000 higher than the quarter ended March 31, 2003.

Funds provided from financing activities amounted to \$651,000 for the quarter ended March 31, 2004 as compared to \$12,000 for the comparative quarter. During the quarter ended March 31, 2004, 180,000 warrants were exercised for a total of 180,000 common shares and for a total cash consideration of \$360,000. In addition proceeds of \$332,000 were obtained from the exercise of stock options.

Accounts receivable totalled \$569,000 as at March 31, 2004 and included primarily amounts receivable for commodities tax, as well as trade and interest receivable on investments. Accounts payable and accrued liabilities decreased from \$7,087,000 as at December 31, 2003 to \$5,038,000 as at March 31, 2004 due to the timing of the payments of the various Phase III studies associated with our once-daily tramadol product. Deferred revenue totalled \$710,000 as at March 31, 2004 and represented the portion of the payments from Gruppo Angelini and Esteve S.A. received at the signing of the distribution and license agreements for our once-daily tramadol product, which will be recognized over the terms of the respective agreements, as well as the unrecognized portion of the up-front payment received from Gruppo Angelini upon initiation of the feasibility work on trazodone. Obligations under capital leases decreased by \$41,000 to \$6,174,000 as at March 31, 2004, as a result of payments made since December 31, 2003.

Cash and cash equivalents, investments and accrued interest on investments totalled \$12,459,000 as at March 31, 2004

compared to \$20,851,000 as at December 31, 2003, an \$8,392,000 reduction, primarily as a result of funds applied to operating activities in the first quarter of fiscal 2004. Our investment policy regulates our investment activities relating to cash resources. We invest in liquid, high-grade investment securities with varying terms to maturity, selected with regard to the expected timing of expenditures for continuing operations. As at March 31, 2004, our unrestricted cash was invested in seven major Canadian companies, including one chartered bank, in amounts ranging from \$451,000 to \$2,499,000.

OUTSTANDING SHARE DATA

The number of common shares outstanding as of May 7, 2004 is 36,341,781 and has increased by 13,300 since March 31, 2004 due to the exercise of 13,300 stock options. The number of options outstanding as of May 7, 2004 is 3,283,775 and has decreased by 13,300 since March 31, 2004, due to the options exercised. Furthermore, we have 10,000 warrants outstanding which can be exercised at a price of \$2.00 per share, and expire in June 2004.

Certification of Interim Filings

I, James R. Howard-Tripp, President and Chief Executive Officer of Labopharm Inc., certify that:

1. I have reviewed the interim filings (as this term is defined in Multilateral Instrument 52-109 *Certification of Disclosure in Issuers' Annual and Interim Filings*) of Labopharm Inc. (the issuer) for the interim period ending March 31, 2004;
2. Based on my knowledge, the interim filings do not contain any untrue statements of a material fact or omit to state a material fact required to be stated or that is necessary to make a statement not misleading in light of the circumstances under which it was made, with respect to the period covered by the interim filings; and
3. Based on my knowledge, the interim financial statements together with the other financial information included in the interim filings fairly present in all material respects the financial condition, results of operations and cash flows of the issuer, as of the date and for the periods presented in the interim filings.

(signed)

President and Chief Executive Officer

May 10, 2004

I, Warren Whitehead, Chief Financial Officer of Labopharm Inc., certify that:

1. I have reviewed the interim filings (as this term is defined in Multilateral Instrument 52-109 *Certification of Disclosure in Issuers' Annual and Interim Filings*) of Labopharm Inc. (the issuer) for the interim period ending March 31, 2004;
2. Based on my knowledge, the interim filings do not contain any untrue statements of a material fact or omit to state a material fact required to be stated or that is necessary to make a statement not misleading in light of the circumstances under which it was made, with respect to the period covered by the interim filings; and
3. Based on my knowledge, the interim financial statements together with the other financial information included in the interim filings fairly present in all material respects the financial condition, results of operations and cash flows of the issuer, as of the date and for the periods presented in the interim filings.

(signed)

Chief Financial Officer

May 10, 2004

Consolidated Statements of Loss

[Unaudited] [note 1]

For periods of three months ended:	March 31, 2004	March 31, 2003
[Thousands of dollars, except share and per share amounts]	\$	\$
REVENUE		
Research and development	81	78
Licensing	12	-
Investment income	106	228
	199	306
EXPENSES		
Research and development expenses, net [note 4]	4,974	6,161
Selling, general and administrative expenses	2,141	1,797
Depreciation and amortization	398	126
Foreign exchange loss	30	25
Interest expense	212	10
	7,755	8,119
LOSS BEFORE INCOME TAXES	(7,556)	(7,813)
Income taxes:		
Current	13	4
NET LOSS FOR THE PERIOD	(7,569)	(7,817)
NET LOSS PER SHARE - BASIC AND DILUTED	(0.21)	(0.25)
Weighted average number of common shares outstanding	36,039,311	31,060,549

See accompanying notes.

Consolidated Statements of Cash Flows

[Unaudited] [note 1]

For periods of three months ended:	March 31, 2004	March 31, 2003
[Thousands of dollars]	\$	\$
OPERATING ACTIVITIES		
Net loss for the period	(7,569)	(7,817)
Items not affecting cash		
Depreciation of property, plant and equipment	365	101
Amortization of intangible assets	33	25
Stock-based compensation	411	-
	(6,760)	(7,691)
Net change in non-cash operating items	(1,894)	1,452
	(8,654)	(6,239)
INVESTING ACTIVITIES		
Acquisition of investments	(451)	(2,622)
Disposals of investments	2,150	6,010
Maturities of investments	8,148	3,556
Acquisition of property, plant and equipment	(322)	(1,292)
Acquisition of intangible assets	(50)	(27)
	9,475	5,625
FINANCING ACTIVITIES		
Repayment of capital leases obligations	(41)	(2)
Proceeds from issuance of capital stock	692	14
	651	12
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	1,472	(602)
Cash and cash equivalents, beginning of period	720	1,718
CASH AND CASH EQUIVALENTS, END OF PERIOD	2,192	1,116

See accompanying notes.

Consolidated Balance Sheets

[note 1]

	As at March 31, 2004 [Unaudited] \$	As at Dec. 31, 2003 [Audited - note 2] \$
[Thousands of dollars]		
ASSETS		
Current		
Cash and cash equivalents	2,192	720
Short-term investments	8,881	18,727
Accounts receivable	569	1,295
Research and development tax credits receivable	1,100	900
Prepays and other assets	941	337
	13,683	21,979
Long-term investments	1,280	1,281
Property, plant and equipment	11,425	11,468
Intangible assets	2,008	1,991
	28,396	36,719
LIABILITIES		
Current		
Accounts payable and accrued liabilities	5,038	7,087
Current portion of deferred revenue	276	46
Current portion of obligations under capital leases	173	169
	5,487	7,302
Deferred revenue	434	431
Obligations under capital leases	6,001	6,046
	11,922	13,779
SHAREHOLDERS' EQUITY		
Capital stock [note 5]	104,731	104,035
Contributed surplus	3,383	-
Deficit	(91,640)	(81,095)
	16,474	22,940
	28,396	36,719

See accompanying notes.

Consolidated Statements of Deficit

[Unaudited] [note 1]

	March 31, 2004 \$	March 31, 2003 \$
For periods of three months ended:		
[Thousands of dollars]		
		[restated - note 3c]
BALANCE, beginning of period [as previously reported]	-	(53,385)
Adjustment for change in accounting policy [note 3c]	-	6,211
BALANCE, beginning of period [adjusted]	(81,095)	(47,174)
Adjustment for change in accounting policy [note 3a]	(2,976)	-
Net loss	(7,569)	(7,817)
BALANCE, end of period	(91,640)	(54,991)

See accompanying notes.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS [UNAUDITED]

As at March 31, 2004 [thousands of dollars, except share and per share amounts]

Note 1

DESCRIPTION OF BUSINESS AND GOING CONCERN UNCERTAINTY

The Company, incorporated under the *Companies Act (Québec)* is specialized in the development of drugs using advanced controlled-release technologies and the development of pharmaceutical products incorporating its proprietary technologies. The Company carries on business in Canada, Barbados and Ireland and substantially all of the Company's tangible assets are located in Canada and substantially all revenues have been derived from business carried on in Canada. The intangible assets are jointly owned by the Company and its foreign subsidiaries.

The Company's strategy is to develop products internally in order to form strategic alliances or licensing agreements with national or international pharmaceutical companies that have the necessary resources and distribution networks to market and sell the pharmaceutical products incorporating the Company's proprietary technologies. To date, the Company has financed its cash requirements primarily through share issuances, investment tax credits, collaborative research contracts and interest income. The future profitability of the Company is dependent upon such factors as the success of the clinical trials, the approval of regulatory authorities of products developed by the Company and the ability of the Company to obtain the necessary financing to complete its projects through licensing and research agreements.

The Company has incurred significant operating losses and cash outflows from operations. As at March 31, 2004, the Company's committed sources of funds and the Company's cash and cash equivalents on hand are expected to be sufficient to meet the Company's committed cash obligations and expected level of expenses into the third quarter of 2004. The ability of the Company to continue as a going concern is dependent upon raising additional financing through borrowings or equity financing, receiving funds through collaborative research contracts or product licensing agreements and achieving future profitable operations. The outcome of these matters is dependent on a number of items outside of the Company's control. As a result, there is significant uncertainty as to whether the Company will have the ability to continue as a going concern.

The consolidated financial statements have been prepared on a going concern basis, which assumes the Company will continue in operation for the foreseeable future and will be able to realize its assets and discharge its liabilities and commitments in the ordinary course of business. These financial statements do not include any adjustments to the amounts and classification for assets and liabilities that may be necessary should the Company not be successful in its effort to obtain additional financing or receiving significant funds on signing collaborative research contracts or by out licensing its products.

Note 2

BASIS OF PRESENTATION AND ACCOUNTING POLICIES

The unaudited interim consolidated financial statements of the Company have been prepared in accordance with generally accepted accounting principles ("GAAP") in Canada 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, 2003 and the accompanying notes, included in the Company's annual report. In the opinion of management, 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 preparation of these 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, 2003 included in the Company's annual report, except for the changes in accounting policies as described in note 3.

Note 3

CHANGES IN ACCOUNTING POLICIES

a) Stock-Based Compensation

In 2003, the Canadian Institute of Chartered Accountants ("CICA") amended its pronouncement relating to stock-based compensation requiring companies to measure and expense all equity instruments awarded to employees and directors starting in fiscal years beginning on or after January 1, 2004 in accordance with the fair value method. The fair value of stock options to employees and directors is determined at the date of grant using the Black-Scholes option pricing model, and expensed over the vesting period of the options. The transitional provisions provide for a prospective treatment to this change in accounting policy for those companies who adopt this new pronouncement in fiscal years beginning before January 1, 2004 and a retroactive treatment for those companies adopting on or after January 1, 2004. Effective January 1, 2004, the Company adopted the retroactive treatment without restatement, for options granted since March 1, 2002. Consequently, the opening deficit and contributed surplus balances as at January 1, 2004 increased by \$2,976. The compensation expense charged against income was \$411 for the three-month period ended March 31, 2004, \$162 of which was included with research and development expenses and \$249 of which was included with selling, general and administrative expenses. The counterpart has been recorded as contributed surplus. Prior to January 1, 2004 no compensation expense was recognized when stock options were granted to employees and directors, however the Company provided pro forma information as if the fair value method had been applied.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS [UNAUDITED]

As at March 31, 2004 [thousands of dollars, except share and per share amounts]

b) Impairment of Long-Lived Assets

Effective January 1, 2004, the Company adopted the new recommendations of the CICA related to Handbook Section 3063, *Impairment of Long-lived Assets*. Section 3063 establishes standards for the recognition, measurement and disclosure of the impairment of long-lived assets held for use by the Company. The new recommendations require that an impairment loss be recognized when the carrying amount of an asset to be held and used exceeds the sum of the undiscounted cash flows expected from its use and disposal. The impairment loss to be recognized is measured as the amount by which the carrying amount of the asset exceeds its fair value. Prior to January 1, 2004, any impairment loss to be recognized was measured by the amount by which the carrying amount of the assets exceeded its net recoverable value. The adoption by the Company of this standard did not have any effect on its results, financial position or cash flows.

c) Issuance Costs of Capital Stock

In 2003, the Company retroactively changed its accounting policy relating to the presentation of issuance costs of capital stock, and records them against capital stock instead of treating them as an increase in the deficit. The financial statements of prior periods presented have been restated to reflect this change. The cumulative effect resulted in a decrease in the opening deficit for the three-month period ended March 31, 2003 of \$6,211 and a decrease in capital stock as at March 31, 2003 by the same amount.

Note 4

RESEARCH AND DEVELOPMENT EXPENSES

Research and development expenses are presented net of tax credits of \$200 and \$177 for the three-month periods ended March 31, 2004 and 2003 respectively.

Note 5

CAPITAL STOCK

Authorized

Unlimited number of preferred shares, non-participating, non-voting, without par value

Unlimited number of common shares, voting, without par value

Issued

36,328,481 common shares [December 31, 2003 – 35,995,581]

Capital Stock Transactions

During the first quarter of 2004, 152,900 [2002 – 4,700] options were exercised for a total cash consideration of \$332 [2002 – \$14]. In addition, capital stock was increased by \$4 [2002- nil] and contributed surplus reduced by the same amount to consider compensation expense recorded for options exercised which were granted after March 1, 2002.

Warrants

On March 17, 2004, 180,000 warrants were exercised for a total of 180,000 common shares and for a total cash consideration of \$360. As at March 31, 2004, 10,000 warrants are outstanding at an exercise price of \$2.00.

Stock Option Plan

The changes to the number of stock options granted by the Company and their weighted average exercise prices, for the three-month period ended March 31, 2004, are as follows:

	#	\$
Balance, beginning of period	3,415,025	4.87
Granted	40,000	7.40
Exercised	(152,900)	2.18
Forfeited	(5,050)	8.15
Balance, end of period	3,297,075	5.03
Options eligible to be exercised	2,472,450	4.75

A compensation expense of \$411 has been recognized during the three-month period ended March 31, 2004 for stock options granted to employees and directors since March 1, 2002 (see note 3).

The fair value of options granted, in each of the three-month periods ended March 31, 2004 and 2003, was estimated at the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions:

	For the three-month period ended March 31, 2004	March 31, 2003
Expected volatility	0.75	0.90
Expected life	4.0 years	4.0 years
Risk-free interest rate	3.32%	4.0%
Dividend yield	Nil	Nil

The weighted average fair value of stock options granted during the three-month period ended March 31, 2004 using the above assumptions amounted to \$4.25 [2003 – \$2.34].

No compensation expense has been recognized during the three-month period ended March 31, 2003 for stock options granted to employees and directors since March 1, 2002. Had compensation expense been determined based on the fair value method at the date of grant of the options granted, the fair value of the options would have been amortized over the vesting period of the options. For the three-month period ended March 31, 2003, the Company's stock compensation expense would have been \$224, the pro forma net loss would have been \$8,041 and pro forma basic and diluted loss per share would have been \$0.26.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS [UNAUDITED]

As at March 31, 2004 [thousands of dollars, except share and per share amounts]

Note 6

COMPARATIVE FIGURES

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

Note 7

SUBSEQUENT EVENTS

On May 6, 2004, the Company entered into an agreement to issue 6,122,449 common shares on a bought deal basis to a syndicate of underwriters. The shares will be publicly offered in Canada under a short-form prospectus at a price of \$4.90 per common share, for gross proceeds of \$30,000. The issue expenses related to this offering are estimated at \$2,300. The Company has also granted the underwriters an over-allotment option to purchase up to an additional 15% of the issue, exercisable on the same terms and conditions at any time until 30 days following the date of closing. The transaction is subject to the receipt of all necessary regulatory and stock exchange approvals.

Subsequent to quarter end, the Company incurred approximately \$1,000 of additional costs related to a financing transaction, which if not finalized will have to be expensed in 2004.

General Information

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

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