

# Quarterly Report

SECOND QUARTER - FISCAL 2004

Q2

Labopharm

# President's Message to Shareholders

## **Moving Ever Closer to Anticipated Regulatory Approval of Once-Daily Tramadol in France**

In our program to commercialize our once-daily formulation of tramadol in Europe, we are continuing discussions with the regulatory authorities in France (the Agence Française de Sécurité Sanitaire des Produits de Santé) following the favourable review of the clinical component of our Marketing Authorization Application (MAA), one of two components of the MAA, during the first quarter of this year. We have fully responded to the Agency's questions regarding the chemistry, manufacturing and control (CMC) portion of the MAA and, upon favourable review, would expect to receive full approval of our application in due course. Together with our partners, we now have in place the majority of the logistical requirements to support the commercial launch of our product.

## **Steadily Moving Our U.S. Once-Daily Tramadol Program Forward**

In our U.S. commercialization program for once-daily tramadol, our objective is to proceed in most prudent manner in order to obtain approval for our product. We are currently evaluating our global clinical trial data in preparation for further discussions with the Food and Drug Administration (FDA) regarding our submission. We are continuing active discussions with several potential U.S. marketing partners and remain very encouraged by our negotiations.

## **Continuing to Advance Programs Across Our Robust Pipeline**

While our primary focus remains the global commercialization of once-daily tramadol, during the second quarter we continued to advance other key programs across our robust pipeline. In our program to develop a once-daily formulation of betahistine, indicated for Ménière's disease or vertigo, we have initiated manufacturing of clinical trial batches for a pharmacokinetic study, which we expect to conduct in the near future.

In our once-daily trazodone program, partnered with Gruppo Angelini, we have completed development of two prototypes and are initiating scale-up for clinical trial batch manufacturing.

In our program to develop a once-daily formulation of the urinary incontinence product oxybutynin, we are currently awaiting the results of the second of a series of pharmacokinetic studies.

Finally, last quarter we announced that the product candidate we had previously referred to as DDS-2003 is a sustained-release formulation of gabapentin, a centrally acting modulator of central nervous system function approved for the treatment of epilepsy and post-herpetic neuralgia. We are now completing the formulation work prior to initiating investigational studies in humans.

## **Other Highlights for the Quarter**

In the other developments during the quarter, we are very pleased to have secured the first partnership for our polymeric nano-delivery systems technology (which we have previously referred to as our micelles technology). Under the agreement, our partner, Debiopharm SA, has engaged us to conduct research into the oral delivery of a current intravenous cancer drug using our technology. We are currently initiating research activities.

It has always been our long-term strategy to build a specialty pharmaceutical company based on multiple integrated drug delivery platforms. Our core platform Contramid® addresses very soluble to relatively insoluble compounds, which comprise the majority of drugs. Polymeric nano-delivery systems address the delivery challenges of water insoluble compounds, ideally complementing our core technology.

### **Strengthening Our Financial Position**

In May, we completed a \$30 million bought deal financing, the proceeds of which will be used to support our global commercialization program for once-daily tramadol, including both the anticipated launch of the product in Europe and submission of a New Drug Application (NDA) in the U.S. Proceeds will also be used to advance development of other product candidates in our pipeline, as well as for working capital and general corporate purposes.

Having concluded the Phase III clinical trials for once-daily tramadol, our cash burn was significantly lower in the second quarter after removing non-recurring costs. Our usage of cash will continue to fluctuate with clinical trial activity as we advance the development programs in our pipeline.

### **Positioned to Create Value**

Labopharm remains on the verge of commercializing its first product in Europe. We are poised to receive regulatory approval for once-daily tramadol in France, which will initiate the Mutual Recognition Procedure (MRP) process for additional approvals across Europe. Both the marketing partnerships and infrastructure are in place to support a speedy launch once approval is confirmed. In the U.S., we are continuing to proceed toward submission of an NDA and we continue to make strong progress in our discussions with potential marketing partners for that country. Finally, we are advancing our other key development programs in our pipeline towards our long-term goal of becoming a fully integrated international specialty pharmaceutical company commercializing our own pharmaceutical products.

Yours truly,



James R. Howard-Tripp  
President and Chief Executive Officer  
July 27, 2004

# Management's Discussion & Analysis

The following information should be read in conjunction with our unaudited interim consolidated financial statements as at June 30, 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 June 30, 2004, as compared to the quarter ended June 30, 2003 and for the six-month periods then ended. This review was performed by management with information available as at July 23, 2004. Additional information relating to the Company, including its Annual Information Form, can be found on SEDAR on [www.sedar.com](http://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 a number of product candidates 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 have completed two Phase III trials and are continuing evaluation of our global clinical trial data in preparation for further discussions with the Food and Drug Administration (FDA) regarding our New Drug Application submission. All but one of 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 commercializing 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

On May 26, 2004, we issued 6,122,449 common shares on a bought deal basis to a syndicate of underwriters for net proceeds of \$27,835,000. The net proceeds received from this offering have significantly improved our liquidity position. Under our current operating plan, we believe that our current cash, cash equivalents, and investments as well as expected milestone payments from existing and anticipated commercial agreements, should be sufficient to finance our operations and capital needs for the next twelve months. However, in light of the inherent uncertainties associated with research and development programs, scale-up and commercialization of products, ability to enter into collaborative research and development agreements, the results of clinical testing, receipt of regulatory approval of certain products and 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.

### Revenue

To date, we have not generated any revenue from product sales. Revenue to date has been generated primarily by 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 June 2004 under which Debiopharm S.A. has engaged us to conduct research on the potential oral delivery of a current intravenous cancer drug using our proprietary polymeric nano-delivery systems technology (previously referred to as micelles technology).

In addition, we also have entered into three distribution and license agreements and two letters of intent in Europe for once-daily tramadol. The terms of these agreements may 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 second quarter of fiscal 2004, research

and development expenses declined considerably in comparison to the quarter ended March 31, 2004, due to completion of the two US phase III clinical trials for once-daily tramadol.

## 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 \$684,000 for the second quarter of 2004 in relation to this new accounting policy for stock options issued to employees and directors since March 1, 2002. The expense for the six-month period ended June 30, 2004 amounted to \$1,095,000. In addition, the opening deficit for 2004 was 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 second quarter ended June 30, 2004, total revenue, which includes investment income, amounted to \$187,000 compared to \$679,000 for the quarter ended June 30, 2003. Total revenue for the six-month period ended June 30, 2004 was \$386,000 compared with \$985,000 for the comparative period.

Revenue from research and development contracts for the quarter ended June 30, 2004 totalled \$81,000, all of which was derived from our agreement with Gruppo Angelini, under which we are formulating a once-daily version of the anti-depressant trazodone. Revenue from research and development contracts of \$522,000 for the quarter ended June 30, 2003 was generated entirely from our agreement with MedPointe for progress made on the formulation of DDS-2001. For the six-month period ended June 30, 2004, revenue from these research and development agreements generated \$162,000 in revenue compared with \$600,000 for the comparative period.

During the quarter, we recognized \$12,000 of 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. For the six-month period ended June 30, 2004, licensing revenues amounted to \$24,000.

Investment income for the quarter ended June 30, 2004 was \$94,000 compared with \$157,000 for the quarter ended June 30, 2003. The decrease results from lower cash and investment balances in the current quarter compared to the quarter ended June 30, 2003, as well as lower rates of return on invested funds caused by a general decrease in market interest rates. For the six-month period ended June 30, 2004, investment income totalled \$200,000 compared with \$385,000 in the comparative period. The decrease is attributable to lower cash and investment balances in the current period and lower returns.

### Research and Development Expenses

Research and development expenses (net of tax credits) for the second quarter ended June 30, 2004 were \$2,118,000 compared with \$7,137,000 for the quarter ended June 30, 2003, a decrease of \$5,019,000. Approximately \$0.9 million of research and development expenses during the quarter ended June 30, 2004 were related to the continued development of our once-daily tramadol product, compared to approximately \$6.3 million in the comparative quarter. The significantly lower costs in the current quarter are attributable to the completion of the two US phase III clinical trials for our once-daily tramadol product.

During the comparative quarter, we were conducting two Phase III clinical studies in the U.S. incurring significant expenditures. An amount of \$164,000 in non-cash stock compensation expense was recorded in the period as a result of the new requirement to expense all stock-based compensation which we adopted as of January 1, 2004.

For the six-month period ended June 30, 2004, research and development expenses totalled \$7,092,000 compared to \$13,298,000 for the comparative period. The decrease is primarily the result of the timing and costs related to clinical trials.

Research and development expense should increase in the next two quarters compared to the quarter ended June 30, 2004, as we pursue development across our product portfolio, and we prepare for commercial production of our once-daily tramadol product including satisfying regulatory requirements. However, we are unable to estimate the specific timing and future costs of our research and development programs.

#### Selling, General and Administrative Expenses

Selling, general and administrative expenses for the quarter ended June 30, 2004 were \$4,476,000 compared to \$1,839,000 for quarter ended June 30, 2003. The increase is due primarily to non-recurring financing costs of \$1,597,000 that were expensed in the quarter due to the postponement of a contemplated cross-border financing. The increase versus the comparative quarter is also attributable to the expensing of non-cash stock-based compensation of which \$520,000 was included in selling, general and administrative expenses. Expenses also increased with respect to salary costs, insurance, and our European operations as we prepare for global commercialization of once-daily tramadol. Selling, general and administrative expenses for the six-month period ended June 30, 2004 were \$6,617,000 compared with \$3,636,000 for the six-month period ended June 30, 2003, the reasons for the increase being similar to that of the quarter.

#### Depreciation and Amortization

Depreciation and amortization expense increased to \$438,000 for the quarter ended June 30, 2004 from \$378,000 for the quarter ended June 30, 2003 as a result of the depreciation of the additional property, plant and equipment, including our new GMP pilot plant and the laboratory equipment purchased or put to use during 2003. For the six-month period ended June 30, 2004, depreciation and amortization expense totalled \$836,000 compared to \$504,000 for the comparative period, the reasons for the increase being similar to that of the quarter.

#### Interest Expense

Interest expense increased to \$212,000 in the quarter ended June 30, 2004 from \$136,000 in the quarter ended June 30, 2003, due to interest on capital lease obligations. Last year's additions of property, plant and equipment through capital leases were a contributing factor to this increase, the most significant capital lease being that for our new facilities. Interest expense for the six-month period ended June 30, 2004 was \$424,000 compared with \$146,000 for the six-month period ended June 30, 2003.

#### Net Loss

Net loss for the quarter ended June 30, 2004 was \$7,084,000, or \$0.18 per share, compared with \$8,827,000, or \$0.28 per share, for the quarter ended June 30, 2003. The decrease in net loss is the result of lower expenses related to the clinical trial program for our once-daily tramadol product which was partially offset by a total stock-based compensation expense of \$684,000 for the current quarter and an increase in selling, general and administrative expenses, depreciation, amortization, and interest expense, as described previously. For the six-month period ended June 30, 2004, net loss was \$14,653,000, or \$0.39 per share, compared with \$16,644,000 or \$0.54 per share for the comparative period.

### 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	June 30, 2004	March 31, 2003	June 30, 2003	Sept. 30, 2003	Dec. 31, 2003	August 31, 2002	Nov. 30, 2002
Revenue	199	187	306	678	217	212	436	1,007
Net loss	(7,569)	(7,084)	(7,817)	(8,827)	(7,889)	(9,388)	(3,491)	(4,212)
Basic and diluted net loss per share	(0.21)	(0.18)	(0.25)	(0.28)	(0.22)	(0.27)	(0.11)	(0.14)

## LIQUIDITY AND CAPITAL RESOURCES

As at June 30, 2004, working capital was \$25,769,000. Our sources of funds and our cash and cash equivalents on hand as well as expected milestone payments from existing and anticipated commercial agreements are expected to be sufficient to meet our committed cash obligations and expected level of expenses for the next twelve months.

On May 26, 2004, we issued 6,122,449 common shares on a bought deal basis to a syndicate of underwriters. The shares were 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 was \$2,165,000, generating net proceeds of \$27,835,000 and increasing our liquidity and capital resources accordingly. As a result of the proceeds of this offering the going concern uncertainty related to our operations for the next twelve months was removed.

Funds applied to operating activities in the quarter ended June 30, 2004 amounted to \$6,542,000 compared to \$6,532,000 for the comparative quarter, and were used primarily to develop our in-house product portfolio. For the six-month period ended June 30, 2004 funds applied to operating activities were \$15,196,000 compared to \$12,771,000 for the comparative period.

Funds applied to investing activities for the quarter ended June 30, 2004 amounted to \$22,877,000 compared to funds provided of \$6,836,000 for the quarter ended June 30, 2003. Capital expenditures for the quarter were \$277,000 compared to \$1,689,000 for the quarter ended June 30, 2003. Capital expenditures for the second quarter of 2004 were principally related to our information technology infrastructure and to the acquisition of laboratory equipment, while in 2003 the level of capital expenditures was consequential with the relocation to our new facilities. Acquisitions of investments were \$31,480,000 compared to \$150,000 for the quarter ended June 30, 2003, reflecting the marketable securities acquired with the net proceeds generated from the financing completed on May 26, 2004. Funds applied to investing activities for the six-month period ended June 30, 2004 amounted to \$13,402,000 compared to \$12,461,000 of funds provided for the six-month period ended June 30, 2003.

Funds provided from financing activities amounted to \$27,873,000 for the quarter ended June 30, 2004 as compared to \$178,000 for the comparative quarter. In addition to the net proceeds of \$27,835,000 generated from the financing completed on May 26, 2004, during the quarter proceeds of \$81,000 were obtained from the exercise of stock options. Funds provided from financing activities amounted to \$28,524,000 for the six-month period ended June 30, 2004 as compared to \$190,000 for the comparative period. During the six-month period ended June 30, 2004, 180,000 warrants were exercised for a total of 180,000 common shares for a cash consideration of \$360,000.

Accounts receivable totalled \$554,000 as at June 30, 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 \$4,130,000 as at June 30, 2004 due primarily to the timing of the payments of the various Phase III studies associated with our once-daily tramadol product. Deferred revenue totalled \$855,000 as at June 30, 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 payments received from Gruppo Angelini and Debiopharm S.A. under their respective research collaboration agreements. Obligations under capital leases decreased by \$71,000 to \$6,144,000 as at June 30, 2004, primarily as a result of payments made since December 31, 2003.

Cash and cash equivalents, investments and accrued interest on investments totalled \$33,476,000 as at June 30, 2004 compared to \$20,851,000 as at December 31, 2003, a \$12,625,000 increase, primarily as a result of funds generated by the May 26, 2004 financing net of the funds applied to operating activities during the period. 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 June 30, 2004, our unrestricted cash was invested in eleven major Canadian companies, including two chartered banks and thirteen governmental agencies, in amounts ranging from \$410,000 to \$2,500,000.

## OUTSTANDING SHARE DATA

The number of common shares and options outstanding as of July 23, 2004 is 42,489,230 and 3,378,675 respectively and has not changed since June 30, 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 June 30, 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.

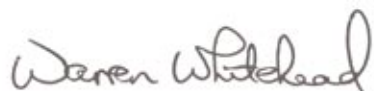


President and Chief Executive Officer

July 23, 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 June 30, 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.



Chief Financial Officer

July 23, 2004

# Consolidated Statements of Loss

[Unaudited]

For periods of:	Three months ended		Six months ended	
	June 30, 2004	June 30, 2003	June 30, 2004	June 30, 2003
[Thousands of dollars, except share and per share amounts]	\$	\$	\$	\$
<b>REVENUE</b>				
Research and development	81	522	162	600
Licensing	12	—	24	—
Investment income	94	157	200	385
	<b>187</b>	<b>679</b>	<b>386</b>	<b>985</b>
<b>EXPENSES</b>				
Research and development expenses, net [note 4]	2,118	7,137	7,092	13,298
Selling, general and administrative expenses	4,476	1,839	6,617	3,636
Depreciation and amortization	438	378	836	504
Foreign exchange loss	9	12	39	37
Interest expense	212	136	424	146
	<b>7,253</b>	<b>9,502</b>	<b>15,008</b>	<b>17,621</b>
LOSS BEFORE INCOME TAXES	<b>(7,066)</b>	<b>(8,823)</b>	<b>(14,622)</b>	<b>(16,636)</b>
Income taxes:				
Current	18	4	31	8
<b>NET LOSS FOR THE PERIOD</b>	<b>(7,084)</b>	<b>(8,827)</b>	<b>(14,653)</b>	<b>(16,644)</b>
NET LOSS PER SHARE - BASIC AND DILUTED	<b>(0.18)</b>	<b>(0.28)</b>	<b>(0.39)</b>	<b>(0.54)</b>
Weighted average number of common shares outstanding	<b>38,767,796</b>	<b>31,086,753</b>	<b>37,403,553</b>	<b>31,073,723</b>

See accompanying notes.

# Consolidated Statements of Cash Flows

[Unaudited]

For periods of:	Three months ended		Six months ended	
	June 30, 2004	June 30, 2003	June 30, 2004	June 30, 2003
[Thousands of dollars]	\$	\$	\$	\$
<b>OPERATING ACTIVITIES</b>				
Net loss for the period	(7,084)	(8,827)	(14,653)	(16,644)
Items not affecting cash				
Depreciation of property, plant and equipment	373	286	738	387
Amortization of intangible assets	65	92	98	117
Stock-based compensation	684	—	1,095	—
	(5,962)	(8,449)	(12,722)	(16,140)
Net change in non-cash operating items	(580)	1,917	(2,474)	3,369
	(6,542)	(6,532)	(15,196)	(12,771)
<b>INVESTING ACTIVITIES</b>				
Acquisition of investments	(31,480)	(150)	(31,931)	(2,772)
Disposals of investments	971	8,615	3,121	14,625
Maturities of investments	7,909	60	16,057	3,616
Acquisition of property, plant and equipment	(276)	(1,626)	(598)	(2,918)
Acquisition of intangible assets	(1)	(63)	(51)	(90)
	(22,877)	6,836	(13,402)	12,461
<b>FINANCING ACTIVITIES</b>				
Repayment of capital leases obligations	(43)	(25)	(84)	(27)
Proceeds from issuance of capital stock	30,081	203	30,773	217
Issuance costs of capital stock	(2,165)	—	(2,165)	—
	27,873	178	28,524	190
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(1,546)	482	(74)	(120)
Cash and cash equivalents, beginning of period	2,192	1,116	720	1,718
CASH AND CASH EQUIVALENTS, END OF PERIOD	646	1,598	646	1,598

See accompanying notes.

# Consolidated Balance Sheets

[Unaudited]

	As at June 30, 2004	As at Dec. 31, 2003
	\$	\$ [note 2]
[Thousands of dollars]		
<b>ASSETS</b>		
Current		
Cash and cash equivalents	646	720
Short-term investments	27,436	18,727
Accounts receivable	554	1,295
Research and development tax credits receivable	1,317	900
Prepays and other assets	556	337
	<b>30,509</b>	21,979
Long-term investments	5,325	1,281
Property, plant and equipment	11,341	11,468
Intangible assets	1,944	1,991
	<b>49,119</b>	36,719
<b>LIABILITIES</b>		
Current		
Accounts payable and accrued liabilities	4,130	7,087
Current portion of deferred revenue	433	46
Current portion of obligations under capital leases	177	169
	<b>4,740</b>	7,302
Deferred revenue	422	431
Obligations under capital leases	5,967	6,046
	<b>11,129</b>	13,779
<b>SHAREHOLDERS' EQUITY</b>		
Capital stock [note 5]	132,647	104,035
Contributed surplus	4,067	—
Deficit	(98,724)	(81,095)
	<b>37,990</b>	22,940
	<b>49,119</b>	36,719

See accompanying notes.

# Consolidated Statements of Deficit

[Unaudited]

	June 30, 2004	June 30, 2003
	\$	\$
For periods of six months ended:		
[Thousands of dollars]		
		[restated - note 3c]
<b>BALANCE, beginning of period [as previously reported]</b>	—	(53,385)
Adjustment for change in accounting policy [note 3c]	—	6,211
<b>BALANCE, beginning of period [adjusted]</b>	<b>(81,095)</b>	(47,174)
Adjustment for change in accounting policy [note 3a]	(2,976)	—
Net loss	(14,653)	(16,644)
<b>BALANCE, end of period</b>	<b>(98,724)</b>	(63,818)

See accompanying notes.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS [UNAUDITED]

As at June 30, 2004 [thousands of dollars, except share and per share amounts]

### Note 1

#### DESCRIPTION OF BUSINESS

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. On May 26, 2004, the Company issued 6,122,449 common shares on a bought deal basis to a syndicate of underwriters, for net proceeds of \$27,835,000. As a result of the proceeds received from this offering the Company's liquidity position has improved significantly. The Company believes that its current cash, cash equivalents and investments are sufficient to support its current operating plan for at least the next twelve months. In addition, during this period, the Company expects to receive additional milestone payments and anticipates receiving regulatory approval which will allow it to commercialize its lead product once-daily tramadol.

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. It may be necessary for the Company to raise additional funds until profitability is achieved.

### 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 \$684 for the three-month period ended June 30, 2004, \$164 of which was included with research and development expenses and \$520 of which was included with selling, general and administrative expenses. The compensation expense for the six-month period ended June 30, 2004 was \$1,095. 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.

##### b) Impairment of Long-Lived Assets

Effective January 1, 2004, the Company adopted the new recommendations of the CICA related to Handbook Section 3063,

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS [UNAUDITED]

As at June 30, 2004 [thousands of dollars, except share and per share amounts]

*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 six-month period ended June 30, 2003 of \$6,211 and a decrease in capital stock as at June 30, 2003 by the same amount.

### Note 4

#### RESEARCH AND DEVELOPMENT EXPENSES

Research and development expenses are presented net of tax credits of \$417 and \$506 for the six-month periods ended June 30, 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

42,489,230 common shares [December 31, 2003 – 35,995,581]

##### Capital Stock Transactions

During the six-month period ended June 30, 2004, 191,200 [2003 – 75,650] options were exercised for a total cash consideration of \$414 [2003 – \$217]. In addition, capital stock was increased by \$4 [2003- nil] and contributed surplus reduced by the same amount to consider compensation expense recorded for options exercised which were granted after March 1, 2002.

On May 26, 2004, the Company issued 6,122,449 common shares on a bought deal basis to a syndicate of underwriters. The total consideration received was \$30,000 and share issue expenses amounted to \$2,165.

##### Warrants

During the six-month period ended June 30, 2004, 180,000 warrants were exercised for a total of 180,000 shares for a total cash consideration of \$360. As of June 30, 2004, no warrants were outstanding.

##### Stock Option Plan

The changes to the number of stock options granted by the Company and their weighted average exercise prices, for the six-month period ended June 30, 2004, are as follows:

	#	\$
Balance, beginning of period	3,415,025	4.87
Granted	170,000	4.88
Exercised	(191,200)	2.16
Forfeited	(15,150)	7.62
Balance, end of period	3,378,675	5.02
Options eligible to be exercised	2,627,500	4.71

A compensation expense of \$1,095 has been recognized during the six-month period ended June 30, 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 six-month periods ended June 30, 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 six-month period ended June 30, 2004	June 30, 2003
Expected volatility	<b>0.72</b>	0.92
Expected life	<b>4.0 years</b>	4.0 years
Risk-free interest rate	<b>3.63%</b>	4.0%
Dividend yield	<b>Nil</b>	Nil

The weighted average fair value of stock options granted during the six-month period ended June 30, 2004 using the above assumptions amounted to \$2.76 [2003 – \$2.86].

No compensation expense has been recognized during the six-month period ended June 30, 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 six-month period ended June 30, 2003,

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS [UNAUDITED]

As at June 30, 2004 [thousands of dollars, except share and per share amounts]

the Company's stock compensation expense, the pro forma net loss and the pro forma basic and diluted loss per share would have been as follows:

	Three-month period ended <b>June 30, 2003</b> \$	Six-month period ended June 30, 2003 \$
Stock compensation expense	<b>631</b>	855
Pro forma net loss	<b>(9,458)</b>	(17,499)
Pro forma basic and diluted loss per share	<b>(0.30)</b>	(0.56)

### Note 6

#### COMPARATIVE FIGURES

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

# General Information

## Labopharm Inc. Officers

**Donald Buxton**  
Chairman of the Board (Non-Executive)

**James R. Howard-Tripp**  
President and Chief Executive Officer

**Sylvie Bouchard, MD, PhD.**  
Vice-President, Clinical Development

**Lisane Dostie, LLB**  
General Counsel and Corporate Secretary

**Allan Mandelzys, PhD., MBA**  
Vice-President, Business Development

**Damon Smith, BSc., PhD.**  
Vice-President, Research and Development

**Warren Whitehead, CMA**  
Chief Financial Officer

## Labopharm Europe Limited Officer

**Anthony C. Playle**  
Managing Director

## Investor Relations

Warren Whitehead, CMA  
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