

Quarterly Report

THIRD QUARTER - FISCAL 2004

Q3

Labopharm

President's Message to Shareholders

Preparing for the Launch of Once-Daily Tramadol as European Regulatory Process Advances

As we near the anticipated regulatory approval of our once-daily formulation of tramadol in France, our first European approval, we are working closely with all our marketing partners to prepare for launch of the product in that country, as well as in other key markets in Europe, including Germany and Spain. As of printing of this report, we await the formal decision of the French regulatory authorities. Approval in France will initiate the Mutual Recognition Procedure (MRP), which will allow rapid approval throughout the European Union countries and position us for broad launch of our product across Europe. It will also trigger milestone payments under the various marketing agreements that we have secured for Europe.

Supporting our commercialization efforts, during the third quarter we signed a definitive distribution and licensing agreement with HEXAL AG to market and sell our once-daily formulation of tramadol in Germany, the largest pharmaceutical market in Europe. Terms of the agreement are consistent with those of previously announced agreements, including an initial payment payable to Labopharm upon execution of the agreement and milestone payments payable to Labopharm upon receipt of its first regulatory approval in Europe and product launch in Germany.

Results of European Phase III Trial for Once-Daily Tramadol Published

I am pleased to report that the results of our European Phase III clinical trial for once-daily tramadol were recently published in a research article in the journal *Clinical Drug Investigation*. The article, co-authored by the lead investigator of the study, Dr. Gérald Mongin, highlights several key advantages that we believe our once-daily formulation (tramadol OAD) of tramadol will have in the marketplace:

"The option of treatment with an effective once-daily formulation, such as tramadol OAD (Contramid® controlled-release technology), offers patients with chronic pain such as osteoarthritis (OA) a significant advantage over faster release formulations. The benefit of increased compliance and convenience due to a simplified dosing regimen is relevant to all patients and in particular to elderly patients for whom simplification of treatment regimens (which often involve multiple dosing regimens) is also a safety issue. Since tramadol OAD provided efficacy at the same median daily dose (200 mg) as tramadol BID (the currently marketed twice-daily formulation), it should be possible to switch patients already treated with tramadol to treatment with tramadol OAD on a milligram per milligram basis. This, in combination with the fact that the treatment with new tramadol OAD formulation offers a clinically favourable adverse events profile in comparison with tramadol BID and immediate release, supports the use of tramadol OAD as an analgesic treatment of choice in chronic conditions such as OA. This study demonstrated that, similar to the twice-daily formulation, the new once-daily tramadol formulation using Contramid® provides analgesia that is sustained over a full 24-hour period."

Enrolment Underway for New U.S. Phase III Trial for Once-Daily Tramadol

In the U.S. portion of our once-daily tramadol commercialization program, our new Phase III clinical trial, MDT3-005, is well underway. We have enrolled patients at multiple sites and every one of the more than 50 sites is up and running. We are working towards finalization of our Special Protocol Assessment (SPA) with the FDA and are confident that this trial will be conducted under an SPA. On the partnering front, we are continuing our discussions with several parties and are encouraged by our progress.

Focusing on Our Nearest-Term Opportunities to Create Value

In an effort to focus resources on our nearest-term opportunities to create value, we have reprioritized our product development programs. Accordingly, in addition to pursuing the global commercialization of our once-daily tramadol product, we will continue to move forward aggressively with our programs for a once-daily formulation of trazodone and a once-daily formulation of betahistine, while slowing the programs for a controlled-release formulation of gabapentin and a once-daily formulation of oxybutynin. Having determined that better commercial opportunities reside with other product candidates in our pipeline, we have terminated our programs for development of a controlled-release formulation of trimebutine maleate (MODULON®), partnered with Axcan Pharma, and implantable Contramid® mini-tablets. Our other partnered programs are unaffected by this strategy.

Other Highlights for the Quarter

While our primary focus remains the global commercialization of once-daily tramadol, during the third quarter we continued to advance other key development programs.

In our once-daily betahistine program, we have entered the clinic with the initiation of a pharmacokinetic study.

In our once-daily trazodone program, partnered with Gruppo Angelini, we have selected two prototypes and commenced clinical trial batch manufacturing as we prepare to enter the clinic. In addition, together with our partner, we have devised a global development plan for this product that focuses initially on Europe, followed by the U.S. and then other key regions of the world.

We have also initiated clinical trial batch manufacturing for our DDS-2001 program partnered with MedPointe Inc., as we prepare to begin a pharmacokinetic study.

Finally, we have achieved the first in a series of milestones under our contract with Debiopharm to conduct research on the potential oral delivery of a current intravenous cancer drug using our proprietary polymeric nano-delivery systems technology. Subsequently, Debiopharm has agreed to move to the next phase of development.

Positioned to Create Value

In closing, we are increasingly excited about the potential for our once-daily tramadol product in Europe. At more than \$400 million in sales in 2003 and growing at a compounded average rate of 15% annually over the past five years, the European tramadol market represents a significant commercial opportunity. We believe our product has a distinct advantage in the marketplace in terms of convenience, compliance and safety, and we have the marketing partnerships and infrastructure in place to ensure that we fully capitalize on this opportunity. In the U.S. our new Phase III trial for once-daily tramadol is now underway and we continue to move closer to concluding a marketing partnership for that country.

Our sharpened focus will moderate our expenditures, ensuring that we have the resources to support fully the commercial launch of our once-daily tramadol product in Europe, as well as the completion of our Phase III study in the U.S. We will continue to pursue our long-term vision of following our success with once-daily tramadol by driving additional products through our development engine. By concentrating on those products with the shortest timelines and most straightforward paths to commercialization, we can maximize the potential return on our investment while ensuring that we have adequate capital to support their development fully.

Yours truly,

[signed]

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

Management's Discussion & Analysis

The following information should be read in conjunction with our unaudited interim consolidated financial statements as at September 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 September 30, 2004, as compared to the quarter ended September 30, 2003 and for the nine-month periods then ended. This review was performed by management with information available as at October 26, 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 products 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 products at various stages of development, including four in clinical development. Our lead product is a once-daily formulation of tramadol, a currently available analgesic for moderate to moderately severe pain. In Europe, on September 16, 2004, our once-daily tramadol product was on the agenda of the meeting of the panel (similar to an FDA Advisory Panel in the U.S.) that makes recommendations regarding the approval of products to the Marketing Authorization (MA) Commission. The MA commission should render a formal decision during the fourth quarter. In the United States, we have initiated a third Phase III clinical trial for our once-daily formulation of tramadol to support a New Drug Application (NDA) to the U.S. Food and Drug Administration (FDA). Enrolment in the trial (MDT3-005) began subsequent to quarter end.

All but one of our existing products 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. We are also developing novel polymeric nano-delivery systems for delivery of water-insoluble and poorly bio-available drugs.

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

Under our current operating plan, we believe that our current cash, cash equivalents, and investments as well as expected milestone payments from existing commercial agreements and letter of intent, should be sufficient to finance our operations and capital needs beyond 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 products. Research collaborations presently exist with Angelini, Medpointe, Debiopharm and Aventis. A research collaboration with Axcan was terminated during the quarter due to the limited potential of the product.

In addition, we also have entered into four distribution and license agreements and one letter of intent in Europe for once-daily tramadol. The latest agreement with HEXAL AG was finalized in September 2004 covering Germany. 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. We are also actively pursuing discussions with potential

marketing partners for once-daily tramadol for those European countries not yet covered as well as for the U.S. and Latin American markets.

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 third quarter of fiscal 2004, research and development expenses declined considerably in comparison to the quarter ended September 30, 2003, due to completion of the two US phase III clinical trials for once-daily tramadol in the first quarter of 2004.

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 \$398,000 for the third 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 nine-month period ended September 30, 2004 amounted to \$1,493,000. 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 third quarter ended September 30, 2004, total revenue, which includes investment income, amounted to \$419,000 compared to \$217,000 for the quarter ended September 30, 2003. Total revenue for the nine-month period ended September 30, 2004 was \$805,000 compared with \$1,202,000 for the corresponding period last year.

Revenue from research and development contracts for the quarter ended September 30, 2004 totalled \$226,000, which was partly derived from our agreement with Debiopharm under which we conduct research on the potential oral delivery of a current intravenous cancer drug using our proprietary polymeric nano-delivery systems technology (previously referred as micelles technology) and partly from our agreement with Gruppo Angelini, under which we are formulating a once-daily version of the anti-depressant trazodone. No revenue was derived from research and development contracts for the corresponding quarter last year. For the nine-month period ended September 30, 2004, revenue from these research and development agreements generated \$388,000 compared with \$600,000 for the corresponding period last year. Revenue from research and development contracts for the nine-month period ended September 30, 2003 was generated entirely from our agreement with MedPointe for progress made on the formulation of DDS-2001.

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. During the quarter ended September 30, 2003 we recognized \$8,000 of licensing revenue. For the nine-month period ended September 30, 2004, licensing revenues amounted to \$36,000 compared with \$8,000 for the corresponding period last year.

Investment income for the quarter ended September 30, 2004 was \$181,000 compared with \$209,000 for the quarter ended September 30, 2003. The decrease results from lower rates of return on invested funds caused by a general decrease in market interest rates. For the nine-month period ended September 30, 2004, investment income totalled \$381,000 compared with \$594,000 in the corresponding period last year. 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 third quarter ended September 30, 2004 were \$3,265,000 compared with \$5,755,000 for the quarter ended September 30, 2003, a decrease of \$2,490,000. Approximately \$2.1 million of research and development costs, before tax credits, expensed during the quarter ended September 30, 2004 were related to the continued development of our once-daily tramadol product, compared to approximately \$4.8 million in the corresponding quarter last year. The decrease in the current quarter is attributable to the timing and the cost of our clinical trial program for our once-daily tramadol product. In addition, development programs for a controlled-release formulation of gabapentin and once-daily formulation of oxybutynin were scaled back as we decided to focus our development efforts on the products with the shortest timelines to commercialization. An amount of \$163,000 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 nine-month period ended September 30, 2004, research and development expenses totalled \$10,357,000 compared to \$19,053,000 for the corresponding period last year. The decrease is primarily the result of the timing and costs related to clinical trials.

Research and development expenses should increase in the next few quarters compared to the quarter ended September 30, 2004, as the enrolment in the additional Phase III clinical trial for our once-daily formulation of tramadol will begin in Canada and in the US, and as we complete the scale-up of our manufacturing process at third-party sites in preparation for commercial launch. However, it is difficult 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 September 30, 2004 were \$2,423,000 compared to

\$1,734,000 for quarter ended September 30, 2003. The increase versus the corresponding quarter last year is mainly attributable to the expensing of non-cash stock-based compensation of which \$235,000 was included in selling, general and administrative expenses. Expenses also increased with respect to increased headcount, insurance costs, capital tax and the costs of our European operations as we prepare for global commercialization of once-daily tramadol. Selling, general and administrative expenses for the nine-month period ended September 30, 2004 were \$9,040,000 compared with \$5,370,000 for the nine-month period ended September 30, 2003. The increase is due primarily to non-recurring financing costs of approximately \$1.6 millions that were expensed in the period, the expensing of non-cash stock-based compensation of which \$1,004,000 was included in selling, general and administrative expenses and the general increase in overhead as we prepare for global commercialization.

Depreciation and Amortization and Interest Expense

For the quarter ended September 30, 2004, there were no significant changes in depreciation and amortization expense and interest expense compared to the quarter ended September 30, 2003.

Net Loss

Net loss for the quarter ended September 30, 2004 was \$5,895,000, or \$0.14 per share, compared with \$7,889,000, or \$0.22 per share, for the quarter ended September 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 \$398,000 for the current quarter and an increase in selling, general and administrative expenses, as described previously. For the nine-month period ended September 30, 2004, net loss was \$20,548,000, or \$0.53 per share, compared with \$24,533,000 or \$0.76 per share for the corresponding period last year.

QUARTERLY INFORMATION

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							
	Sept. 30, 2004	June 30, 2004	March 31, 2004	Dec. 31, 2003	Sept. 30, 2003	June 30, 2003	March 31, 2003	Nov. 30, 2002
Revenue	419	187	199	212	217	678	306	1,007
Net loss	(5,895)	(7,084)	(7,569)	(9,388)	(7,889)	(8,827)	(7,817)	(4,212)
Basic and diluted net loss per share	(0.14)	(0.18)	(0.21)	(0.27)	(0.22)	(0.28)	(0.25)	(0.14)

LIQUIDITY AND CAPITAL RESOURCES

As at September 30, 2004, working capital was \$25,612,000. 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 beyond the next twelve months.

Funds applied to operating activities in the quarter ended September 30, 2004 amounted to \$4,696,000 compared to \$9,510,000 for the corresponding quarter last year, and were used primarily to develop our in-house product portfolio. For the nine-month period ended September 30, 2004 funds applied to operating activities were \$19,892,000 compared to \$22,281,000 for the corresponding period last year.

Funds provided from investing activities for the quarter ended September 30, 2004 amounted to \$5,979,000 compared to funds applied to investing activities of \$3,227,000 for the quarter ended September 30, 2003. Capital expenditures for the quarter were \$245,000 compared to \$431,000 for the quarter ended September 30, 2003. Capital expenditures for the third 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. Investment activities also include the purchase and disposal of marketable securities as we invest our excess liquidity generated from previous financings, according to our investment policy.

Funds applied to financing activities amounted to \$70,000 for the quarter ended September 30, 2004 as compared to funds provided from financing activities of \$21,887,000 for the corresponding quarter last year. The funds applied to financing activities for the current quarter represent the repayment of the capital lease obligations and the issuance costs of capital stock. Funds provided from financing activities for the corresponding quarter last year were primarily derived from the net proceeds of \$21,826,000 generated from the financing completed July 15, 2003. Funds provided from financing activities amounted to \$28,454,000 for the nine-month period ended September 30, 2004 as compared to \$22,077,000 for the corresponding period last year reflecting primarily the equity financing completed in both periods.

Accounts receivable totalled \$2,016,000 as at September 30, 2004 and included primarily the up-front fee under the terms of the distribution and licensing agreement with HEXAL AG of \$1,409,000. The balance is composed of 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 \$3,505,000 as at September 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 \$2,343,000 as at September 30, 2004 and represented the portion of the payments

from HEXAL AG, 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 \$114,000 to \$6,101,000 as at September 30, 2004, primarily as a result of payments made since December 31, 2003.

Cash and cash equivalents, investments and accrued interest on investments totalled \$28,559,000 as at September 30, 2004 compared to \$20,851,000 as at December 31, 2003, a \$7,708,000 increase, primarily as a result of funds generated by the May 26, 2004 equity 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 September 30, 2004, our unrestricted cash was invested in fifteen governmental agencies and five major Canadian companies, including three chartered banks, in amounts ranging from \$410,000 to \$2,500,000.

OUTSTANDING SHARE DATA

The numbers of common shares and options outstanding as of October 26, 2004 are 42,490,530 and 3,377,275 respectively and has not changed since September 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 September 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.

[signed]

James R. Howard-Tripp
President and Chief Executive Officer
October 26, 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 September 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.

[signed]

Warren Whitehead
Chief Financial Officer
October 26, 2004

Consolidated Statements of Loss

[Unaudited]

For periods of:	Three months ended		Nine months ended	
	Sept. 30, 2004	Sept. 30, 2003	Sept. 30, 2004	Sept. 30, 2003
[Thousands of dollars, except share and per share amounts]	\$	\$	\$	\$
REVENUE				
Research and development	226	—	388	600
Licensing	12	8	36	8
Investment income	181	209	381	594
	419	217	805	1,202
EXPENSES				
Research and development expenses, net [note 4]	3,265	5,755	10,357	19,053
Selling, general and administrative expenses	2,423	1,734	9,040	5,370
Depreciation and amortization	387	410	1,223	914
Foreign exchange (gain) loss	9	(8)	48	29
Interest expense	220	212	644	358
	6,304	8,103	21,312	25,724
LOSS BEFORE INCOME TAXES	(5,885)	(7,886)	(20,507)	(24,522)
Income taxes:				
Current	10	3	41	11
NET LOSS FOR THE PERIOD	(5,895)	(7,889)	(20,548)	(24,533)
NET LOSS PER SHARE — BASIC AND DILUTED	(0.14)	(0.22)	(0.53)	(0.76)
Weighted average number of common shares outstanding	42,489,682	35,070,373	39,111,305	32,420,480

See accompanying notes.

Consolidated Statements of Cash Flows

[Unaudited]

For periods of:	Three months ended		Nine months ended	
	Sept. 30, 2004	Sept. 30, 2003	Sept. 30, 2004	Sept. 30, 2003
[Thousands of dollars]	\$	\$	\$	\$
OPERATING ACTIVITIES				
Net loss for the period	(5,895)	(7,889)	(20,548)	(24,533)
Items not affecting cash				
Depreciation of property, plant and equipment	381	334	1,119	721
Amortization of intangible assets	6	76	104	193
Stock-based compensation	398	—	1,493	—
	(5,110)	(7,479)	(17,832)	(23,619)
Net change in non-cash operating items	414	(2,031)	(2,060)	1,338
	(4,696)	(9,510)	(19,892)	(22,281)
INVESTING ACTIVITIES				
Acquisition of investments	(3,013)	(18,074)	(34,944)	(20,846)
Disposals of investments	1,220	3,705	4,341	18,330
Maturities of investments	8,017	11,573	24,074	15,189
Acquisition of property, plant and equipment	(222)	(333)	(820)	(3,251)
Acquisition of intangible assets	(23)	(98)	(74)	(188)
	5,979	(3,227)	(7,423)	9,234
FINANCING ACTIVITIES				
Repayment of capital leases obligations	(43)	(74)	(127)	(101)
Proceeds from issuance of capital stock	4	23,336	30,777	23,553
Issuance costs of capital stock	(31)	(1,375)	(2,196)	(1,375)
	(70)	21,887	28,454	22,077
INCREASE IN CASH AND CASH EQUIVALENTS	1,213	9,150	1,139	9,030
Cash and cash equivalents, beginning of period	646	1,598	720	1,718
CASH AND CASH EQUIVALENTS, END OF PERIOD	1,859	10,748	1,859	10,748

See accompanying notes.

Consolidated Balance Sheets

[Unaudited]

	As at Sept. 30, 2004	As at Dec. 31, 2003
	\$	\$
[Thousands of dollars]		
ASSETS		
Current		
Cash and cash equivalents	1,859	720
Short-term investments	25,259	18,727
Accounts receivable	2,016	1,295
Research and development tax credits receivable	454	900
Prepays and other assets	406	337
	29,994	21,979
Long-term investments	1,278	1,281
Property, plant and equipment	11,182	11,468
Intangible assets	1,961	1,991
	44,415	36,719
LIABILITIES		
Current		
Accounts payable and accrued liabilities	3,505	7,087
Current portion of deferred revenue	719	46
Current portion of obligations under capital leases	158	169
	4,382	7,302
Deferred revenue	1,624	431
Obligations under capital leases	5,943	6,046
	11,949	13,779
SHAREHOLDERS' EQUITY		
Capital stock [note 5]	132,622	104,035
Contributed surplus	4,463	—
Deficit	(104,619)	(81,095)
	32,466	22,940
	44,415	36,719

See accompanying notes.

Consolidated Statements of Deficit

[Unaudited]

For periods of nine months ended:	Sept. 30, 2004	Sept. 30, 2003
[Thousands of dollars]	\$	\$
		[restated - note 3c]
BALANCE, beginning of period [as previously reported]	—	(54,760)
Adjustment for change in accounting policy [note 3c]	—	7,586
BALANCE, beginning of period [adjusted]	(81,095)	(47,174)
Adjustment for change in accounting policy [note 3a]	(2,976)	—
Net loss	(20,548)	(24,533)
BALANCE, end of period	(104,619)	(71,707)

See accompanying notes.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS [UNAUDITED]

As at September 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. 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. During this period, the Company expects to receive regulatory approval in Europe which will allow it to receive additional milestone payments and 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 \$398 for the three-month period ended September 30, 2004, of which \$163 were included in research and development expenses and of which \$235 were included in selling, general and administrative expenses. The compensation expense for the nine-month period ended September 30, 2004 was \$1,493 of which \$489 were included in research and development expenses and of which \$1,004 were included in 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.

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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS [UNAUDITED]

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

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

Note 4

RESEARCH AND DEVELOPMENT EXPENSES

Research and development expenses are presented net of tax credits of \$567 and \$655 for the nine-month periods ended September 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

42,490,530 common shares [December 31, 2003 – 35,995,581]

Capital Stock Transactions

During the nine-month period ended September 30, 2004, 192,500 [2003 – 135,450] options were exercised for a total cash consideration of \$418 [2003 – \$353]. In addition, capital stock was increased by \$6 [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 \$2,196.

Warrants

During the nine-month period ended September 30, 2004, 180,000 warrants were exercised for a total of 180,000 shares for a total cash consideration of \$360. As of September 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 nine-month period ended September 30, 2004, are as follows:

	#	\$
Balance, beginning of period	3,415,025	4.87
Granted	178,300	4.79
Exercised	(192,500)	2.17
Forfeited	(23,550)	7.59
Balance, end of period	3,377,275	5.01
Options eligible to be exercised	2,638,950	4.70

A compensation expense of \$1,493 has been recognized during the nine-month period ended September 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 nine-month periods ended September 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 nine-month periods ended	
	Sept. 30, 2004	Sept. 30, 2003
Expected volatility	0.72	0.92
Expected life	4.0 years	4.0 years
Risk-free interest rate	3.64%	4.0%
Dividend yield	Nil	Nil

The weighted average fair value of stock options granted during the nine-month period ended September 30, 2004 using the above assumptions amounted to \$2.71 [2003 – \$2.86].

No compensation expense has been recognized during the nine-month period ended September 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 nine-month period ended September 30, 2003, the Company's stock compensation

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS [UNAUDITED]

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

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 Sept. 30, 2003 \$	Nine-month period ended Sept. 30, 2003 \$
Stock compensation expense	176	1,031
Pro forma net loss	(8,065)	(25,564)
Pro forma basic and diluted loss per share	(0.23)	(0.79)

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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