



The Perfect Fit.

# A Pivotal Year

The year 2006 saw LAB International attain a long sought goal. Having divested our contract research organization while establishing through acquisition a major analytical, formulation, development and manufacturing presence in the United States, LAB is now firmly established as a focused integrated product development organization. That means our exclusive focus from now on is the development and commercialization of innovative drugs and reformulated products. The Company's expertise and proprietary delivery platforms in dry powder inhalation technology – and more recently abuse deterrent and transmucosal platforms following the PharmaForm acquisition – have already made us an acknowledged leader in these respective fields. Two of our lead compounds, addressing the unmet needs of large patient populations, have advanced steadily to the later stages of the clinical trial process. Their progress and promise have rendered massive the near term value creation potential of the Company.

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# LAB International Profile

## Inhaled Therapeutics for Huge Patient Populations

**LAB International** (LAB) is a well capitalized product development organization engaged in developing and manufacturing innovative drugs for multi-billion dollar markets. The Company is addressing unmet medical needs with unique dosage forms of existing drugs, as well as with new compounds. Its pipeline advancement has consistently met expectations and has reached later stage clinical status with two novel therapeutics. At the same time, the Company has staked a leadership position with its patented dry powder drug delivery platform. Two of LAB's lead compounds are administered through inhalation, and have clinically demonstrated exciting potential to provide unique relief to millions of people suffering from cancer pain and asthma.

**Inhalation Opportunity:** A new era of delivery of drugs through the lungs for the treatment of diseases that are not lung-involved has commenced. Dry powder inhalable drug formulations for systemic delivery, activated deep in the lungs, promise powerful efficiencies for treatment of a wide variety of conditions. Their simplicity of use and swift onset of action provides significant patient benefit, and also promise major costs savings for the healthcare system as a whole. LAB's inventive technologies and drugs are forerunners in the inhalation field and promise to command a major role in this important therapeutic evolution.

**Inhalation Platforms:** LAB's TAIFUN® dry powder inhaler device, resulting from many years of development and major capital investment, is proprietary and protected by a strong network of patents. It contains a first-in-class moisture-balancing reservoir with precise and reproducible dose metering. Having obtained regulatory approval, it has also been peer reviewed and is widely acknowledged as state-of-the-art. In and of itself our TAIFUN® inhaler device represents a major asset, and LAB may choose to realize additional value creation by licensing the platform technology to other drug developers.

**Giant Market Prospects:** The two lead compounds in LAB's pipeline, and their steady advancement through clinical trials, have globally positioned the Company at the head of the class in terms of addressing their respective targeted conditions. LAB's closest product to market is Fentanyl TAIFUN®, a treatment for breakthrough cancer pain. Clinically shown to effectively reduce pain with significantly greater rapidity than the product currently used by most cancer patients, Fentanyl TAIFUN® is entering the final stage of clinical trials and is expected to earn a healthy share of a market in excess of US\$1 billion. LAB's second lead compound, LAB CGRP, represents a ground-breaking potential new treatment for asthma. Unlike any available therapeutic for asthma sufferers, LAB CGRP may soon offer them unique hybrid relief; the drug has been shown in pre-clinical animal models to combine broncho-dilatory and broncho-protective properties with anti-inflammatory effect. With a successful first Phase II efficacy trial behind it, and additional trials ongoing, LAB CGRP could attract a lucrative partnership transaction in the near term and a major share of the US\$15 billion anti-asthma market in the mid- and long term. LAB GHRH, a potential treatment for malnutrition in chronic renal failure patients, showed a marked ability to stimulate growth hormone secretion in a Phase I/II clinical trial. If efficacy is confirmed in its current Phase II trial, LAB GHRH could quickly find a development and marketing partner to address a market that exceeds US\$1 billion.

# LAB International Highlights

## Significant Events 2006

January

LAB International ("LAB") and Teikoku Seiyaku of Japan entered into a licensing and development agreement for Fentanyl TAIFUN<sup>®</sup> for the Japanese market.

LAB announced the final and complete safety, tolerability and pharmacokinetic results from the Phase I trial for its novel asthma product, LAB CGRP (Calcitonin Gene Related Peptide). LAB CGRP was demonstrated to be safe with no serious adverse events reported at all doses tested.

April

LAB completed patient enrollment for the Phase IIa trial of its lead product, Fentanyl TAIFUN<sup>®</sup>, investigating efficacy and safety for the treatment of breakthrough cancer pain

LAB enrolled the first patient in its LAB CGRP Phase IIa trial, designed to investigate the protective efficacy of LAB CGRP on patients with mild to moderate asthma, and to evaluate the safety and tolerability of LAB CGRP in asthma patients.

May

LAB announced that its wholly owned subsidiary, LAB Research, filed a preliminary prospectus with the applicable securities regulatory authorities in each of the provinces in Canada for an initial public offering of its common shares.

June

LAB enrolled the first patients for its Fentanyl TAIFUN<sup>®</sup> Phase IIb clinical trial, designed to teach LAB more about titration patterns leading to an optimal dose in the treatment of breakthrough cancer pain.

July

LAB announced positive results for the first Phase II trial of Fentanyl TAIFUN<sup>®</sup> in the treatment of breakthrough cancer pain. The results supported clinical efficacy at the lowest dose of 100 µg, and a trend of dose response relationship. The safety of Fentanyl TAIFUN<sup>®</sup> was similar to that of placebo, with the exception of an increase in mild to moderate somnolence.

LAB Research Inc. filed a final prospectus in connection with the initial public offering of its common shares, qualifying a total of 10,000,000 common shares including 6,250,000 common shares to be sold by LAB International at a price per share of \$4.00, for total gross proceeds to LAB International of \$25 million.

LAB Research Inc. closed the initial public offering of its common shares, selling a total of 6,250,000 common shares at a price per share of \$4.00 for total gross proceeds of \$25,000,000.

LAB completed patient enrollment in its LAB CGRP Phase IIa trial. No serious adverse events were reported in any of the patients dosed.

**August**

LAB closed the over-allotment option exercised by the syndicate of underwriters for the initial public offering of its former subsidiary LAB Research Inc. ("LRI"). The over-allotment option provided for the purchase of an additional 1,500,000 common shares of LRI at a price of \$4.00 per share for aggregate gross proceeds to LAB of \$6.0 million.

**September**

LAB announced positive results from the first Phase II clinical trial of its LAB CGRP product. LAB CGRP showed statistically significant broncho-protective effects compared to placebo and a similar safety profile to placebo except for transient and mild headaches and flushing in some of the patients. This trial demonstrated for the first time in human asthmatics the bronchodilatory efficacy of CGRP.

**October**

LAB signed a non-binding letter of intent to acquire all of the outstanding membership interests of PharmaForm L.L.C., a privately held specialty pharmaceutical and drug development company headquartered in Austin, Texas. PharmaForm operates a DEA and FDA registered Pharma contract manufacturing business, and its proprietary platform technologies include alternate delivery mechanisms for narcotics and products entering clinical trial stages.

LAB announced the closing of a "bought deal" private placement entered into with Desjardins Securities Inc. of 6,392,857 special warrants at \$4.05 per special warrant for gross proceeds of \$25,891,070 regarding its residual ownership position in LAB Research.

**November**

LAB closed the definitive Purchase and Sale Agreement for the acquisition of all the outstanding membership interests of PharmaForm.

**Immediately  
subsequent  
to year end**

# Dear Shareholders

**In the evolution** of LAB International, 2006 represented a major step forward. Advancing our lead compounds through clinical trials created substantial value. The corporate side saw two key events taking place: the first being a divestment, the second, an acquisition of the highest strategic importance. Both of these define our mission as a Company and the immense near term potential of our candidate drugs.

Our prime objective: To become a focused integrated Product Development Organization for Pain and CNS medicaments is practically reached. Concentrating exclusively upon the development and commercialization of novel therapeutics and reformulated products, we are targeting the unmet needs of large patient populations. We are certain; this orientation will prove tremendously rewarding for our shareholders in the near future.



The divestment of our Contract Research Organization (CRO), LAB Research, was an event long anticipated. We had built the CRO to a highly marketable critical mass, and then realized the enterprise value, once our drug development program reached later stage status.

The strategy has been vindicated. The initial public offering of LAB Research was one of the most successful in its sector in Canada in the last few years. We divested our ownership position in the organization and received total gross proceeds in excess of \$56 million. We do maintain a preferred supplier relationship with our former subsidiary and wish them luck for the future.

The event signalled LAB's undivided focus on drug development. Subsequent to year end, the closing of the PharmaForm acquisition, based in Austin, Texas, represented a major substantiation of the same commitment. The acquisition has not only contributed directly to our strategy of becoming an integrated Product Development Organization and leader in pain management, it has also given us a substantial U.S. presence.

PharmaForm's proprietary platforms are of enormous value. EDACS®, the abuse deterrent platform cannot be valued high enough, complementing LAB's inhalative platform TAIFUN®. It will provide us with NDA-stage products at the time of regulatory approval of Fentanyl TAIFUN®. Moreover, PharmaForm is a leading provider of innovative technologies in formulation and manufacturing. It has grown rapidly and profitably in its decade of existence, while earning reputation as a market leader.

Also of highest importance for the future, our Austin facility is also registered by DEA and FDA for formulation, importation and manufacturing of controlled substances. This will ensure US-based production for our lead compound Fentanyl TAIFUN®, and also leverage synergies. Austin will be the centre-point of our development and manufacturing operations. We do recognize the U.S. market as being of the utmost importance to LAB. Our presence in Austin will maximize our potential in that regard.

## Milestone Progress in Clinical Trials

The year 2006 saw significant advances for two of our lead compounds in clinical trials, while enrollment of patients in a pilot Phase II study for our third compound, GHRH, continued. We reported exciting Phase IIa-results from our lead product, Fentanyl TAIFUN®, targeting breakthrough cancer pain. We announced key results from the first Phase II trial of LAB CGRP, our innovative anti-asthmatic drug.

LAB's focus on pulmonary administration of its lead compounds is now recognized as a tremendously efficient mechanism for systemic delivery of drugs, and our proprietary platform technology makes LAB a forerunner in the field.

**Fentanyl TAIFUN®** is a dry powder inhalation formulation of a proven drug. The findings of our Phase IIa trial demonstrate superior clinical efficacy to marketed products and confirm the outstanding safety profile: Our product provides an extremely rapid pain relief comparable to intra-venous injection, combined with a safety profile not different from placebo. The significance of this accomplishment cannot be overstated. Fentanyl TAIFUN® addresses a market of over US\$1 billion. We have licensed our product for the Japanese market and are in serious late stage negotiations for other territories.

Our ongoing Phase IIb trial for Fentanyl TAIFUN® will provide important additional information to optimize the dosage regimen. We expect to initiate Phase III by the end of 2007.

**LAB CGRP** moved closer to fulfillment of its promises to be an ideal anti-asthmatic with bronchodilative, bronchoprotective and anti-inflammatory properties. Early in the year the drug's final Phase I trial results were announced, demonstrating safety with no serious adverse events reported.

Later in the year, we announced positive results from our first Phase IIa trial. LAB CGRP showed statistically significant broncho-protective efficacy – a milestone accomplishment.

We are now preparing additional studies to explore dose optimization and anti-inflammatory properties of LAB CGRP and report results by year end. If indeed LAB CGRP demonstrates an anti-inflammatory effect in addition to its broncho-dilatory properties, it has the ability to become a true block-buster drug.

**LAB GHRH's** pilot Phase IIa results may be available at the time this annual report is printed. LAB GHRH targets malnutrition in chronic renal failure, as well as other growth hormone deficiencies and wasting. The Company anticipates that the trial will demonstrate the ability of LAB GHRH to effect an increase in growth hormone secretion levels as well as other surrogate markers such as IGF-1, and to effect improvement in biochemical indicators of the nutritional and metabolic state. Such results would confirm the compound's strong potency demonstrated in earlier clinical trials.

**In summary:** We are moving constantly and unquestionably forward towards our goal. With sufficient funds already at our disposal, we expect to report at least one major partnering event, with very significant revenue implications, before the end of 2007.

The credit for LAB's progress belongs as always to our dedicated team. I thank our scientists for their innovation and commitment; our Board of Directors for their acumen and judgment; and our support staff for their professionalism and constancy. Not least, I wish to express gratitude to you, the shareholders, for your trust. I have every expectation that your support will be repaid substantially in the pivotal year ahead.

Sincerely,



**Halvor Jaeger**, M.D., F.C.P.  
Chief Executive Officer

“ The sale of our wholly owned contract research organization exemplified LAB's move to become a focused integrated product development organization, and the acquisition of PharmaForm emphasized and confirmed the transition. Going forward, the integrated capabilities of LAB and PharmaForm will serve to highlight our exclusive focus on drug development – and accelerate commercialization of our product candidates. ”

# LAB's Value Drivers

## Targeting cancer pain: Fentanyl TAIFUN®

Cancer patients, particularly those at end stage, suffer from continuous pain for which they are prescribed a variety of medications. At present, however, when their pain reaches its highest intensity, i.e., when their pain overwhelms the relief offered by their regular medication and they suffer what is known as “breakthrough cancer pain” (BCPT), only a few self-administered options are available that provide significant relief within twenty to forty minutes. One is a medicated lozenge on a stick, and another is a fast-melt buccal tablet. Cancer patients desperately require a faster self-administered analgesic. The demonstrated rapid onset of action of LAB’s inhaled Fentanyl TAIFUN® shows imminent promise of fulfilling that requirement.

Fentanyl is an established drug; it has been marketed worldwide for a number of years and its effectiveness is long proven. LAB’s Fentanyl TAIFUN® is a novel formulation of this powerful painkiller. It comes in the form of a dry powder which is administered through our patented and regulatory approved inhaler platform, using activation within the lungs for systemic delivery of its analgesic property. The patient afflicted with BCPT can immediately reach for this painkiller, and inhale it. Demonstrated clinically to reduce pain within five to nine minutes, LAB’s Fentanyl TAIFUN® enjoys a major competitive advantage. It provides the fastest non-injected time to relief. Injection most often requires skilled assistance, and is therefore more time-consuming; it is a method only rarely self-administered. Inhalation is also less painful than injection – it represents a clearly superior alternative for cancer patients. Fentanyl TAIFUN® could become the standard of care for BTCP, and a potential blockbuster revenue producer for LAB in the US\$1 billion-plus BTCP market.

## Targeting asthma: LAB CGRP

Calcitonin Gene Related Peptide (CGRP) is a natural neuropeptide produced in the lungs after an asthma attack. As a potential therapeutic, LAB CGRP demonstrated in preclinical studies a profile that could make it an ideal anti-asthmatic drug candidate with bronchodilator, bronchoprotector and anti-inflammatory properties. Showing such effects in patients would represent a revolutionary benefit over the usual combination asthma therapies. With LAB CGRP, a hybrid drug delivered directly to the lungs, LAB has taken giant steps toward demonstrating precisely the desired effects.

Our Phase I clinical trial demonstrated a well tolerated compound with an excellent safety profile. No serious adverse events were reported. The compound then completed a Phase IIa trial which showed statistically significant broncho-protective efficacy, while confirming non-toxicity. The compound’s safety profile was found similar to placebo. LAB CGRP’s Phase IIb trial, underway as this Report goes to press, was designed to test the compound’s anti-inflammatory properties. Anti-inflammatory data will form the decisive key that opens the door to enormous commercial opportunity. LAB CGRP promises to be positioned as a supremely convenient and faster-onset alternative to existing combination therapies, and adopted for use in both prevention and treatment of severe asthma. Very few pharmaceutical categories match the size of the anti-asthmatic opportunity. Should all anti-asthmatic properties be demonstrated in LAB CGRP, we have tremendous confidence in its potential to capture a major share of a market that exceeds US\$15 billion.

## Targeting malnutrition: LAB GHRH

Some 400,000 patients in the United States alone are in late pre-dialysis chronic renal failure (CRF). Approximately half of these patients also suffer from malnutrition, and very few effective options exist to provide them with symptomatic relief. LAB’s peptide analogue of the Growth Hormone Releasing Hormone (LAB GHRH) demonstrated a potent ability in a Phase I/II clinical trial to stimulate growth hormone secretion, as well as other surrogate markers such as IGF-1. The compound effected a rapid and marked increase in growth hormones at all dosage levels, and no significant safety concerns arose.



## Addressing Multi-Billion Dollar Markets

**Fentanyl TAIFUN®**: first-in-class treatment for breakthrough cancer pain

**LAB CGRP**: unique dual-effect anti-asthmatic therapeutic

**LAB GHRH**: potent drug for malnutrition in chronic renal failure

**Proprietary** inhalation technology platform

**Innovative delivery** platforms and products gained in PharmaForm acquisition

The current Phase II trial is expected to confirm the compound's efficacy in regard to growth hormone secretion levels, and additionally reveal its role in the improvement in biochemical indicators of the nutritional and metabolic state. Proof of efficacy could broaden LAB GHRH's target treatments to include adult muscle wasting, HIV lipodystrophy, and other diseases caused by growth hormone deficiency. Should that potential be realized, the drug could be a major value creator for LAB in a market that has grown to beyond US\$1 billion.

## LAB's world-leading specialty: inhalation technology

Pulmonary systemic delivery, whereby drugs are administered through the lungs to treat diverse diseases and not just lung diseases, is a relatively young science. As an alternative to oral and injectable delivery, inhalation offers numerous advantages. Precedents have only recently been set for regulatory approval of inhaled therapeutics, and the future of the technology appears unconstrained. For investors seeking to identify compelling trends and powerful new dynamics at work within the healthcare industry, this new drug delivery system holds major opportunity in terms of potential reward. At LAB, inhalation technology forms our very foundation; it constitutes our core strategy and drives LAB's development program.

The benefits of inhaling dry powder formulations of drugs point to the tremendous value of the technology. Foremost among the benefits afforded by inhalation is swift absorption of the required drug into the bloodstream. The onset of efficacy is appreciably more rapid compared to oral, transdermal patch or mucosal delivery. Inhalation promises to prove particularly instrumental for peptides, which tend to degrade in the stomach and normally carry much reduced effect through oral delivery. Two of LAB's candidate drugs, LAB CGRP and LAB GHRH, are peptides. Once their efficacy is confirmed, our aim is to develop dry powder formulations that will allow them to be delivered through the lungs. The inhalation procedure, in contrast to injection, is non-invasive and painless. Additionally, inhalation technology allows for novel and flexible dosages. Finally, LAB's proprietary inhalers preclude the need for a nurse or doctor – patients can self-administer their medication – which spells important convenience for patients and long term cost savings for the healthcare system.

## Platforms and products from the PharmaForm acquisition

The technologies and expertise at our new Austin facility, in addition to being synergistic to LAB's current programs, will broaden LAB's mission and pipeline with new platforms and products. We

have a GMP production site in Austin that is focused on novel delivery systems. The manufacturing operations in Austin are licensed by the Food and Drug Administration and the Drug Enforcement Agency, which could prove critical to the success of LAB's Fentanyl TAIFUN®, because fentanyl is a controlled substance. On the innovative product side, a narcotic abuse deterrent formulation is being developed in Austin, as well as other innovative formulations. At least one of these products is expected to enter clinical trials in 2007.



# The Year's Achievements

## Fentanyl TAIFUN®

LAB's Fentanyl TAIFUN® targets breakthrough cancer pain (BTCP). In this market a key consideration determining ultimate competitive advantage is the speed of the drug's onset of action. End stage cancer patients in intense pain currently have no means of very rapidly alleviating their suffering. In 2006, the Phase II clinical trial of Fentanyl TAIFUN® further demonstrated and confirmed that this inhaled therapeutic can be the painkiller they require.

A total of 122 cancer patients on maintenance opioid therapy for persistent pain were enrolled in the Phase IIa trial of Fentanyl TAIFUN®. The analgesic efficacy in the responding patients was very rapid. Results demonstrated significant reductions in pain intensity, as early as within five minutes in some cases, with average time to major pain relief approximately eight minutes in the 100 µg and 400 µg dosage groups. In contrast, the time to relief offered by currently marketed drugs for BTCP varies from twenty to forty minutes.

Fentanyl TAIFUN® provided instantaneous availability of fentanyl in the blood within one minute after inhalation and may provide more rapid pain relief than any existing non-injectable pain medication, as demonstrated by the time to significant pain relief. The speed of analgesia with Fentanyl TAIFUN® approached the theoretical minimum of 3-5 minutes observed with intravenous administration of fentanyl.

The safety of Fentanyl TAIFUN® was demonstrated to be similar to that of placebo, with the exception of an increase in mild to moderate somnolence.

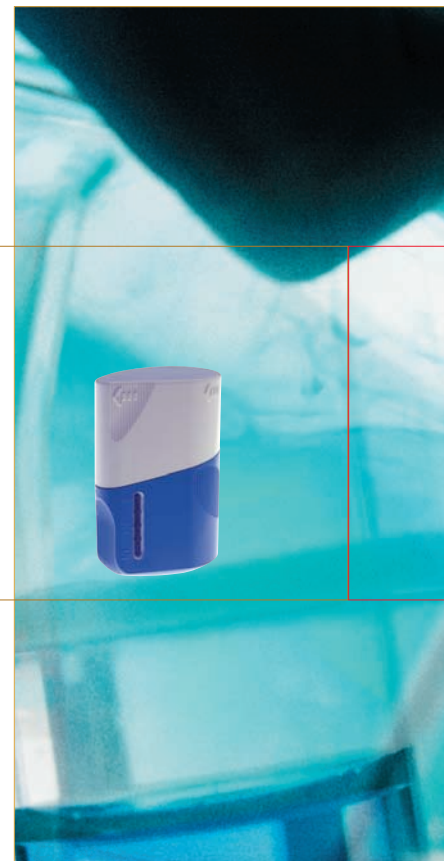
Based on this favorable safety profile and confirmation of clinical activity, LAB is now focused on optimizing the dosage regimen for the Phase III study. The ongoing Phase IIb study is based on individual titration of the dose, starting from a dose of 100µg. The open-label results from the Phase IIb have demonstrated successful titration in all patients treated to a dose of 400µg or less resulting in effective control of breakthrough pain episodes. The patients experienced significant pain relief in 95% of the pain episodes treated with a median time to significant pain relief of 7 minutes. All Fentanyl TAIFUN® doses were well tolerated.

## LAB CGRP

The Company's proprietary 37-amino acid neuropeptide, LAB CGRP, targets asthma. This drug holds promise of delivering a much sought after hybrid effect, which could replace combination therapies with a single treatment. LAB CGRP's pre-clinical profile made it an ideal candidate for that revolutionary role, showing bronchodilator, bronchoprotector and anti-inflammatory properties. The market being pursued by LAB CGRP is enormous; it exceeds US\$15 billion. A conveniently inhaled therapeutic that delivers in one treatment the full range of relief that asthma patients require can be expected to earn a considerable share of that market.

In 2006, the Company moved LAB CGRP closer to commercialization. It reported final findings of the drug's Phase I trial, which showed that LAB CGRP's safety profile is similar to placebo. Importantly, since the drug works directly on the lungs, the study showed that LAB CGRP does not cause dose-limiting side effects.

In the subsequent Phase IIa asthma study, the patients in the trial were randomly administered either a 5 mg dose of LAB CGRP, or salbutamol (an existing medication for asthma), or placebo. The patients were then administered an agent used to identify bronchial hyper-reactivity, namely methacholine. The dose of methacholine was sufficient to diminish forced expiratory volume by 20%.



This trial showed LAB CGRP's efficacy to be superior to placebo, and approached the efficacy of salbutamol. LAB demonstrated for the first time in human asthmatics the bronchodilatory efficacy of CGRP. The successful completion of this first Phase II trial confirming clinical activity allowed the Company to prepare additional studies to explore dose optimization and LAB CGRP's anti-inflammatory properties.

LAB CGRP's Phase IIb trial is in progress at the time of writing. Results are expected by the end of the fourth quarter of 2007, and are being awaited by numerous potential development and marketing multinationals in the pharmaceutical industry.

## LAB GHRH

Subsequent to year end, the Company announced completion of enrollment for LAB GHRH's pivotal Phase II clinical trial targeting malnutrition in chronic renal failure (CRF). Results of the study are expected in May 2007. It is anticipated that the data will confirm efficacy in regard to the compound's ability to stimulate growth hormone production. That important clinical milestone may in turn trigger a partnering alliance for further development (targeting other indications in addition to malnutrition in CRF). The market addressed by LAB GHRH exceeds US\$1 billion.

## PharmaForm acquisition

The addition to LAB of the capabilities and products of PharmaForm in Austin, Texas, represented an important steppingstone for LAB, and a key indicator of our orientation as a specialty pharma company. This acquisition is not only highly synergistic to LAB's development pipeline, but a major supplement to our abilities and mission.

As a GMP manufacturing site registered with both the Food and Drug Administration and Drug Enforcement Agency in the U.S., the acquisition will have immediately positive bearing upon the clinical development and eventual production of LAB's Fentanyl TAIFUN®. The highly regarded scientists and professionals of our new Austin facility are formulation specialists and creators of unique and proven transdermal and transmucosal delivery systems. They will contribute greatly to LAB's continuing product innovation and accelerated product commercialization.

Perhaps most significantly, our Austin laboratories bring outstanding product prospects to LAB's pipeline. Included among them are an abuse deterrent formulation that is increasingly called for by government authorities, and which could be fast-tracked through the regulatory process. Other compounds are also in development, and announcements will be made in 2007 concerning their targets and development time-lines.



# Acquisition of PharmaForm LLC

The acquisition of PharmaForm, a private company based in Austin, Texas, has brought LAB significant new abilities directly related to our existing programs, as well as valuable platforms and products to broaden our pipeline. At the same time it has elevated LAB's profile in the world's most important pharmaceutical and investment marketplace.

**FDA and DEA Accredited:** As a facility certified by both the Food and Drug Administration (FDA) and Drug Enforcement Agency (DEA) in the U.S., our new Austin arm will meet two important requirements related to the eventual production of our lead product, Fentanyl TAIFUN®. On one hand it will act as a manufacturing site fully compliant with FDA regulations, and on the other as a facility licensed by the DEA to work with controlled substances.

**WideRanging Clientele:** Our Austin facility has earned international reputation for delivering unique solutions to challenging problems in pharmaceutical product development, manufacturing, and analytical services. Its clients have been drawn from the full range of players in the pharmaceutical and biotechnology industries, from small virtual companies to giant multinationals.

**Commercialization Specialists:** Our Austin facility has gained a particular reputation for providing assistance throughout the process of creating therapeutics, with the aim of enabling and accelerating commercialization. It provides services such as analytical testing to find new uses for chemical compounds, and offers patented transdermal and transmucosal delivery systems that can be applied to many drug candidates and product applications. For example, PharmaForm's professionals in Austin specialize in taking a novel molecule and rendering it into a skin cream, an injectable liquid, an eyedrop, or a suppository. They identify

dosage forms, and undertake the documentation work for regulatory filings. In addition, our Austin facility offers private-label and contract packaging, blending and filling services.

**Manufacturing Expertise:** As a novel chemical entity moves toward commercialization, Phase III batches of the compound must be produced in identical fashion to how it will be manufactured commercially. Our Austin site's technical expertise focuses on process development, manufacturing scale-up and process validation activities for commercial launch. These are all capabilities vital to LAB's development agenda, while they also generate top and bottom line enhancements to our revenue.

**Deepening LAB's Pipeline:** Our Austin acquisition has brought a long history of know-how and exciting new potential to LAB's pipeline. Under development in Texas, for instance, is a drug abuse deterrent formulation that we regard as state-of-the-art. The formulation addresses a problem that is growing worldwide, namely the abuse of prescription narcotics. Although the ability



ENHANCING LAB'S PRODUCTION CAPABILITIES

EXPANDING LAB'S PIPELINE

ENTRENCHING LAB'S U.S. PRESENCE



to prevent abuse of controlled substances represents a major commercial opportunity, the technologies under development to address it remain limited. We anticipate introducing our technology shortly, and we expect that it will place LAB at the forefront of an important new category in pharmaceutical marketing. We also expect that regulatory authorities will regard such a product with exceptional favour.



**Essential American Presence:** Ultimately, one of the greatest advantages to LAB of our facility in Austin will derive from the fact that it is located in the United States. The importance of establishing a resident profile in the U.S. cannot be over-emphasized. The American market is the world's largest for our products. Heightened visibility on the radar screens of the American investment community holds promise of exerting significant influence on how rapidly and effectively we bring those products to market.

## Management

	<b>Dr. Halvor Jaeger</b> M.D., F.C.P. Chief Executive Officer		<b>Dr. Taneli Jouhikainen</b> M.D., Ph.D., MBA Vice President Corporate Development		<b>Frédéric Dumais</b> Bcom, LLB. Vice President Investor Relations	
	<b>Andrew Reiter, CA</b> Chief Financial Officer		<b>Dr. Josef Bossart</b> Senior Vice President Business Development		<b>Dr. Roman Denk</b> Vice President, Corporate Support	

## Board of Directors

	<b>Dr. Günter Knorr</b> Chairman Partner Knorr Rechtsanwälte AG		<b>Dr. Hans Rainer Hoffmann</b> President LTS Lohmann Therapy Systems AG,		<b>Dr. Maurice St-Jacques</b> Professor University of Montreal	
	<b>Dr. Halvor Jaeger</b> M.D., F.C.P. Chief Executive Officer		<b>Jean-Marie Pomerleau, CA</b> EIC Partner Demers Beaulne, LLP		<b>Keijo Vakiparta</b> M.Sc., MBA Partner and Investment Director Bio Fund Management Ltd.	
	<b>Dr. Peter Barrett</b> Senior Partner, Atlas Venture LLC		<b>Dr. Robert O. (Bill) Williams III, Ph.D.</b> Johnson & Johnson Centennial Professor College of Pharmacy University of Texas at Austin Director LAB International, Inc		<b>Rolf K. Reininghaus</b> Business Development Consultant	

# Management's discussion and analysis of the financial condition and results of operations

The statements contained in the following Management's Discussion and Analysis of Financial Condition and Results of Operations of LAB International Inc. ("LAB" or the "Company"), other than statements of fact that are independently verifiable at the date hereof, may be forward-looking statements regarding the industry in which LAB operates and the Company's expectations as to its future performance, liquidity and capital resources. Forward-looking statements look into the future and may include such words as "plans", "trends", "anticipates", "should", "estimates", "expects", "believes", "indicates", "targeting", "suggests" and similar expressions. This MD&A contains forward-looking statements about LAB's objectives, strategies and financial condition, as well as statements with respect to our beliefs, expectations, estimations and intentions. These "forward-looking" statements are based on current expectations and various factors and assumptions. Accordingly, these statements entail various risks both known and unknown, including those set forth in the "Risks and Uncertainties" section of this document. Consequently, actual future results may differ materially from the anticipated results expressed in the forward-looking statements. It is important to note that, unless otherwise indicated, forward-looking statements in this MD&A describe our expectations as of March 13, 2007. We assume no obligation to update or revise any forward-looking statement, whether as a result of new information, future events or for any other reason.

This analysis explains the material variations in the consolidated statements of operations, financial position and cash flows of LAB for the three and twelve -month periods ended December 31, 2006 and the three and twelve-month periods ended December 31, 2005.

This document should be read in conjunction with the audited consolidated financial statements of LAB and related notes included therein which have been prepared in accordance with Canadian Generally Accepted Accounting Principles ("GAAP") for the years ended December 31, 2006 and December 31, 2005. All amounts are presented in thousands of Canadian dollars unless otherwise indicated.

## Background

LAB is an integrated product development company that has historically operated as two distinct business units: LAB Pharma, a product development organization focused primarily on the development of novel therapeutics for the inhalation market; and LAB Research, a contract research organization that provided research services to the pharmaceutical and biotechnology industry. The Company's business model was established to enable it to benefit from the synergy of combining a profitable proprietary contract research organization with operations in North America and Europe with a pharmaceutical product development organization. The business model was to use the cash flow generated by LAB Research as a non-dilutive source of capital to fund the product research and development of LAB Pharma.

By early 2006, management had become increasingly concerned that the combination of the LAB Research and LAB Pharma businesses within one entity was responsible for two negative consequences. First, it was limiting the ability of the Company to grow the LAB Research business and fully capitalize on the growing demand for pre-clinical contract research services. Second, the business model was not being properly reflected in the market when considering the underlying value of each of the individual businesses and the synergies derived from the dual business model. For these reasons LAB decided to pursue the initial public offering of LAB Research.

## Initial public offering of Lab Research

On May 24, 2006, the Company incorporated a new entity LAB Research Inc. ("LRI") acquired the pre-clinical contract research services business of the Company. These services were conducted by LAB Pre-clinical International Research Inc. ("LAB Canada"), Scantox, Biologisk Laboratorium A/S ("LAB Denmark"), LAB International Research Center Hungary Limited Liability Company ("LAB Hungary") and LAB Research International, Inc. ("LAB US").

The transfer of the pre-clinical contract research business by LAB to LRI involved the following corporate reorganization:

- (a) LAB Canada transferred all of the assets and undertakings comprising its contract research business as well as the shares of LAB US that it held directly to LRI in consideration for a \$26.2 million note and 101,915 common shares of LRI;
- (b) The Company transferred all of the shares of LAB Denmark that it held to LRI in consideration for the issuance of a \$14.0 million note and 2,015,713 common shares of LRI;
- (c) The Company transferred all of the shares of LAB Hungary that it held to LRI in consideration for the issuance of a \$7.8 million note and one common share of LRI;
- (d) LAB Canada transferred all the shares of LAB Hungary that it held to LRI in consideration for the issuance of a \$0.08 million note and one common share of LRI;
- (e) The Company sold all notes referred to above to 4349695 Canada Inc. ("4349695"), a wholly-owned subsidiary of the Company, in exchange for common shares of 4349695; and
- (f) 4349695 subscribed for 12,025,226 common shares of LRI for a total of \$48.1 million payable by the cancellation of the note referred to above.

Upon completion of the foregoing transactions, LRI owned all of the contract research assets of LAB Canada and all of the outstanding shares of LAB Hungary, LAB Denmark and LAB US.

On August 3, 2006, the initial public offering of LRI closed. LAB sold 6,250,000 common shares of LRI for gross proceeds of \$25 million with an over allotment option granted to the underwriters for an additional 1,250,000 common shares at \$4.00 per share.

LAB retained approximately 44% of LRI subsequent to the sale of the 6,250,000 common shares and the LRI IPO. Net proceeds to the Company were approximately \$21.7 million after deducting the Company's share of the Underwriters' commissions and related professional fees of \$1.5 million and \$1.8 million respectively.

On September 12, 2006, the Underwriters exercised their over-allotment option which reduced LAB's interest in LRI to 35.4% and generated net proceeds of approximately \$5.6 million after Underwriters' commissions and related professional fees of \$3.6 million and \$0.4 million respectively.

On November 9, 2006 the Company sold to its remaining investment in LRI through the issue 6,392,857 special warrants at a price of \$4.05 per warrant to the Underwriters for gross proceeds of \$25.9 million. Each special warrant entitled the holder to receive from the Company at any time upon exercise or deemed exercise, without payment of additional consideration, one common share of LRI. After deducting underwriters' fees of \$1.7 million and \$0.2 million in related professional fees, the Company received net proceeds of approximately \$24 million.

The Company recognized a gain of \$34.1 million on the disposal which included \$56,891 in gross proceeds less the carrying value of the investments sold and \$8,680 of related Underwriter's commissions, professional fees and senior management bonuses. \$2.8 million in bonuses were paid to Dr. Halvor Jaeger and Andrew Reiter as a result of the successful completion of the IPO and disposal of the LRI interest.

## Corporate Highlights

- On January 11, 2006, LAB announced the licensing of its lead product Fentanyl TAIFUN® to Teikoku Seiyaku Co. Ltd for the Japanese market.
- On January 24, 2006, LAB announced the final and complete safety, tolerability and pharmacokinetic results of its Phase I trial for its novel asthma product, LAB CGRP (Calcitonin Gene Related Peptide). CGRP was demonstrated to be safe with no serious adverse events reported at all doses tested.
- On July 12, 2006, LAB announced positive results for the first phase II trial of its lead product, Fentanyl TAIFUN®. The results support clinical efficacy at the lowest dose of 100 µg and a trend of dose response relationship with no significant adverse side effects.
- On October 4, 2006 LAB announced positive results from the first Phase II clinical trial of its LAB CGRP product. LAB CGRP showed statistically significant broncho-protective effects compared to placebo with a similar safety profile.
- On January 25, 2007, LAB announced the closing of the acquisition of PharmaForm L.L.C, a privately held specialty pharmaceutical drug delivery company based in Austin, Texas. LAB paid US \$7.5 million cash and US \$5.658 million in LAB shares on closing. The Sellers will be eligible for additional amounts payable in LAB shares upon completion of certain milestones relating to specific revenue targets and to its drug delivery platforms currently under development.
- On March 5, 2007, LAB announced positive results from the open-label part of its Fentanyl TAIFUN® Phase IIb clinical trial. The results from 24 patients demonstrated successful dose titration resulting in effective control of breakthrough pain episodes.

## Financing

The Company continued to devote significant capital resources to the creation and development of a pipeline of novel therapeutics and platforms targeting the delivery of products via the lungs.

- TEKES, the National Technology Agency of Finland, which supports local Biotech industries, provided approximately \$1.6 million (1.1 million Euros) in loans towards inhalation product development during the year. These loans carry favorable interest rates and repayment terms as described in note 10 of the audited year end consolidated financial statements. An additional \$0.4 million (0.3 million Euros) of the funding was provided by way of grants. TEKES funding was directly related to the level of inhalation product development spending.
- On November 8, 2006, Laurus converted the balance of its debenture, US \$1.4 million, into 1,673,444 additional common shares. In 2006, the Company made principal repayments of \$0.5 million and issued 4,618,444 common shares in settlement of the convertible debentures.
- The Company raised gross proceeds of \$57 million from the disposal of its majority interest in LRI. See 'Initial public offering of LAB Research' and note 3 of the audited year end consolidated financial statements.

## Strategy

LAB possesses a portfolio of intellectual property for novel product and drug delivery systems and focuses on the development of therapeutics utilizing its unique inhalation delivery platforms, including the regulatory approved TAIFUN® DPI (dry powder inhaler) and its formulation expertise. The acquisition of PharmaForm is key to the Company's strategy by adding FDA and DEA approved specialized drug formulation / manufacturing capabilities and unique patent pending abuse deterrent and trans-mucosal drug delivery systems.

In order to maximize value creation over the next twelve months, LAB intends to:

- 1) Complete Fentanyl Taifun Phase IIb program and start Phase III.
- 2) Centralize all formulation, manufacturing and product / platform development at PharmaForm.
- 3) Complete LAB Calcitonin Gene Related Peptide (CGRP) Phase IIb anti-inflammatory trials.

- 4) Complete LAB Growth Hormone Release Hormone (GHRH) Phase IIa study and, depending on the outcome, start a larger scope Phase IIb trial.
- 5) Accelerate the development of PharmaForm's abuse deterrent and trans-mucosal platforms.
- 6) Out-license LAB's products and inhalation platforms in the U.S. and Europe.
- 7) Broaden delivery platforms and product offerings with a focus on reformulated generics for pain and CSN indications through co-sponsored programs, and/or strategic alliances.
- 8) Aggressively pursue other synergistic acquisition opportunities.

### Lead Products Candidates

The Company's lead product candidates target the multi-billion dollar inhalation drug market for the treatment of respiratory diseases as well as opportunities for improving drug effectiveness via systemic administration of medicaments using its pulmonary delivery technologies. Normally, the risk of product failure in clinical development is significant but diminishes with each successfully completed clinical milestone. However, by focusing on the development of products using its TAIFUN® inhalation platform which has been approved for commercialization in Europe, LAB mitigates the regulatory risk typically associated with the inhalation device.

### Fentanyl TAIFUN® - Break Through Cancer Pain

Fentanyl is an opiate analgesic that has been subject to clinical investigation and use for more than 30 years and is commonly used for the treatment of severe chronic pain associated with conditions such as cancer. One of the most frequently used opiate based products is Duragesic® Fentanyl in a transdermal delivery system used for the treatment of chronic cancer pain. Even though persistent cancer pain is controlled with maintenance doses of Duragesic® and other long-acting products, the majority of patients experience episodes of break-through pain during treatments with long acting formulations. Fentanyl is a highly lipid soluble drug, enabling its delivery via transdermal, transmucosal and pulmonary routes. The Company is developing fentanyl in its TAIFUN® inhalation delivery platform, as inhalation is the fastest painless alternative to intravenous administration.

The Company believes that the rapid onset of action and ease of use of Fentanyl TAIFUN® have clear advantages, compared to oral, transmucosal and injectable alternatives, and should significantly improve cancer pain therapy. The clinical development plan has been structured in compliance with FDA and European Union requirements to enable registration in both markets and is currently being performed in Europe.

In October 2005, the Company successfully completed an additional comparative Phase I trial with a peak plasma concentration of 935 pg/ml achieved within the first minute suggesting very rapid pain relief versus 371 pg/ml reached in one hour after the start of administration for the Actiq® 200µg lozenge. Actiq® is a transmucosal formulation of fentanyl citrate, specifically designed for the treatment of cancer break-through pain. The Company also reported positive results from a Phase IIa clinical trial in July 2006. The results supported clinical efficacy at the lowest dose of 100 µg, and a trend of dose response relationship. The safety of Fentanyl TAIFUN® was similar to that of a placebo, with the exception of an increase in mild to moderate somnolence. A total of 122 cancer patients on maintenance opioid therapy for persistent pain were enrolled in the Phase IIa trial. The analgesic efficacy in the responding patients was very rapid with Fentanyl TAIFUN®. In the Per Protocol analysis, time to significant pain relief was achieved on average in 7.8 to 11.6 minutes, depending on the dose.

In June 2006, the Company started enrolment of the first patients in its Fentanyl TAIFUN® Phase IIb clinical trial. The first part of the multi-centered, multinational, dose titration clinical trial is a single arm and open-label dose titration trial evaluating the time to significant pain relief with Fentanyl TAIFUN® with successful titration in the treatment of breakthrough cancer pain. The first part of the trial is enrolling 32 cancer patients on maintenance opioid therapy for persistent pain. The second part of the trial is randomized, double-blind, cross-over and placebo-controlled, continuing with a total of 28 patients from the open-label part.

## LAB CGRP - Asthma

LAB CGRP is a natural neuropeptide (37 amino-acids) produced in the lung in response to allergic stimuli. Unlike the current asthma drugs, LAB CGRP is a unique product combining broncho-dilatory, anti-inflammatory, and broncho-protective properties, which falls in a new class of asthma therapeutics called “hybrid”. Pre-treatment with LAB CGRP completely abolished airway hyper-responsiveness to allergen challenge in sheep and mouse models. Its efficacy is proportional to the severity of lung inflammation. Inhaled LAB CGRP blocks both the acute and late-phase bronchial response associated with asthma attack. From a therapeutic point of view, LAB CGRP’s properties, if reproduced in human clinical testing, may be extremely significant for asthma treatment.

In September 2005, the Company successfully completed a Phase I trial in which CGRP was administered for the first time into the lungs of humans. The product was well tolerated and no serious adverse events were observed. In August 2006, the Company completed patient enrolment in its LAB CGRP Phase IIa trial to investigate the protective efficacy of LAB CGRP on metacholine induced bronchial hyper-responsiveness in adult patients with mild to moderate asthma, to compare this efficacy to Salbutamol, a long standing generic asthma treatment drug, and placebo and to evaluate the safety and tolerability of LAB CGRP in asthma patients. The trial enrolled a total of 12 patients. No serious adverse events have been reported in any of the patients dosed.

In October 2006, the Company reported positive results from its LAB CGRP Phase IIa trial. The trial showed statistically significant broncho-protective effects compared to placebo and a similar safety profile to placebo except for transient and mild headaches and flushing in some of the patients. Each patient received one dose of LAB CGRP (5mg), one dose of Salbutamol sulphate (500µg) and one dose of placebo. The doses were given in a randomized order and study agents were compared in terms of absolute provocative concentration (PC<sub>20</sub>) of methacholine causing at least a 20% fall in forced expiratory ventilation volume. LAB CGRP increased PC<sub>20</sub> in a majority of patients (7 out of 12) while Salbutamol and placebo respectively achieved 11 and 2 out of 12. On average, the PC<sub>20</sub> with LAB CGRP was approximately two-fold as compared to placebo.

## LAB GHRH - Late Pre-End Stage Chronic Renal Failure

Growth hormone is a major element controlling several complex physiologic processes, including growth and metabolism. Growth hormone stimulates the liver and other tissues to secrete insulin-like growth factor (“IGF-1”) to stimulate the body and muscle growth. Growth hormones are secreted in a pulsative pattern. Growth hormone secretion is controlled by hypothalamic hormones (GHRH and somatostatin) as well as a hormone from the stomach, called ghrelin. When growth hormone is not secreted in sufficient quantity, recombinant growth hormone has been used as a replacement. The significant cost of producing recombinant growth hormone, the long-term safety concerns of growth hormone therapy and the disruption of the endogenous growth hormone releasing rhythm, limit the hormone’s clinical uses. Consequently, the development of successful methods for increasing growth hormone secretion without disturbing the body’s own growth hormone releasing pattern and the resultant steep increase in IGF-1 levels represent significant opportunities.

The Company is developing GHRH through a worldwide exclusive licensing agreement with the Université de Montréal and Centre Hospitalier de l’Université de Montréal. The licensed molecules have been selected based on their high binding affinity to the GHRH receptor and resistance to degradation in the blood. It is anticipated that the effective therapeutic dose of the present GHRH antagonists will be much lower and the duration of their therapeutic effect in various anticipated clinical applications much longer than with the competing products on the market or in development. The Company is planning to develop GHRH for indications for which an increase in growth hormone secretion would provide therapeutic benefits.

In July 2005, the Company initiated a pilot Phase II trial for its GHRH analogue. The placebo controlled Phase II trial is being conducted in two centers in Europe and is investigating the efficacy and safety of LAB GHRH for the treatment of malnutrition in patients with late pre-dialysis chronic renal failure. The Company anticipates demonstrating an increase in growth hormone secretion levels as well as other surrogate markers such as IGF-1 and improvement in biochemical indicators of the nutritional and metabolic state. The results of this pilot trial will provide crucial insights in assessing its effectiveness and designing the subsequent development protocol.

## Drug Delivery Systems

### TAIFUN®

The Company's TAIFUN® technology platform combines highly efficient inhaler technology with a patented integrated desegregation system (vortex-chamber) and a unique humidity control system (desiccant capsule inside the drug reservoir). The wet suspension formulation method gives very high homogeneity to the formulations, prevents the formation of amorphous particles, and ensures high stability of the formulations. In contrast to most other inhalers that have obtained regulatory approval, the mechanical robustness, the strong characteristics, and the inexpensive cost to manufacture have positioned TAIFUN® as one of the most attractive second generation dry powder inhalers.

The Company's dry powder inhaler ("DPI") provides a number of technical improvements and clinical benefits, compared to current leading inhaled drug delivery systems. In particular, the TAIFUN® DPI enables highly reliable and efficient delivery of active drugs into patients' lungs in a wide range of clinical and environmental conditions. In addition, the platform technology can be applied to a variety of active compounds.

The Company has demonstrated that its TAIFUN® inhaler is a significant improvement over the currently marketed metered dose inhalers ("MDIs") and DPIs, and believes that the unique combination of strong technical performance, user friendliness, and distinctive style offers a strong competitive advantage against other new generation inhalers in development.

The clinical and technical advantages of TAIFUN® are:

- advanced powder formulations with high physical and chemical stability
- high lung deposition of active ingredient
- high resistance to humidity
- dose uniformity and accurate dose metering complying with the tight FDA requirements
- modern style and ease of use

The development advantages of TAIFUN® are:

- regulatory approved - TAIFUN® Salbutamol has been approved in ten European countries
- robustness and simplicity of design, effective commercialization
- quality standards and Good Manufacturing Practices ("GMP")
- fast track to market with low risk

The approvability of TAIFUN® demonstrates the technical performance of the platform, and significantly decreases the development risk associated with the application of new drug delivery systems.

The acquisition of PharamForm on January 25, 2007, significantly broadens the Company's drug delivery system pipeline by adding the EDACS™ and PharmaFilm platforms.

### EDACS - Abuse-deterrent systems

The Extruded Deterrence of Abusable Controlled Substances (EDACS™, patent pending) is a solid oral dosage form designed to deter abuse of controlled substances and is targeted towards the multi-billion dollar drug abuse market as well as extend the competitive advantage of any number of patented opioid and non-opioid based treatments. It has the following features:

- prevents alcohol-induced dose-dumping by maintaining its oral sustained release characteristics in 40% alcohol for more than 3 hours
- is significantly harder than conventional oral dosage forms and, as a result, is very difficult to be crushed or chewed in an attempt to bypass the sustained release characteristics
- prevents dissolving and injection since it contains a polymer that forms a viscous gel not miscible in common solvents

EDACS™ can be formulated either with hydrophobic or hydrophilic drugs, in various sizes, shapes and colors and can provide a wide range of sustained release profiles.

### **PharmaFilm - Transmucosal Film Technology**

This patent protected film is produced by a hot-melt extrusion process and features the following advantages:

- water and solvent are not necessary
- suitable for a wide variety of drugs
- simple process
- excellent content uniformity

The film is totally customizable (size, shape and color) and multiple release profiles are possible through multiple layers (immediate or controlled release). The technology has advantages in the delivery of drugs with poor oral bio-availability due to significant first pass metabolism, or gastrointestinal tract degradation, and for patients with difficulties swallowing. The benefits of this technology include:

- proven delivery system
- improved patient compliance
- difficult to reverse engineer
- dose removal in emergency situations
- improved bio-availability
- site specific delivery

### **Contract Services**

PharmaForm operates a 40,000 sqft. facility located in Austin, Texas providing drug formulation solutions, limited run drug manufacturing and product development services to mid-sized pharmaceutical and biotech companies. The specific types of service offered by PharmaForm include;

- Specialty drug manufacturing and formulation
- Drug development
- Process optimization
- QC testing / methods validation
- Analytical methods development
- Stability, storage and testing
- Consulting (IP validation and contestation)

### **Critical success factors**

Critical success factors include successful and timely outcomes of our clinical trials, the availability of capital, US and European regulatory approvals and the Company's ability to market and sell its products.

# Financial Analysis

## Operating Results

Business Units:

The summarized financial information by business unit covers the three and twelve month periods ended **December 31, 2006 and 2005**, except for the financial information relating to LAB Research which includes seven months of activity to August 3, 2006. Research activities were no longer controlled by the Company as of August 3, 2006 as a result of the disposal of a majority interest on this date.

As a result of the disposal of the Research segment, the Company's continuing operation will consist of its activities in the Pharma sector. Accordingly, the revenues and costs of the Research sector presented in the Research column below will not be realized in the future.

### 3 Months

	2006			
	\$	\$	\$	\$
	Research	Pharma	Corporate	Total
Revenues	-	1,149	356	1,505
Direct costs	-	-	-	-
SG&A	-	1,187	1,386	2,573
R&D costs	-	4,403	-	4,403
Stock-based compensation	-	114	224	338
Amortization	-	500	137	637
Interest LTD	-	34	(239)	(205)
Foreign exchange	-	246	385	631
Share in net Income of LRI	-	-	(300)	(300)
Restructuring charges	-	4,376	-	4,376
Gain on disposal of LRI	-	-	(12,907)	(12,907)
Income taxes	-	31	2,771	2,802
Net earnings (loss)	-	(9,742)	8,899	(843)

### 12 Months

	2006			
	\$	\$	\$	\$
	Research (7 months)	Pharma	Corporate	Total
Revenues	26,261	2,551	636	29,448
Direct costs	15,977	-	-	15,977
SG&A	5,337	4,065	5,685	15,087
R&D costs	-	13,066	-	13,066
Stock-based compensation	34	294	677	1,005
Amortization	1,902	1,451	449	3,802
Interest LTD	345	138	1,146	1,629
Foreign exchange	25	813	292	1,130
Share in net Income of LRI	-	-	(300)	(300)
Restructuring charges	-	4,376	-	4,376
Gain on disposal of LRI	-	-	(34,149)	(34,149)
Income taxes	2,962	(97)	5,187	8,052
Net earnings (loss)	(321)	(21,555)	21,649	(227)
<b>Total assets</b>				54,310
<b>Total long-term liabilities</b>				6,167

2005			
\$	\$	\$	\$
Research	Pharma	Corporate	Total
10,155	1,152	4	11,311
6,871	-	-	6,871
1,237	3,323	850	5,410
-	2,677	-	2,677
32	39	144	215
766	364	54	1,184
34	34	343	411
(5)	(11)	61	45
-	-	-	-
-	-	-	-
-	-	-	-
(2,148)	(15)	-	(2,163)
3,368	(5,259)	(1,448)	(3,339)

2005				2004			
\$	\$	\$	\$	\$	\$	\$	\$
Research	Pharma	Corporate	Total	Research	Pharma	Corporate	Total
43,335	3,109	46	46,490	23,832	1,354	2	25,188
26,123	-	-	26,123	12,746	-	-	12,746
7,613	6,028	4,560	18,201	5,421	2,658	3,659	11,738
-	9,373	-	9,373	-	6,242	-	6,242
128	184	490	802	105	226	738	1,069
2,979	1,447	205	4,631	1,412	635	28	2,075
762	138	916	1,816	395	123	-	518
(118)	(58)	(250)	(426)	(186)	2	125	(59)
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
(771)	(184)	-	(955)	(838)	(61)	-	(777)
6,619	(13,819)	(5,875)	(13,075)	3,101	(8,471)	(4,548)	(9,918)
			<b>73,946</b>				<b>54,167</b>
			<b>20,667</b>				<b>11,433</b>

## Comments on Financial Results:

**General** The Company's results of operations include those of LRI to August 3, 2006, the date of LRI's IPO. After this date, the Company no longer controlled LRI and ceased to consolidate its financial results. From August 3, 2006 to November 9, 2006, the Company accounted for its investment in LRI using the equity method. After November 9, 2006, the Company no longer had a share interest in LRI as a result of the sale of its residual interest through the issue of 6,392,857 special warrants. Accordingly the Company will no longer be reporting results for this segment in the future.

**Revenues:** LAB's consolidated revenues were \$1.5 million for the fourth quarter and \$29.4 million for the year.

Year-to-date consolidated revenues include \$26.3 million relating to LAB Research to the date of the IPO, August 3, 2006. LAB Canada revenues had been under pressure for most of the period due to an 8% year-over-year decrease in the value of the US dollar, a higher mix of longer term studies and recent organizational changes to the Company's business development and scientific groups which took place during the first half of the year. Approximately 60% of LAB Canada's revenues were generated in US dollars. During the same period, LAB Denmark posted revenues of \$13.4 million, approximately 8% more than in 2005. LAB Denmark operated at full capacity for most of the reporting period. LAB Hungary revenues of \$3.0 million for the first seven months of the year were 17% lower than the same 2005 period. The year-over-year decrease relates specifically to the use of LAB Hungary's inhalation toxicology capacity by LAB Pharma and a 16% decrease in the value of the local currency. To August 3, 2006 the value of inter company studies was \$1.7 million.

LAB Pharma revenues consisted primarily of fees from development and license agreements relating to Fentanyl TAIFUN®. Fourth quarter revenues include \$0.8 million recognized on the sale of formulation dossiers previously accounted for as deferred revenue. 2005 revenues were generated principally from the co-development and licensing agreement with Grupo Ferrer Internacional, S.A (Ferrer). At December 31, 2005, the Company recorded a reserve of \$2,200 (€1,598) against the amount receivable from Ferrer. In December 2006, the Company agreed to accept \$300 (€200) from Ferrer as full and final settlement of amounts owing under the Fentanyl development agreement.

**Direct costs:** The decrease in gross margin percentage in Lab Research was due primarily to LAB Canada's building lease which began on November 1, 2005 coupled with a period-over-period revenue shortfall. LAB Denmark's direct costs as a percentage of its revenues were higher than that of either LAB Canada or LAB Hungary. This was attributable to higher Danish labor costs. Salaries and benefits represented approximately 61% (62% - 2005) of direct costs during the first seven months of the year and were semi-variable over the short term. LAB Hungary's direct costs and gross margins were in line with prior periods given the level of inter company volume.

**SG&A expenses:** Consolidated SG&A expenses for the year were \$15.1 million. The increase in Corporate SG&A for the quarter and year-to-date reflect the payment of approximately \$0.6 million in severance not related to the restructuring of LAB Finland and higher than normal professional fee spending due the pursuit of the LAB Research monetization strategy.

The \$2.0 million year-over-year decrease in LAB Pharma SG&A is due to inclusion, in the 2005 results, of a write-down of accounts receivable from Ferrer LAB Pharma SG&A for the current year includes the hiring of several senior operational and scientific personnel to accelerate the Company's product development plan and a lower professional fee spend rate during the year.

LAB Research SG&A expenses to August 3, 2006 were in line with prior periods.

Continued emphasis will be placed on securing strategic product development and M&A opportunities and creating increased market awareness about LAB.

**R&D costs:** R&D represents costs incurred by LAB Pharma for the development of its product pipeline. R&D costs to December 31, 2006 of \$13.1 were 39% more than the same 2005 period and relate primarily to costs incurred in connection with Fentanyl TAIFUN®.

On July 12, 2006, LAB announced positive results for the first phase II trial of its lead product, Fentanyl TAIFUN®. The pivotal Phase IIb titration study will be completed during the second quarter of 2007.

On October 4, 2006 LAB announced positive results from the first Phase II clinical trial of its LAB CGRP product. LAB CGRP showed statistically significant broncho-protective effects compared to placebo along with a similar safety profile.

The completion of each product development milestone serves to reduce the product's overall risk but increases the amount of future funding required.

**Amortization:** Amortization expense for the first nine months of the year is in line with prior periods.

**Interest on LTD:** LAB Corporate interest expense includes \$0.2 million relating to the Laurus convertible debenture and a \$0.8 million 'loss on early settlement' component on the conversion of the remaining \$4.4 million principal amount into 4.6 million Common Shares of the Company during the year.

**Foreign exchange:** The majority of LAB Pharma's revenues and expenses are incurred in Euros. The increase in the LAB Pharma foreign exchange loss over the previous year reflects the change in method of translating its assets and liabilities from the 'current rate' to the 'temporal' method on July 1st 2005. LAB Pharma has a significant net Euro liability position which adds to the foreign exchange loss when there is an increase in the value of the Euro against the reporting currency. In 2007, monthly exchange contracts to purchase 0.5 million Euros through to April 2007 have been entered into to minimize the impact of a significant increase in the value of this currency over the period covered.

LAB Corporate's expenses are incurred largely in Canadian dollars. The Corporate segment foreign exchange loss consists principally of the foreign exchange loss component on the early settlement of the Laurus convertible debenture.

**Restructuring** The restructuring charge consists of a \$4.0 million write-down of property and equipment located in Finland to reflect their estimated net recoverable value and a \$0.4 million severance charge related to employees in LAB Pharma. Please refer to note 14 of the audited consolidated financial statements for additional details.

**Gain on disposal:** A gain of \$34.1 million was recognized on the disposal of LRI and included \$56,891 in gross proceeds less the carrying value of the investments sold, \$8,680 of related underwriter's commissions, professional fees and senior management bonuses as well as the proportionate reduction in the cumulative translation adjustment. For details on the IPO transaction, please see section 'Initial public offering of LAB Research' and note 3 of the audited consolidated financial statements.

**Income taxes:** The year-to-date consolidated income tax provision comprises taxes payable as a result of the disposal of the Company's interest in LRI in 2006, as well as the related tax charge incurred by the Company in connection with the corporate reorganization that was completed immediately prior to the IPO. The Company has recorded a full valuation against its tax assets in Canada and Finland since the criteria for recognition of these assets have not been met.

**Net Income:** The consolidated net loss for the fourth quarter was \$0.8 million (\$0.01 per share) compared to a consolidated net loss of \$3.3 million (\$0.06 per share) in 2005. The consolidated net loss for the year was \$0.2 million (\$0.00 per share) compared to a consolidated net loss of \$13.1 million (\$0.24 per share) for the same 2005 period. In the quarters ended September 30 and December 31, 2006, the Company recognized a gain of \$21.1 million and \$13.0 million respectively on the disposal of its ownership in LRI. These transactions account for the reduction of the net loss in both periods compared to the prior year. See 'Initial Public Offering of LAB Research' and note 3 of the audited consolidated financial statements for details.

## Quarterly Results

Quarter	Revenues	Net Income	Net income (loss) per share	
		(loss)	Basic	Diluted
Quarter ended December 31, 2006	1,505	(843)	(0.01)	(0.01)
Quarter ended September 30, 2006	4,783	11,055	0.15	0.15
Quarter ended June 30, 2006	11,945	(5,398)	(0.07)	(0.07)
Quarter ended March 31, 2006	11,216	(5,041)	(0.07)	(0.07)
Quarter ended December 31, 2005	11,311	(3,339)	(0.06)	(0.06)
Quarter ended September 30, 2005	12,681	(2,700)	(0.05)	(0.05)
Quarter ended June 30, 2005	13,170	(3,812)	(0.07)	(0.07)
Quarter ended March 31, 2005	9,328	(3,224)	(0.06)	(0.06)

The quarterly results include the results of LRI to the date of the IPO, August 3, 2006. The Company ceased consolidating the results of operations of LRI in the third quarter of 2006, which accounts for the reduction in revenues in this period and the fourth quarter. The Company also recorded gains on disposal of its interest in LRI in both the third and fourth quarters of 2006.

## Liquidity and capital resources

Historically, LAB Pharma's cash requirements were provided by the cash flow generated by LAB Research and by the capital raised by LAB through the issuance of shares and/or debt. The disposition of LRI through its initial public offering will increase LAB's reliance on capital market funding should the need arise. Cash and cash equivalent balances at December 31, 2006 were \$41.1 million compared with \$16.3 million as at December 31, 2005 and \$25.1 million at the end of the third quarter of 2006.

The Company's working capital ratio increased to 4.6 as of December 31, 2006 from 1.33 a year earlier and 3.0 as at September 30, 2006. This reflects the net proceeds of \$48.3 million generated on the secondary, over-allotment and special warrant sale of the Company's LRI shares as described in the section 'Initial Public Offering of LAB Research'. The \$1.9 million in deferred revenue represents amounts billed and/or collected but which have not been earned. The average monthly operating cash consumption excluding LAB Research operations was approximately \$1.6 million during 2006. The addition of PharmaForm is expected to be accretive to both earnings and cash flow and allow for substantial cost synergies as a result of the transfer-in of product development and formulation expertise from LAB Finland.

Fixed asset additions for the year were \$2.6 million (\$4.4 million -2005), including those financed through capital leases, and were primarily for improvements to LAB Research facilities and computer hardware relating to the implementation of its data management system. Equipment expenditures are expected to increase significantly in 2007 in preparation for the commercialization of Fentanyl TAIFUN®.

TEKES, the National Technology Agency of Finland, which supports local Biotech industries, provided approximately \$1.6 million (1.1 million Euros) in loans towards inhalation product development during the year. These loans carry favorable interest rates and repayment terms as described in note 10 of the audited year end consolidated financial statements. An additional \$0.4 million (0.3 million Euros) of the funding was provided by way of grants. TEKES funding was directly related to the level of inhalation product development spending.

During 2006, Laurus Master Fund Ltd. converted the remaining US \$3.9 million (\$4.4 million CAD) of its convertible debenture into 4.6 million common shares of the Company.

On October 16, 2006, the Company issued 1,348,316 common shares in connection with research and development milestones (first efficacy study successfully performed in humans) attained relating to calcitonin gene related peptide (LAB CGRP). The market value of these shares at the date of issuance was \$1,173.

## Contractual obligations and commercial commitments

As at December 31, 2006, LAB's future contractual commitments are principally obligations under loans, operating leases for facilities as well as management fees to PRI International Consulting Inc., a company controlled by Dr. Halvor Jaeger, Chief Executive Officer of LAB. Obligations by year of maturity and future rental payments under operating leases and long-term debt repayments are presented below. The Company was not engaged in off-balance sheet activities or commodity contract trading at December 31, 2006.

The aggregate maturities of the contractual obligations are as follows:

	\$	\$	\$	\$	\$	\$
	2007	2008	2009	2010	2011+	Total
Operating leases <sup>(a)</sup>	2,925	179	10	-	-	3,114
Clinical Studies <sup>(b)</sup>	3,085	-	-	-	-	3,085
Service contracts	11	-	-	-	-	11
Management fees <sup>(c)</sup>	275	275	275	183	-	1,008
Long-term debt	1,697	-	-	-	4,951	6,648
	7,993	454	285	183	4,951	13,866

- a) On March 5, 2007, Lab Pharma and its landlord agreed to an early settlement of their lease agreement. The settlement requires a lump sum payment of \$3,256 (2,130 Euros) which includes \$2,221 (1,452 Euros) covering the base rent for the period from February 1, 2007 to September 30, 2008, \$359 (236 Euros) for maintenance costs and the repayment of the unsecured long-term debt of \$676 (442 Euros), including related accrued interest of \$58 (38 Euros). The prepaid rent and maintenance costs will be expensed in 2007.
- b) To pursue the development of its pharmaceutical products, the Company entered into various agreements. Under these agreements, the Company is committed to pay minimum payments of \$3,085 in 2007.
- c) The Company entered into a service agreement with a company controlled by a shareholder, which will provide the services of the CEO with respect to the overall management of the Company for a period of five years commencing on September 1, 2005. The amount payable under this agreement is \$275 per year.
- d) The Company entered into one exclusive world-wide master license agreement whereby the Company was granted licenses to further develop and exploit commercial applications to be derived from a specific invention bearing a United States patent serial number. Under the license agreement, the Company undertakes to pay a royalty of 1.5% to 5% of specified sales, with a minimum annual amount of \$10. This license agreement will expire when the last of the patent rights expire.
- e) The Company entered into license agreements and obtained exclusive rights to test an inhalation devices process. Under the first agreement, the Company is committed to paying royalties based on a percentage of sales derived from commercial products developed using the licensed process. The license expires when the last of the patent rights expires. Under the second agreement, the Company is committed to paying royalties based on a percentage of sales derived from commercial products developed using the licensed product with a minimum amount of: 2008 - \$50; 2009 - \$75 and thereafter - \$150 each year.
- f) As part of the 2004 acquisition of LAB Pharma OY, the Company may contingently issue up to 1,500,000 additional common shares to the principal vendors should other specified regulatory milestones be achieved for the development of Fentanyl Taifun®. As part of the 2003 acquisition of Seyvika, the Company is committed to pay royalties based on a percentage of future sales derived from commercial products developed using the licensed process with a minimum amount of \$50 one year after commercialisation and \$100 every year thereafter.
- g) The Company remains a guarantor of LRI's Laval, Quebec facility lease. Minimum lease payments under the lease agreement are as follows: 2007 - \$2,915; 2008 - \$2,175; 2009 - \$2,024; 2010 - \$2,004; 2011 - \$2,105 and thereafter \$36,145. On March 8, 2007, LRI announced that it had entered into an agreement with the landlord to purchase the building that is subject to the lease agreement. The closing of the transaction, subject to conditions to be met by each party, is scheduled to occur on or before 16 April, 2007. At December 31, 2006, the Company was also a guarantor of a term loan of LRI in the amount of \$223. LRI repaid this loan after year end.

## Related party transactions

The Company incurred \$420 in 2006 (2005 - \$314) in expenses with firms connected with outside directors of the Company for professional services rendered. The Company incurred \$3,242 (2005 - \$606) as remuneration for services rendered by companies connected to certain shareholders and outside director, including \$3,000 (2005 - \$385) to PRI International Consulting Inc., a company directly controlled by the Company's Chief Executive Officer (CEO) under the agreement referred to in note 17 (d) of the 2006 audited consolidated financial statements. In 2005, the Company issued 200,000 common shares with a fair value of \$254 in connection with a purchase of a customer list from a company whose chief executive officer is a member of the Company's board of directors.

In 2006, the Company incurred \$998 (2005 - \$870) to non-controlling shareholders for rent expense and services rendered. In addition, the Company incurred \$127 (2005 - \$139) to non-controlling shareholders for interest expense on long-term debt.

From August 3 to November 9, 2006, the Company purchased \$410 of inhalation toxicology services from LRI. Included in accounts payable are amounts due to related parties of \$308 (2005- \$513).

These transactions are measured at the exchange amount of consideration established and agreed to by the related parties.

During the three-month period ended December 31, the Company incurred \$190 (2005 - \$70) to firms connected with outside directors of the Company for professional services rendered. The Company also incurred \$211 (2005 - \$244) as remuneration for services rendered by companies connected to certain shareholders and outside director, including \$116 (2005 - \$164) to PRI International Consulting Inc., a company directly controlled by the Company's Chief Executive Officer (CEO).

The Company incurred \$271 (2005 - \$210) to non-controlling shareholders for rent expense and services rendered. In addition, the Company incurred \$33 (2005 - \$11) to non-controlling shareholders for interest expense on long-term debt.

These transactions are measured at the exchange amount of consideration established and agreed to by the related parties.

## Subsequent events

On January 25, 2007, the Company acquired all of the outstanding membership interests of Formulation Technologies L.L.C., (Pharmaform) a privately held company headquartered in Austin, Texas. On closing, the Company paid to the sellers \$15,406 (US\$13,158), including \$8,823 (US\$7,500) of cash and common shares valued at \$6,583 (US\$5,658). Under the purchase agreement, additional consideration is payable by the Company upon completion of certain milestones relating to PharmaForm's drug development programs. These amounts are payable at the option of the vendor, either in cash or in common shares. In total, the maximum contingent consideration payable by the Company is \$15,400 (US\$13,200).

The following table summarizes the estimated fair value of the assets acquired and liabilities assumed at the date of acquisition. The Company is in the process of finalizing its valuation of the net assets acquired; thus, the allocation of the purchase price is subject to final modifications.

	\$
Net assets acquired:	
Current assets, including cash of \$500	2,050
Long-term assets	15,286
Current liabilities	(675)
Long-term liabilities	(1,255)
	15,406

## Outstanding share data

At March 13, 2007, the number of common shares issued and outstanding was 82,333,454. In addition, the Company had 8,014,000 outstanding options and one warrant to purchase 1,770,286 common shares at a price of \$1.28 (US \$1.10) per share at any time prior to April 22, 2010.

## Disclosure controls and procedures

Disclosure controls and procedures are designed to provide reasonable assurance that material information is gathered and reported to senior management on a timely basis so that appropriate decisions can be made regarding public disclosure. The Company's Chief Executive Officer and its Chief Financial Officer are responsible for establishing and maintaining disclosure controls and procedures. Based on an evaluation of the Company's disclosure controls and procedures, the Chief Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures were effective as of December 31, 2006.

## Changes in internal controls over financial reporting

The Chief Executive Officer (CEO) and Chief Financial Officer (CFO) are responsible for designing internal control over financial reporting or causing it to be designed under their supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with Canadian generally accepted accounting principles. The CEO and CFO assessed the design of the Company's internal control over financial reporting as at December 31, 2006. As a result of the disposal of its interest in LRI, the Company was left with fewer office employees and will require additional resources in the corporate segment to assist with the quarterly and annual process of preparing the Company's financial statements. Subsequent to the disposition of LRI, the Company supplemented its resources through the use of outside consultants. Management is actively working to strengthen the accounting and finance team in 2007 and plans to increase the number of skilled individuals involved in the accounting function.

## Outlook

### LAB Pharma Outlook

The most important trends affecting the healthcare products industry are demographic changes and the growing influence of managed care. Shifting demographics will drive industry growth in the years ahead as an aging population will provide further stimulus for industry demand.

The search for improved routes of administration and the desire for non-invasive delivery methods for self-medication of chronic conditions represent therapeutic application opportunities for developers of inhalation drug delivery based products such as LAB.

Inhalation forms the basis for the treatment and control of upper respiratory tract diseases such as asthma and chronic obstructive pulmonary disease ('COPD') and will continue to experience steady growth over the next several years. The systematic delivery of drugs through the lungs is now a reality for diabetes, paving the way for other major indications such as cancer and post-operative pain, Parkinson's disease and erectile dysfunction.

Advances in inhaler design and powder engineering should drive growth in dry powder inhalation (DPI) for both upper respiratory tract and systemic applications. The inherent advantages of dry powder formulations for large molecule drug compounds and new DPI inhalers specifically engineered to deliver these expensive new chemical entities to the deep lung should serve as a catalyst for the adoption of DPI as the technology of choice.

In summary, the factors that will influence the total demand for inhalation-based therapeutics include:

- The growth in the number of cases of upper respiratory disease;
- The expected increase in self-administration for the treatment of chronic conditions;
- The pulmonary administration of therapeutics for systemic delivery;
- Technological improvements in inhalation delivery.

LAB is well positioned to take advantage of these and other trends such as the growing demand for drug abuse deterrence solutions, given its current product development and drug delivery platform portfolios. LAB will continue to focus on those therapeutic opportunities which can be accelerated to market and facilitate licensing and co-development agreements to offset product development costs and risk.

### Critical accounting policies

In preparing the Company's consolidated financial statements in conformity with GAAP, management is required to make certain estimates, judgments and assumptions that the Company believes are reasonable based upon the information available. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the periods presented. The accounting policies which the Company considers to be critical are those that require the most difficult, subjective, or complex judgments and that are the most important to aid in fully understanding and evaluating its consolidated financial statements. These accounting policies are discussed in the following paragraphs.

**Property, equipment and intangible assets** are stated at cost and are amortized over their estimated useful lives on a straight-line basis. The Company regularly reviews property, equipment and intangible assets costs for impairment whenever events or changes in business circumstances indicate that the carrying amount of the assets exceed the sum of the expected cash flows from their uses and disposal. Management's judgment regarding the existence of impairment indicators is based on legal factors, market conditions and operating performances. Future events could cause management to conclude that impairment indicators exist and that the carrying values of the Company's property, equipment or intangible assets costs are impaired. Any resulting impairment loss could have a material adverse impact on the Company's financial position and results of operations.

**Income taxes** are accounted for under the asset and liability method. Future tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carry forwards. Future tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Management provides valuation allowances against the future tax assets for amounts which are not considered "more likely than not" to be realized. In assessing the realizability of tax assets, management considers whether it is more likely than not that some portion or all of the tax assets will not be realized. The ultimate realization of future tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of tax liabilities, projected future taxable income, and tax planning strategies in making this assessment.

**Research and development** costs consist of direct and indirect expenditures, including a reasonable allocation of overhead expenses, associated with the Company's various research and development programs. Research and development costs are expensed as incurred. Overhead expenses comprise general and administrative support provided to the research and development programs and involve costs associated with support activities such as facility maintenance, utilities, office services, information technology and human resources. The Company reviews and accrues clinical trials expenses based on work performed, which relies on estimates of total costs incurred based on completion of patient studies and other events. The Company follows this method since reasonable dependable estimates of the costs applicable to various stages of a research agreement of clinical trial can be made. Accrued clinical costs are subject to revisions as trials progress to completion. Revisions are charged to expense in the period in which the facts that give rise to the revision become known.

**Stock-based compensation** is recorded using the fair value based method for all issued options. Under this method, compensation cost is measured at fair value at the date of grant and is expensed over the award's vesting period. The Company uses the Black-Scholes options pricing model to calculate stock options values, which required certain assumptions, including the future stock price volatility and expected time to exercise. Changes to any of these assumptions, or the use of a different option pricing model, could produce different fair values for stock-based compensation, which could have a material impact on the Company's earnings.

**Revenue for LAB Research** consists of services rendered to customers and are recognized as the services are performed by the Company. Revenue is recorded by determining the status of work performed per contract in relation to the total services to be provided. Work in progress represents amounts receivable for services rendered, but which only become billable in accordance with contractual payment terms. Deferred revenues represent amounts billed in accordance with customer contracts, but not yet earned.

**Revenue for LAB Pharma** consists of development services performed on behalf of third parties. Revenues are recognized at the time research activities are performed under the agreement. Revenue from development and license agreements that include multiple elements are considered to be revenue arrangements with multiple deliverables. Under this type of arrangements, the identification of separate units of accounting is required and revenue is allocated among the separate units based on their relative fair values or using the residual method. Payments received under these agreements may include up-front payments, regulatory based milestones for specific achievements as well as fees for development funding, sales and royalties. Up-front and regulatory milestones payments, which require the Company's ongoing involvement, are deferred and amortized into income on a straight-line basis over the estimated period of service. When a milestone is achieved, a portion of the milestone revenue equal to the progress toward completion would be recognized. The remaining portion of the milestone is amortized into future periods as additional progress toward completion is achieved. Fees for development funding, sales and royalties are recognized when the service is rendered or the product is delivered and the amount is determinable and collectibility is reasonably assured.

### Recent accounting pronouncements

During 2005, the Canadian Institute of Chartered accountants (CICA) released new accounting standards for the recognition, measurement and disclosure of financial instruments (Section 3855), hedges (Section 3865) and comprehensive income (Section 1530).

Under these new standards, all financial assets are measured at fair value with the exception of loans, receivables and investments that are intended to be held to maturity and certain equity investments, which are measured at cost. Similarly, all financial liabilities held for trading and derivatives are measured at fair value.

Gains and losses on financial instruments measured at fair value will be recognized in the income statement in the periods they arise with the exception of gains and losses arising from:

- Financial assets available for sale, for which unrealized changes in fair value and initially reported in other comprehensive income and subsequently reclassified to net income when the financial assets are sold or become impaired; and
- Certain financial instruments that qualify as hedging items under the application of hedge accounting for which unrealized changes in fair value are initially reported in other comprehensive income and subsequently reclassified into net income when the offsetting loss or gain of the hedged item affects net income.

Other comprehensive income comprises net income adjusted for revenues, expenses, gains and losses that are excluded from net income under generally accepted accounting principles. Unrealized gains and losses on qualifying hedging instruments, translation of self-sustaining foreign operations, and unrealized gains or losses on financial instruments held for sale will be included in other comprehensive income and reclassified in net income when realized. Comprehensive income and its components will be a new financial statement required under the new standards. The new standards will be effective for the Company's 2007 financial year. The Company is currently evaluating the impact of these standards on the Company's financial position and results of operations.

## Risks and uncertainties

These risks and uncertainties should be read in conjunction with the Risk Factors detailed in our Annual Information Form.

### Additional funding

LAB's long-term success depends, in part, on its ability to access the capital markets. There is no assurance that additional capital will be available on a timely basis and with acceptable conditions.

To obtain the necessary capital, the Company must rely on additional share / debt issues, collaboration agreements and corporate partnerships to provide full or partial funding for its activities and commercialization of its products. Should the Company fail to obtain the necessary capital, it will have to reduce its development activities, unless it is able to enter into agreements to obtain financial support from third parties. Such financial support may require that the Company waive its rights to some of its eventual products or technologies.

### Volatility of share price

The market price of the Company's shares is subject to volatility. General market conditions as well as differences between the Company's financial, scientific and clinical results and the expectations of investors as well as securities analysts can have a significant impact on the trading price of the Company's shares. In recent years, the stocks of many biopharmaceutical companies have experienced extreme price fluctuations, unrelated to the operating performance of the affected companies. There can be no assurance that the market price of the common shares will not continue to experience significant fluctuations in the future, including fluctuations that are unrelated to the Company's performance.

### Preclinical and clinical studies

The Company is presently conducting preclinical and clinical studies for these programs which will take several years to complete and require considerable resources from the Company. Confirmation of positive, timely and conclusive results from this program is an essential condition of regulatory approval and, therefore, product commercialization. There can be no assurance that the positive results achieved will be confirmed and unsatisfactory results may considerably hinder the development, approval and commercialization of the Company's products.

### Regulatory approvals

In order to commercialize its products and, hence, generate revenues, the Company must first obtain the approval of regulatory agencies in each of the countries where it wishes to sell its products. The Company's products may not meet the safety and effectiveness criteria established by the various agencies and, consequently, may not obtain required approvals for commercialization for any or all targeted indications. Furthermore, no assurance can be given that current regulations relating to regulatory approval will not change or become more stringent. Moreover, any regulatory approval of a drug which is eventually obtained may entail limitations on the indicated uses for which that drug may be marketed. In addition, it must be noted that product approvals may be withdrawn if problems occur following initial marketing or if compliance with regulatory standards is not maintained.

### Product Development

The success of the Company will depend upon its ability to commercialize or license the commercial rights to the proprietary products which it discovers and develops. Development of new chemical compounds through the various testing phases is a lengthy and costly process. Most newly discovered compounds, regardless of their early promise, do not survive the development process to become new products. There is no assurance that any of the new products or technologies currently being developed by the Company will reach the market or that, if any does so, it will be commercially successful.

### **Patents**

The Company's success will depend in part on its ability to obtain patents or rights to patents, and to operate without infringing the exclusive rights of third parties. There is no assurance that any patent (or rights) thereto granted to the Company will bring any competitive advantage to the Company, that its patent protection will not be contested by third parties, or that the patents of competitors will not be detrimental to the Company's commercial activities. It cannot be assured that competitors will not independently develop products similar to the Company's products, that they will not imitate the Company's products or that, if the Company obtains patents, its competitors will not manufacture products designed to circumvent the exclusive patent rights of the Company.

### **Competition**

LAB is subject to significant competition from pharmaceutical companies, biotechnology companies, academic and government research institutions, and other organizations pursuing technologies or offering services similar to those of the Company. Many of the organizations competing with the Company have greater capital resources, research and development staffs, facilities and marketing capabilities.

### **Key personnel and ability to manage growth**

The Company continues to experience growth in the number of its employees and the scope of its operations. LAB needs to be able to attract and retain a highly skilled workforce which includes MDs, PhD's of various disciplines, chemists, biologists, laboratory technicians and support staff.

### **Ability to manage growth**

Future growth, if any, may cause a significant strain on the Company's management and its operational, financial and other resources. The Company's ability to manage growth effectively will require it to implement and improve operational, financial, manufacturing and management information systems and to expand, train, manage and motivate employees. These demands may require the addition of management personnel and the development of additional expertise by management. Any increase in resources devoted to research, product development and marketing and sales efforts without a corresponding improvement in operational, financial, manufacturing and management information systems could have a material adverse effect on the Company's business, financial condition and results of operations.

### **Foreign currency risk**

LAB's revenues are generated primarily in Euros with the majority of its expenses paid in local currencies. The Company's consolidated profitability could therefore be affected by fluctuation in the Euro relative to the Canadian dollar. These fluctuations may be substantial and are difficult to predict. From time to time the Company uses derivative financial instruments to mitigate the risk of foreign exchange losses which may materially effect its operations.

Additional information relating to the Company is available on SEDAR'S website @ [www.sedar.com](http://www.sedar.com).

On behalf of Management,



**Andrew Reiter, CA**

Chief Financial Officer

Montreal, Quebec, Canada

March 22 , 2007

## Management's report

The accompanying consolidated financial statements have been prepared by management and were approved by the Board of Directors of the Company. Management is responsible for the information and representations contained in these financial statements and other sections of this Annual Report. The financial statements have been prepared in accordance with accounting principles generally accepted in Canada. In preparing these consolidated financial statements, management selects appropriate accounting policies and uses its judgement and best estimates to report events and transactions as they occur. Management has determined such amounts on a reasonable basis in order to ensure that the financial statements are presented fairly, in all material respects. Financial information included throughout this Annual Report is prepared on a basis consistent with that of the financial statements.

To assist management in discharging these responsibilities, the Company maintains a system of internal controls which are designed to provide reasonable assurance that its assets are safeguarded, that transactions are executed in accordance with management's authorization and that the financial records form a reliable base for the preparation of accurate and timely financial information.

KPMG LLP, the Company's auditors, are appointed by the shareholders. They independently review the Company's system of internal controls and perform the necessary tests of accounting records and procedures to enable them to report their opinions as to the fairness of the consolidated financial statements and their conformity with generally accepted accounting principles.

The Board of Directors ensures that management fulfills its responsibilities for financial reporting and internal controls. The Board exercises this responsibility through an Audit Committee composed of three Directors. The Audit Committee meets periodically with management and with the external auditors, to review audit recommendations and any matters that the auditors believe should be brought to the attention of the Board of Directors. The Audit Committee also reviews the consolidated financial statements and recommends to the Board of Directors that the statements be approved for issuance to the shareholders.



Halvor Jaeger, M.D., F.C.P.  
Chief Executive Officer



Andrew Reiter, CA  
Chief Financial Officer

## Auditors' Report to the Shareholders

We have audited the consolidated balance sheets of Lab International Inc. as at December 31, 2006 and 2005 and the consolidated statements of operations, deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2006 and 2005 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

KPMG LLP

Chartered Accountants  
Montréal, Canada  
March 21, 2007

# Consolidated Balance Sheets

December 31, 2006 and 2005

(in thousands of Canadian dollars)

	2006	2005
	\$	\$
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	41,144	16,269
Cash held in escrow	-	541
Accounts receivable (note 6)	1,569	8,469
Work in progress	-	2,314
Research tax credits receivable	-	1,333
Prepaid expenses	830	1,262
	<b>43,543</b>	<b>30,188</b>
Property and equipment (note 7)	462	22,748
Intangible assets (note 8)	9,340	11,831
Other assets (note 9)	965	2,222
Future income taxes (note 12)	-	6,957
	<b>54,310</b>	<b>73,946</b>
<b>Liabilities and Shareholders' Equity</b>		
Current liabilities:		
Bank loan	-	432
Accounts payable and accrued liabilities	5,372	11,046
Income taxes payable	323	-
Deferred revenue	1,872	6,059
Current portion of long-term debt (note 10)	1,697	2,328
Due to Scantox selling shareholders	-	541
Current portion of convertible debentures (note 11)	-	1,509
Deferred gain on sale of property	-	68
Future income taxes (note 12)	185	688
	<b>9,449</b>	<b>22,671</b>
Long-term debt (note 10)	4,951	12,496
Deferred rent liability	-	37
Deferred gain on sale of property	-	1,603
Debt component of convertible debenture (note 11)	-	2,510
Future income taxes (note 12)	1,216	4,021
Shareholders' equity:		
Share capital (note 13 (a))	63,046	54,380
Warrants (note 13 (d))	556	794
Holder conversion options (note 13 (d))	-	1,099
Additional paid-in capital (note 13 (d))	9,232	8,083
Cumulative translation adjustment	(199)	(1,662)
Deficit	(33,941)	(32,086)
	<b>38,694</b>	<b>30,608</b>
Commitments and contingencies (note 17)		
Subsequent events (note 24)		
	<b>54,310</b>	<b>73,946</b>

See accompanying notes to consolidated financial statements.

Approved on behalf of the Board of Directors:

  
Director

  
Director

# Consolidated Statements of Operations

Years ended December 31, 2006 and 2005

(in thousands of Canadian dollars, except per share data)

	2006	2005
	\$	\$
Revenues	29,448	46,490
Operating expenses:		
Direct costs	15,977	26,123
Selling, general and administrative	15,087	18,201
Research and development	13,066	9,373
Stock-based compensation (note 15)	1,005	802
Amortization of property and equipment	2,349	2,968
Amortization of intangible assets	1,453	1,663
Interest on long-term debt and loss on convertible debentures (note 11)	1,629	1,816
Foreign exchange	1,130	(426)
	51,696	60,520
Loss before undernoted items	(22,248)	(14,030)
Other:		
Gain on disposal of Lab Research Inc. (note 3)	34,149	-
Share in net income of a company subject to significant influence	300	-
Restructuring (note 14)	(4,376)	-
	30,073	
Earnings (loss) before income taxes	7,825	(14,030)
(Provision for) recovery of income taxes (note 12):		
Current	(2,857)	(2,137)
Future	(5,195)	3,092
	(8,052)	955
Net loss	(227)	(13,075)
Net loss per share (note 16):		
Basic	0.00	(0.24)
Diluted	0.00	(0.24)

See accompanying notes to consolidated financial statements.

# Consolidated Statements of Deficit

Years ended December 31, 2006 and 2005

(in thousands of Canadian dollars)

	2006	2005
	\$	\$
Deficit, beginning of year	(32,086)	(17,572)
Net loss	(227)	(13,075)
Settlement of convertible debentures (note 11)	(1,672)	-
Share issue costs	44	(1,439)
Deficit, end of year	(33,941)	(32,086)

See accompanying notes to consolidated financial statements.

# Consolidated Statements of Cash Flows

Years ended December 31, 2006 and 2005

(in thousands of Canadian dollars)

	2006	2005
	\$	\$
Cash flows from operating activities:		
Net loss	(227)	(13,075)
Adjustments for:		
Amortization and write-off of property and equipment	2,349	3,032
Amortization of intangible assets	1,453	1,663
Amortization of other assets	490	72
Accretion expense on convertible debentures	178	915
Stock-based compensation	1,005	802
Restructuring (note 14)	3,996	-
Gain on disposal of Lab Research Inc. (note 3)	(34,149)	-
Share in net income of a company subject to significant influence	(300)	-
Gain on disposal of long-term investment	(146)	-
Services rendered in exchange of shares	27	-
Loss on settlement of convertible debenture (note 11)	746	-
Unrealized foreign exchange loss (gain)	1,120	(605)
Amortization of deferred gain on sale of property	(64)	(12)
Deferred rent liability	(125)	-
Future income taxes	5,195	(3,092)
Net changes in operating assets and liabilities (note 18 (a))	(111)	2,232
	<b>(18,563)</b>	<b>(8,068)</b>
Cash flows from financing activities:		
Proceeds from exercise of stock options and warrants	331	-
Proceeds from private placements	-	14,683
Proceeds from issue of convertible debentures	-	6,243
Repayment of convertible debentures	(519)	(1,079)
Share issue costs	44	(1,430)
Proceeds from issuance of long-term debt	1,614	2,606
Repayment of long-term debt	(1,485)	(5,332)
Repayment of capital leases	-	(311)
Proceeds from bank loan	223	432
Repayments under bank credit facilities	(432)	(53)
	<b>(224)</b>	<b>15,759</b>
Cash flows from investing activities:		
Proceeds from disposal of Lab Research Inc. (note 3)	56,891	-
Fees on sale of Lab Research Inc. (note 3)	(8,680)	-
Deferred corporate transaction costs	(965)	-
Business acquisition, net of cash acquired	-	(6,171)
Cash balance transferred to Lab Research Inc. upon sale	(961)	-
Payment of holdback payable	-	(65)
Additions to property and equipment	(2,075)	(2,847)
Deferred financing fees	(10)	(317)
Additions to intangible assets	(443)	(327)
Proceeds from sale lease-back transaction	-	6,250
Fees on sale lease-back transaction	-	(303)
Other assets	(170)	(1,484)
	<b>43,587</b>	<b>(5,264)</b>
Net increase in cash and cash equivalents	24,800	2,427
Cash and cash equivalents, beginning of year	16,269	12,049
Effect of exchange rate changes	75	1,793
Cash and cash equivalents, end of year	<b>41,144</b>	<b>16,269</b>

See accompanying notes to consolidated financial statements.

# Notes to Consolidated Financial Statements

Years ended December 31, 2006 and 2005

(in thousands of Canadian dollars, except per share data)

## 1. Nature of operations:

Established in 1998, LAB International Inc. (the "Company") is a drug development company. During the year, the Company completed an initial public offering of one of its two business units, LAB Research Inc. ("LRI"; formerly LAB Research segment), as explained in note 3. The primary business activity of the remaining unit, LAB Pharma, is the development of therapeutics and platforms with a focus on inhalation delivery.

## 2. Significant accounting policies:

### (a) Principles of consolidation:

The consolidated financial statements include the consolidated accounts of the Company and its wholly-owned subsidiaries. As described in note 3, the Company disposed of a majority interest in LRI on August 3, 2006. The results of operations of LRI are consolidated with those of the Company up until the date of loss of control. From August 3 up until November 9, 2006, the date of sale of the remaining interest in LRI, the Company accounted for its interest in LRI using the equity method. Under the equity method, the carrying value of the investment is adjusted for the Company's share of earnings or losses less dividends.

All significant intercompany balances and transactions have been eliminated on consolidation.

### (b) Cash and cash equivalents:

All highly liquid investments with an original maturity of three months or less are accounted for as cash equivalents.

### (c) Property and equipment:

Property and equipment are recorded at cost. Assets under capital leases are recorded at the present value of minimum lease payments. Amortization is computed using the straight-line method over the following periods:

Laboratory equipment	5 to 10 years
Manufacturing equipment	5 to 10 years
Computer equipment and software	3 to 5 years
Furniture and office equipment	3 to 7 years
Leasehold improvements	7 years
Automotive equipment	5 to 7 years

### (d) Intangible assets:

The capitalized amount with respect to patents relates to direct costs incurred in connection with securing the patents. Patents are stated at cost and are amortized using the straight-line method over periods ranging from ten to twenty years. Licenses, trademarks and intellectual property rights acquired are stated at cost and are amortized over their estimated useful lives of ten years using the straight-line method. Customer contracts and relationships are amortized over their estimated useful lives of seven years.

### (e) Impairment and disposal of long-lived assets:

Long-lived assets, consisting of property and equipment and intangible assets with definite useful lives, are tested for recoverability whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognized for long-lived assets, 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 recognized is measured as the amount by which the carrying amount of the net asset exceeds its fair value. Fair value is the estimated value at which the asset would be bought or sold in a transaction between willing parties. The fair value against which the asset is measured may be established based on comparable information or transactions, or any other acceptable method of assessment.

## 2. Significant accounting policies (continued):

### (f) Deferred financing fees:

The costs of obtaining long-term financing are deferred and amortized on a straight-line basis over the term of the related debts ranging from three to five years.

### (g) Income taxes:

The Company applies the asset and liability method to account for income taxes. Under this method, future income tax assets and liabilities are determined based on the differences between the financial reporting and the tax basis of assets and liabilities and are measured using substantively enacted tax rates and laws that are expected to be in effect in the periods in which the future tax assets or liabilities are expected to be realized or settled. The Company establishes a valuation allowance against future income tax assets if, based on available information, it is more likely than not that some or all of the future income tax assets will not be realized.

### (h) Revenue recognition:

LAB Pharma revenues consist of pharmaceutical development services performed on behalf of third parties. Revenues are recognized at the time research activities are performed under the agreement. Upfront and milestone payments which require the Company's on going involvement, are deferred and amortized into income over the estimated period of service. When a milestone is achieved, a portion of the milestone revenue equal to the amount of progress toward completion would be recognized. The remaining portion of the milestone is amortized into future periods as additional progress toward completion is achieved. Fees for development funding, sales and royalties are recognized when the service is rendered or the product delivered, the amount is determinable and collectibility is reasonably assured.

LAB Research revenues are included up until August 3, 2006 (see note 3) and consist of services rendered to customers and are recognized as the services are performed or delivered by the Company. Revenue is recorded by determining the status of work performed per contract in relation to the total services to be provided. Work in progress represents amounts receivable for services rendered, but which only become billable in accordance with contractual payment terms.

Revenues that include multiple elements are considered to be revenue arrangements with multiple deliverables. Under these arrangements, the identification of separate units of accounting is required and revenue is allocated among the separate units based on their relative fair values or using the residual method. Revenues for each unit of accounting are then recorded as described above.

### (i) Research and development expenses:

Research costs are expensed as incurred. Development costs are charged against income in the year of expenditure unless a development project meets the criteria under generally accepted accounting principles for deferral and amortization. Deferred development costs are amortized using the straight-line method over a period of three years beginning in the year of commercialization.

### (j) Government assistance:

Amounts received resulting from government assistance programs, including grants and investments tax credits for research and development, are reflected as a reduction of the cost of the asset or expense to which they relate at the time the eligible expenditures are incurred. Tax credits are recorded in the accounts when reasonable assurance exists that they will be realized.

### (k) Foreign currency translation:

#### (i) Domestic and integrated foreign operations:

Assets and liabilities in foreign currencies related to domestic and integrated foreign operations are translated into Canadian dollars using current exchange rates for monetary assets and liabilities, historical exchange rates for non-monetary assets and liabilities, and the average exchange rate during the year for revenues and expenses, except for amortization, which is translated at the historical exchange rate of the corresponding non-monetary assets. Exchange gains and losses arising on translation are included in income in the period incurred.

## 2. Significant accounting policies (continued):

### (ii) Self-sustaining foreign operations:

Assets and liabilities of self-sustaining foreign operations are translated into Canadian dollars using the rate of exchange in effect at the balance sheet date. Revenue and expense items (including amortization) are translated at the average exchange rate for the year. Exchange gains and losses arising from the translation are included in the cumulative translation adjustment account, a separate component of shareholders' equity.

### (l) Stock-based compensation:

Employee stock options are accounted for using the fair value based method. Under this method, compensation cost is measured at fair value at the date of grant and is expensed over the award's vesting period.

### (m) Earnings per share:

Basic earnings per share are computed by dividing net earnings by the weighted average number of common shares outstanding during the year. Diluted earnings per share are computed in a manner consistent with basic earnings per share except that the weighted average number of shares outstanding is increased to include additional shares from the assumed exercise of options and warrants, if dilutive. The number of additional shares is calculated by assuming that outstanding options and warrants were exercised and that the proceeds from such exercises are used to repurchase common shares at the average share price for the reporting period.

The dilutive effect of the convertible debentures is reflected in diluted earnings per share by application of the "if-converted" method, if dilutive. Under the if-converted method, convertible notes are assumed to have been converted at the beginning of the year (or at time of issuance, if later) and the resulting common shares are included in the denominator for purposes of calculating diluted earnings per share.

### (n) Guarantees:

In the normal course of business, the Company enters into various agreements that may contain features that meet the definition of a guarantee. A guarantee is defined to be a contract (including an indemnity) that contingently requires the Company to make payments to a third party based on (i) changes in an underlying interest rate, foreign exchange rate, equity or commodity instrument, index or other variable, that is related to an asset, a liability or an equity security of the counterparty, (ii) failure of another party to perform under an obligating agreement or (iii) failure of another party to pay its indebtedness when due.

A liability is recorded when the Company considers probable that a payment relating to a guarantee has to be made to the other party by the contract or agreement.

### (o) Use of estimates:

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and revenue and expenses for the period reported.

Significant areas requiring the use of management estimates include estimating the advancement of work on certain contracts for revenue recognition purposes, estimating the useful lives of long-lived assets, including property and equipment and intangible assets, estimating the fair value of the financial liability and equity components of a compound financial instrument, estimating the fair value of assets and liabilities in connection with business combinations as well as estimating stock-based compensation and the recoverability of deferred development costs, research tax credits receivable and future tax assets. The reported amounts and note disclosures are determined to reflect the most probable set of economic conditions and planned courses of action. Actual results could differ from those estimates.

### 3. Corporate reorganization and disposal of LAB Research Inc.:

#### (a) Corporate reorganization:

As part of the initial public offering of LRI completed on August 3, 2006, the Company completed the following corporate reorganization:

- (i) On May 24, 2006, the Company incorporated a new entity, LRI, to acquire the pre-clinical contract research services business of the Company. These services were conducted by the LAB Research Segment and consisted of LAB Pre-clinical International Research Inc. ("LAB Canada"), Scantox, Biologisk Laboratorium A/S ("LAB Denmark"), LAB International Research Center Hungary Limited Liability Company ("LAB Hungary") and LAB Research International, Inc. ("LAB US").
- (ii) LAB Canada transferred all of the assets and undertakings comprising its contract research business as well as the shares of LAB US that it held directly to LRI in consideration for a \$26,181 note and 101,915 common shares;
- (iii) The Company transferred all of the shares of LAB Denmark that it held to LRI in consideration for a \$14,000 note and 2,015,713 common shares;
- (iv) The Company transferred all of the shares of LAB Hungary that it held to LRI in consideration for a \$7,841 note and one common share;
- (v) LAB Canada transferred all the shares of LAB Hungary that it held to LRI in consideration for a \$79 note and one common share;
- (vi) The Company sold all of the notes referred to above to 4349695 Canada Inc, a wholly-owned subsidiary of the Company, in exchange for common shares; and
- (vii) 4349695 Canada Inc. subscribed for 12,025,226 common shares of LRI for a total of \$48,101 payable by the cancellation of the notes referred to above.

Upon completion of these transactions, LRI owned all of the contract research assets of LAB Canada and all of the outstanding shares of LAB Hungary, LAB Denmark and LAB US.

As part of this reorganization, the Company and LRI entered into a number of agreements including a Preferred Supplier Agreement which requires that the Company use the pre-clinical inhalation toxicology services of LRI on an exclusive basis for a period of 60 months at reasonable terms and conditions. Both parties also entered into a 60 month non-competition agreement covering Canada, the U.S., and Europe with the exception of Russia, Ukraine, Romania and Belarus.

#### (b) Disposal of interest in LRI:

On August 3, 2006, the Company sold 6,250,000 common shares that it held in LRI for gross proceeds of \$25,000 with an over allotment option granted to the Underwriters for an additional 1,500,000 common shares at \$4 per share. Concurrently, LRI issued 3,750,000 common shares for aggregate proceeds of \$15,000. The Company retained approximately 44% of LRI subsequent to this transaction. Net proceeds amounted to \$23,500 after Underwriters' commissions of \$1,500.

On September 12, 2006, the Underwriters exercised their over allotment option and the Company sold an additional 1,500,000 common shares for gross proceeds of \$6,000. The transaction reduced the Company's interest in LRI to 35.4% and generated net proceeds of \$5,640 after Underwriters' commissions of \$360.

On November 9, 2006 the Company sold its remaining interest in LRI for gross proceeds of \$25,891 and net proceeds of \$24,195 after Underwriters' commissions of \$1,696.

The \$34,149 gain on dilution and disposal of LRI included in the consolidated statement of operations includes \$56,891 in gross proceeds less the carrying value of the assets sold and \$8,680 of related Underwriter's commissions, professional fees and senior management bonuses related to the transactions. Senior management bonuses consisted of \$2,800 in cash payments. The gain is also net of \$1,279 in cumulative translation adjustment ("CTA") representing the proportionate amount of the CTA disposed of by the Company.

#### 4. Business acquisition:

Scantox, Biologisk Laboratorium A/S ("LAB Denmark"):

On February 9, 2005, the Company acquired all of the issued and outstanding shares of LAB Denmark located in Ejby, Denmark. The acquisition has been accounted for using the purchase method.

The total purchase price for the acquisition was \$6,259 including \$156 of corporate transaction costs, of which \$51 were incurred before December 31, 2004. Of the \$6,259 purchase price, approximately ninety percent was paid at closing and the remaining portion was held in escrow and paid on March 31, 2006.

The following table summarizes the estimated fair value of the assets acquired and liabilities assumed at date of acquisition. The purchase price allocation is based upon management's best estimate of the relative fair values of the identifiable assets acquired and liabilities assumed.

	\$
Net assets acquired:	
Current assets	3,826
Property and equipment	10,550
Customer contracts and relationships	3,948
Current liabilities, including bank indebtedness of \$53	(3,621)
Long-term debt	(5,588)
Future income taxes	(2,856)
Net assets acquired for cash	6,259
Consideration:	
Cash	5,718
Balance of sale held in escrow and paid on March 31, 2006	541
	6,259

LAB Denmark was subsequently disposed of as part of the corporate reorganization and disposal of LAB Research Inc. described in note 3.

#### 5. Development and license agreements:

The Company has concluded four development and license agreements for its Fentanyl TAIFUN® inhaler, a fast-acting Fentanyl formulation delivered using the Company's approved TAIFUN® dry powder inhaler platform. Under these agreements, the Company granted development, marketing and distribution rights to its Fentanyl TAIFUN® inhaler in specified world markets. The Company has received or will receive upfront payments, funding for development costs, milestone payments and revenues for supplying the finished product once commercialization begins along with royalties based on future sales.

The Company recognized \$1,625 of revenues under these agreements in 2006 (2005-\$2,911), representing development funding fees of \$1,450 (2005-\$2,691) and amortization of non-refundable upfront and milestone payments received of \$175 (2005-\$220).

## 6. Accounts receivable:

	2006	2005
	\$	\$
Trade <sup>(1)</sup>	1,040	702
Grant receivable <sup>(2)</sup>	122	520
Sales taxes	231	291
Interest	140	-
Other	36	10
	<b>1,569</b>	<b>1,523</b>
LRI:		
Trade	-	6,066
Sales taxes	-	233
Note receivable	-	590
Other	-	57
	-	6,946
	<b>1,569</b>	<b>8,469</b>

- (i) The Company and Grupo Ferrer Internacional SA (« Ferrer ») entered into a development and licensing agreement for Fentanyl TAIFUN® in April 2004. In 2005, the Company invoiced Ferrer \$2,624 (€1,739) for services performed under the agreement in connection with Fentanyl TAIFUN®, of which \$2,400 (€1,743) remained uncollected at December 31, 2005. LAB and Ferrer have had irreconcilable differences of opinion relating to the execution of the Fentanyl development plan. At December 31, 2005, the Company recorded a reserve of \$2,200 (€1,598) against the amount receivable from Ferrer. In December 2006, the Company agreed to accept \$300 (€200) from Ferrer as full and final settlement to cancel the Fentanyl development agreement.
- (ii) In 2004, the Company entered into a funding agreement with Tekes, a Finnish governmental body, which provides government assistance for the research and development of the Company's inhalation products. The Company is eligible to receive funding of up to 50% of eligible projects costs to a maximum of \$6,791 (€4,500), of which 30% or \$2,037 (€1,350) will represent a grant and, 70% or \$4,754 (€3,150), will take the form of a loan. Refer to note 10. During the year, the Company submitted claims under the agreement with Tekes of \$2,004 (€1,408) (2005-\$3,084 (€2,044)), of which \$122 (€79) were receivable at year-end. Of the total claim, \$422 (2005-\$904) was recorded as a reduction of research and development expenses and \$1,582 (2005 - \$2,180) was recorded as a liability in capital loans.

## 7. Property and equipment:

	2006		
	\$		
	Cost	Accumulated amortization	Net carrying amount
Laboratory equipment	931	931	-
Manufacturing equipment	3,802	3,802	-
Computer equipment and software	787	468	319
Furniture and office equipment	158	125	33
Leasehold improvements	48	2	46
Automotive equipment	85	21	64
	<b>5,811</b>	<b>5,349</b>	<b>462</b>
Laboratory equipment	991	209	782
Manufacturing equipment not yet in service	1,401	-	1,401
Manufacturing equipment	2,401	272	2,129
Computer equipment and software	484	151	333
Furniture and office equipment	156	74	82
Automotive equipment	84	-	84
	<b>5,517</b>	<b>706</b>	<b>4,811</b>

## 7. Property and equipment (continued):

	2005		
	\$		
	Cost	Accumulated amortization	Net carrying amount
LRI:			
Land	55	-	55
Buildings	11,422	886	10,536
Laboratory equipment	6,234	1,881	4,353
Laboratory equipment under capital lease	890	170	720
Computer equipment and software	1,684	897	787
Computer equipment and software under capital lease	1,352	310	1,042
Furniture and office equipment	572	265	307
Furniture and office equipment under capital lease	123	75	48
Leasehold improvements	124	80	44
Automotive equipment	56	32	24
Automotive equipment under capital lease	29	8	21
	22,541	4,604	17,937
	28,058	5,310	22,748

Depreciation expense related to assets under capital leases of was \$170 (2005-\$234).

In December 2006, an impairment charge of \$3,996 was recorded against Lab Pharma property and equipment. See note 14.

## 8. Intangible assets:

	2006		
	\$		
	Cost	Accumulated amortization	Net carrying amount
Intellectual property rights acquired	6,826	1,608	5,218
Customer list	254	254	-
Licenses	4,127	778	3,349
Patents	966	202	764
Trademarks	20	11	9
	12,193	2,853	9,340
	2005		
	\$		
	Cost	Accumulated amortization	Net carrying amount
Intellectual property rights acquired	6,826	927	5,899
Customer list	254	160	94
Licenses	2,796	452	2,344
Patents	682	141	541
Trademarks	20	10	10
	10,578	1,690	8,888
LRI:			
Customer contracts and relationships	3,387	444	2,943
	13,965	2,134	11,831

## 9. Other assets:

	2006	2005
	\$	\$
Deferred corporate transaction costs	965	-
Deferred development costs, at cost	-	221
Deferred financing fees	-	251
Other	-	5
	<b>965</b>	<b>477</b>
LRI:		
Deferred financing fees, at cost, net of accumulated amortization of \$269 (2005 - \$30)	-	41
Term deposit pledged as security for non-revolving loan	-	645
Long-term investments, at cost which approximates fair value	-	144
Long-term note receivable from lessor	-	910
Other	-	5
	-	1,745
	<b>965</b>	<b>2,222</b>

Deferred corporate transaction costs relate to direct and incremental costs incurred in connection with the acquisition of PharmaForm LLC, which was acquired on January 25, 2007. See subsequent event note 24.

## 10. Long-term debt:

	2006	2005
	\$	\$
Long-term debt in Euros (2006 and 2005: €404) bearing 8% interest, repayable in 2007 (note 14)	621	556
Long-term debt in Euros (2006 and 2005: €700) bearing 8% interest, repayable October 2007, unsecured	1,076	964
Capital loan in Euros (2006-€3,033; 2005-€1,922) from Finnish governmental agency, bearing interest at the basic rate of interest of the European Central Bank less 1% with a minimum interest rate of 3%. The term of the loan is eight years with no capital repayments in the first four years; repayments are conditional on specified equity requirements in LAB Pharma	4,661	2,645
Capital loans in Euros (2006 and 2005: €188) bearing 5% interest; repayments are conditional on specified equity requirements in LAB Pharma, unsecured	290	259
Long-term debt relating to LRI transferred on corporate reorganization (note 3)	-	10,400
	<b>6,648</b>	<b>14,824</b>
Current portion of long-term debt	1,697	2,328
	<b>4,951</b>	<b>12,496</b>

Long-term debt repayments for the next five years are as follows:

	\$
2007	1,697
2008	-
2009	-
2010	-
2011 and thereafter	4,951
	<b>6,648</b>

## 11. Convertible debentures:

On April 22, 2005, the Company entered into a securities purchase agreement providing for the issuance of a Secured Convertible Term Note (the "Note") in the aggregate principal amount of US \$5,000 (CDN \$6,243).

The Note bears interest at the Wall Street Journal U.S. prime rate plus 2% (subject to reduction in certain events), has a term of three years, is secured by the pledge of the shares of certain subsidiaries and is convertible into common shares at a price of US \$0.85 per share. The Note is repayable over 32 months in equal monthly capital repayments of US \$156 beginning in September 2005 and will be subject to mandatory conversion provided that the market price of the common shares for the five days preceding repayment is equal to or greater than 115% of the conversion price and the amount of conversion does not exceed a specified percentage of the aggregate dollar trading volume for the twenty-two days preceding the repayment. The Purchaser will not be entitled to convert if the number of common shares then held including the effect of dilutive securities would exceed 9.99% of the Company's outstanding common shares. In connection with this transaction, LAB has also issued to the holder a warrant exercisable to purchase up to 1,770,286 common shares of LAB for five years at a price of \$1.28 (US \$1.10) per share. The aggregate amount of common shares issued by the Company pursuant to the Note and the warrant cannot exceed 13,531,413.

The Note was recorded according to its components based on the weighted average of their respective fair values. The financial liability component of the Note is presented as long-term debt and the values of the warrant and the equity instrument component representing the conversion options held by the holder is recorded in shareholders' equity. At date of issuance, the face value of the Note was allocated as follows: debt component - \$4,492; warrant - \$551 and holder conversion options - \$1,200. The value of the debt component of the Note has been determined by discounting the future principal and interest payments at a discount rate which represents the estimated borrowing rate available to the Company for similar debentures having no warrants and no conversion rights. The fair values of the warrant and the holder conversion options were determined using the Black Scholes option pricing model using the following weighted average assumptions: risk free interest rate - 3.13%; expected volatility - 49%; expected year in life - 2.7 years; dividend yield - 0%.

In 2006, the Company made principal repayments of \$519 (2005 - \$1,079). In addition, during 2006, the Company issued 4,618,444 common shares as settlement for \$3,500 of the carrying value of the Note. The consideration paid by the Company as settlement was allocated to the liability and the equity elements of the convertible debenture based on the relative fair values at the date of the transaction. The amount of the loss on settlement related to the liability element was charged to the statement of operations and the difference between the carrying amount and the amount considered to be settled relating to the holder conversion option was charged to the statement of deficit. At December 31, 2006, the Note was settled in full.

## 12. Income taxes:

The income tax provision (recovery) differs from the amount computed by applying the combined Canadian federal and Quebec tax rates to earnings before income taxes. The reasons for the difference and the related tax effects are as follows:

	2006	2005
	\$	\$
Earnings (loss) before income taxes	7,825	(14,030)
Combined Canadian federal and Quebec provincial income taxes at 32% (2005 - 31%)	2,504	(4,351)
Adjustments for:		
Non-taxable portion of capital gains	(6,119)	-
Difference with foreign tax rates	1,621	759
Benefit of losses not recorded	8,885	3,365
Stock-based compensation	330	249
Tax credits not taxable	(52)	(62)
Recognition of previously unrecognized tax assets	-	(852)
Permanent differences and others	883	(63)
Income tax provision (recovery)	8,052	(955)

## 12. Income taxes (continued):

The provision for (recovery of) income taxes is composed of the following:

	2006	2005
	\$	\$
Current income taxes	2,857	2,137
Future income taxes	5,195	(3,092)
	8,052	(955)

The future income tax balances are summarized as follows:

	2006	2005
	\$	\$
Future income tax assets:		
Non-capital losses	15,612	14,194
Share issue costs and deferred financing fees	862	862
Research and development expenses	5,253	4,903
Property and equipment	-	13
Deferred gain on sale of property	-	554
Other	389	233
	22,116	20,759
Less valuation allowance	(22,116)	(13,059)
	-	7,700
Future income tax liabilities:		
Property and equipment	-	(2,337)
Intangible assets	(1,401)	(2,246)
Work in progress	-	(688)
Other assets	-	(181)
	(1,401)	(5,452)
Net future income tax assets	(1,401)	2,248
Presented as:		
Long-term assets	-	6,957
Current liabilities	(185)	(688)
Long-term liabilities	(1,216)	(4,021)
	(1,401)	2,248

## 12. Income taxes (continued):

The Company has accumulated scientific research and experimental expenditures and non-capital losses which are available to reduce future years' taxable income. Details of the available deductions, before valuation allowance, are as follows:

	Federal	Provincial	Foreign
	\$	\$	\$
Scientific research and experimental expenditures:			
Available indefinitely	23,746	-	-
Non-capital losses expiring:			
2011	-	-	6,780
2012	-	-	5,775
2013	-	-	7,981
2014	-	-	5,941
2015	2,824	2,802	9,853
2016	-	-	19,071

## 13. Share capital:

Authorized:

An unlimited number of

- Common shares

- Class A shares, issuable in one or more series, each series to consist of such number of shares as may be fixed by the board of directors. The directors shall determine the rights, privileges, restrictions and conditions attached to each class A series
- Class B shares, designated as voting, redeemable and non-participating

(a) Issued and outstanding:

	2006	2005
	\$	\$
76,238,528 common shares		
(2005 – 69,982,335 common shares)	63,046	54,380

### 13. Share capital (continued):

(a) Issued and outstanding (continued):

Changes in the issued and outstanding common shares for the years ended December 31, 2006 and 2005 were as follows:

	Common Shares	
	Number	Dollars
		\$
Balance, December 31, 2004	49,062,689	35,280
Issued in connection with private placements	16,250,055 <sup>(1)</sup>	14,683 <sup>(1)</sup>
Conversion of debentures	2,609,375 <sup>(2)</sup>	2,720 <sup>(2)</sup>
Issued in connection with the purchase of a customer list	200,000 <sup>(3)</sup>	254 <sup>(3)</sup>
Issued in connection with the acquisition of Seyvika	1,860,216 <sup>(4)</sup>	1,443 <sup>(4)</sup>
Balance, December 31, 2005	69,982,335	54,380
Conversion of debentures (note 11):		
Shares issued	4,618,444	5,970
Ascribed amount from holder conversion option	-	1,060
Issued in connection with services rendered	1,368,316 <sup>(4)(5)</sup>	1,200 <sup>(4)(5)</sup>
Exercise of warrants	110,000	165
Exercise of options	159,433	271
Balance, December 31, 2006	76,238,528	63,046

<sup>(1)</sup> On January 13, 2005, the Company issued 1,453,571 units for gross proceeds of \$1,526. Each unit consisted of one common share and ½ warrant which have since expired.

On January 17, 2005, the Company issued 800,000 units for gross proceeds of \$840. Each unit consisted of one common share and ½ warrant. Each whole warrant is exercisable to purchase one common share of the company at \$1.45 at any time prior January 17, 2007.

The Company also issued 15,750 and 7,000 broker warrants to the agents as additional compensation for the transaction. Each broker warrant still outstanding is exercisable to purchase one common share of the Company at a price of \$1.05 at any time prior to January 17, 2007.

Share issue costs in connection with those transactions were \$395. Share issue costs also comprise fees paid in cash of \$386, as well as the fair value of the broker warrant, which was determined to be \$9. The fair value was determined using the following assumptions: risk free interest rate – 3.2%; expected volatility –61%; expected year in life –1; dividend yield: 0%.

On December 12, 2005, the Company issued 13,996,484 common shares for gross proceeds of \$12,317. Share issue costs in connection with this transaction were settled in cash for a total amount of \$1,044.

<sup>(2)</sup> As part of the acquisition of Lab Pharma in 2004, the principal vendors of Lab Pharma co-invested €4,000 in the form of zero coupon convertible debentures to finance the operations of LAB Pharma. The remaining portion of the convertible debentures were converted into 2,609,375 common shares in February 2005.

<sup>(3)</sup> On December 18, 2004, the Company entered into a marketing agreement with a counter party whose chief executive officer is a member of the Board of Directors. Under the agreement, a customer list was purchased and paid for by the issuance of 200,000 common shares with a fair value of \$254. The shares were issued on April 5, 2005.

<sup>(4)</sup> On October 16, 2006, the Company issued 1,348,316 common shares (2005 – 1,860,216) in connection with research and development milestones attained relating to calcitonin gene related peptide which was acquired as part of the Seyvika transaction. The common shares had an aggregate market value of \$1,173 (2005 - \$ 1,443) at date of issuance.

### 13. Share capital (continued):

<sup>(s)</sup> On January 25, 2005, the Company entered into an agreement in connection with investor relation services. Services were rendered and 20,000 shares were issued on June 5, 2006 for a fair value of \$27.

#### (b) Warrants and broker units:

As of December 31, 2006, the following warrants were outstanding:

Warrants	Broker units/ warrants	Exercise price	Expiry
400,000 <sup>(2)</sup>	-	1.45	January 17, 2007
-	7,000 <sup>(2)</sup>	1.05	January 17, 2007
1 <sup>(1)</sup>	-	1.28	April 22, 2010
400,001	7,000		

<sup>(1)</sup> In connection with the issuance of the convertible debentures, the Company has issued one warrant exercisable to purchase up to 1,770,286 common shares at a price of \$1.28 (US \$1.10) per share at any time prior to April 22, 2010.

<sup>(2)</sup> These warrants and broker units/warrants expired unexercised on January 17, 2007. In addition, 4,186,405 warrants with an exercise price of \$1.45 and 500,097 broker units/warrants with an exercise price of \$1.05 expired unexercised on December 31, 2006.

#### (c) Stock option plan:

The stock option plan (the "Plan") is designed to attract, retain and motivate directors, officers, employees and consultants of the Company and to advance the interests of the Company by providing such persons with the opportunity to participate in the long-term growth of the Company. The Plan is administered by the Company's Board of Directors and, subject to the provisions of the Plan, the number of shares subject to each option, the option price, the expiration date of each option, the extent to which options are exercisable from time to time and the terms and conditions relating to each such option shall be determined by the Board.

The aggregate number of common shares available for issuance is 10% of the common shares outstanding. The number of common shares, which may be issued to any one person under the Plan, and any other stock compensation agreement, shall not exceed 5% of the Company's common shares on a non-diluted basis. The exercise price of the stock options granted under the Plan must not be less than the most recent quoted closing market price per share. Options are granted for a term not exceeding ten years. In general, options vest over periods of up to three years.

Changes in outstanding options issued under the Company's stock option plan for the years ended December 31, 2006 and 2005, were as follows:

	Number	Weighted Average Exercise Price
Balance, December 31, 2004	4,176,699	1.17
Granted	1,706,331	0.97
Cancelled	(606,300)	1.08
Balance, December 31, 2005	5,276,730	1.12
Granted	1,885,749	1.10
Cancelled	(403,382)	1.07
Exercised	(159,433)	1.04
Balance, December 31, 2006	6,599,664	1.12
Options exercisable, December 31, 2006	4,988,825	1.12

### 13. Share capital (continued):

#### (c) Stock option plan (continued):

The following table summarizes information about stock options outstanding and exercisable at December 31, 2006:

\$			
Exercise price	Options outstanding	Options exercisable	Weighted average remaining contractual life (years)
1.55	100,000	100,000	0.17
1.25	200,000	200,000	0.17
1.00	9,600	9,600	1.17
0.98	133,332	133,332	1.17
1.55	20,000	20,000	1.36
1.25	70,000	70,000	1.36
0.98	40,000	40,000	1.36
0.95	85,250	85,250	2.19
1.55	521,670	521,670	5.66
0.98	167,222	167,222	6.72
1.21	305,000	305,000	6.88
1.00	1,005,945	1,005,945	7.18
1.25	257,222	173,333	7.40
1.25	213,056	193,056	7.54
1.25	41,667	41,667	7.71
1.10	75,833	65,833	7.79
1.00	250,000	166,666	7.84
1.01	50,000	33,333	7.90
1.17	50,000	30,000	7.93
1.06	153,334	146,667	8.08
0.94	304,167	126,665	8.36
0.95	456,567	405,454	8.53
0.95	150,000	50,000	8.69
0.95	100,000	50,000	8.75
0.95	50,000	50,000	9.00
1.04	975,216	725,216	9.09
1.19	14,583	14,583	9.09
1.60	200,000	-	9.34
1.57	150,000	-	9.34
0.83	100,000	33,333	9.84
0.90	350,000	25,000	10.00
	6,599,664	4,988,825	7.31

### 13. Share capital (continued):

(d) Changes in “warrants” and “additional paid-in capital” were as follows:

	\$	\$	\$
	Warrants	Holder conversion options	Additional paid-in capital
Balance, December 31, 2004	1,986	-	5,427
Stock-based compensation	-	-	802
Fair value of broker warrants issued as compensation to agents	10	-	-
Fair value of warrants and holder conversion options issued in relation with the convertible debenture	551	1 200	-
Expiry of brokers units	(261)	-	261
Expiry of warrants	(1,492)	-	1,492
Expiry of holder conversion options	-	(101)	101
Balance, December 31, 2005	794	1 099	8,083
Stock-based compensation	-	-	1,005
Exercise of warrants	(28)	-	-
Expiry of warrants	(210)	-	210
Expiry of holder conversion options	-	(39)	39
Exercise of stock options	-	-	(105)
Conversion of debentures - amount transferred to share capital (note 11)	-	(1,060)	-
Balance, December 31, 2006	556	-	9,232

Upon expiry of the warrants and the holder conversion options, the amount previously ascribed to those items is transferred into additional paid-in capital.

### 14. Restructuring:

The Company recorded a charge of \$4,376 relating to the restructuring of the Lab Pharma segment, which includes a \$3,996 impairment loss on property and equipment and \$380 for employee severance. As at December 31, 2006, all amounts accrued for severance costs remained unpaid and are included in “Accounts payable and accrued liabilities” on the consolidated balance sheet.

On March 5, 2007, Lab Pharma and its landlord agreed to an early termination of their lease agreement. The agreement requires a lump sum payment of \$3,258 (€2,130) which includes \$2,221 (€1,452) covering the base rent for the period from February 1, 2007 to September 30, 2008, \$359 (€236) for maintenance costs and the repayment of the unsecured long-term debt of \$676 (€442), including related accrued interest of \$58 (€38). The lump sum payment for rent and maintenance costs will be expensed in 2007.

### 15. Stock-based compensation:

For the year ended December 31, 2006, the Company granted 1,885,749 (2005 – 1,706,331) options. The Company recognized total stock-based compensation of \$1,005 (2005 – \$802).

The weighed average fair value of each option granted is estimated on the date of grant using the Black-Scholes pricing model with the following assumptions:

	2006	2005
Risk-free interest rate	4.01%	3.24%
Expected volatility	65.00%	53.45%
Expected life in years	5.00	3.27
Expected dividend yield	-	-

The following table summarizes the weighted average grant-date fair value per share for options granted during the years ended December 31, 2006 and 2005:

	Number of options	Weighted average grant-date fair value
Exercise price per share equal to market price per share:		
2006	1,885,749	0.60
2005	1,706,331	0.39

Dividend yield was excluded from the calculation since it is the present policy of the Company to retain all earnings to finance operations.

### 16. Earnings per share:

The reconciliation between basic and diluted earnings per share is as follows:

	2006	2005
	\$	\$
Basic:		
Basic weighted average number of common shares outstanding	72,720,104	55,340,410
Basic loss per share	0.00	(0.24)
Diluted:		
Basic weighted average number of common shares outstanding	72,720,104	55,340,410
Plus impact of convertible debentures	2,344,944	5,193,015
Plus impact of stock options and warrants (1)	309,769	8,094
Diluted common shares	75,374,817	60,541,519
Diluted loss per share	0.00	(0.24)

<sup>(1)</sup> Excluded from the above calculations in 2006 are 991,670 stock options, and 400,001 warrants (convertible into 2,170,286 common shares) which were deemed to be anti-dilutive because the exercise prices were greater than the average market price of the common shares (2005: 3,992,000 stock options, 4,586,000 warrants and 507,000 broker units excluded).

The impact of stock options, warrants and convertible debentures is anti-dilutive because the Company incurred losses in 2006 and 2005.

#### 17. Commitments and contingencies:

- (a) The Company entered into operating leases for premises, cars and service contracts related to property and equipment. Minimum lease payments under these agreements are as follows: 2007 - \$2,925; 2008 - \$179; 2009 - \$10.
- (b) To pursue the development of its pharmaceutical products, the Company entered into various agreements. Under these agreements, the Company is committed to pay minimum payments of \$3,085 in 2007.
- (c) The Company entered into one exclusive world-wide master license agreement whereby the Company was granted licenses to further develop and exploit commercial applications to be derived from a specific invention bearing a United States patent serial number.

Under the license agreement, the Company undertakes to pay a royalty of 1.5% to 5% of specified sales, with a minimum annual amount of \$10. This license agreement will expire when the last of the patent rights expire.

- (d) The Company entered into a service agreement with a company controlled by a shareholder, which will provide the services of the CEO with respect to the overall management of the Company for a period of five years commencing on September 1, 2005. The amount payable under this agreement is \$275 per year.
- (e) The Company entered into license agreements and obtained exclusive rights to test an inhalation devices process. Under the first agreement, the Company is committed to paying royalties based on a percentage of sales derived from commercial products developed using the licensed process. The license expires when the last of the patent rights expires. Under the second agreement, the Company is committed to paying royalties based on a percentage of sales derived from commercial products developed using the licensed product with a minimum amount of: 2008 - \$50; 2009 - \$75 and thereafter - \$150 each year.
- (f) As part of the 2004 acquisition of LAB Pharma Oy, the company may contingently issue up to 1,500,000 additional common shares to the principal vendors should other specified regulatory milestones be achieved for the development of Fentanyl Taifun®. As part of the 2003 acquisition of Seyvika, the Company is committed to pay royalties based on a percentage of future sales derived from commercial products developed using the licensed process with a minimum amount of \$50 one year after commercialisation and \$100 every year thereafter.
- (g) The Company is a guarantor under LRI's lease agreement for premises. Minimum lease payments under the lease are as follows: 2007 - \$2,915; 2008 - \$2,175; 2009 - \$2,024; 2010 - \$2,004; 2011 - \$2,105 and thereafter \$36,145. On March 8, 2007, LRI announced that it had entered into an agreement with the landlord to purchase the building that is subject to the lease agreement. The closing of the transaction, subject to conditions to be met by each party, is scheduled to occur on or before April 16, 2007. In addition, under a banking agreement entered into prior to the spin-off and disposal of LRI, the Company was a guarantor of a term loan of LRI. At December 31, 2006, the amount of the loan outstanding was \$223. LRI repaid this amount after year-end.

**18. Supplemental cash flow disclosure and other information:**

## (a) Net changes in operating assets and liabilities:

	2006	2005
	\$	\$
Accounts receivable	(1,643)	432
Work in progress	190	(249)
Research tax credits receivable	791	(413)
Prepaid expenses	(5,781)	(514)
Accounts payable and accrued liabilities	3,358	1,594
Deferred revenue	2,974	1,123
Long-term work in progress	-	259
	(111)	2,232

## (b) Cash paid for:

	2006	2005
	\$	\$
Interest	535	1,167

## (c) Non-cash transactions:

	2006	2005
Warrants issued as settlement for additional compensation to agents	-	10
Issuance of additional common shares in connection with the acquisition of Seyvika	1,173	1,443
Settlement of convertible debentures through issuance of common shares	7,030	2,720
Property and equipment financed through capital leases	525	1,592

## (d) Cash and cash equivalents:

Cash and cash equivalents consist of:

	2006	2005
Cash balances with banks	41,144	4,467
Money market fund	-	11,802
	41,144	16,269

## (e) Direct costs:

Direct costs were net of related research tax credits of \$1,806 (2005 - \$2,445).

#### 19. Related party transactions:

The Company incurred \$420 in 2006 (2005 - \$314) in expenses with firms connected with outside directors of the Company for professional services rendered. The Company incurred \$3,242 (2005 - \$606) as remuneration for services rendered by companies connected to certain shareholders and outside director, including \$3,000 (2005 - \$385) to PRI International Consulting Inc., a company directly controlled by the Company's Chief Executive Officer (CEO) under the agreement referred to in note 17 (d). In 2005, the Company issued 200,000 common shares with a fair value of \$254 in connection with a purchase of a customer list from a company whose chief executive officer is a member of the Company's board of directors.

In 2006, the Company incurred \$998 (2005 - \$870) to non-controlling shareholders for rent expense and services rendered. In addition, the Company incurred \$127 (2005 - \$139) to non-controlling shareholders for interest expense on long-term debt.

From August 3 to November 9, 2006, the Company purchased \$410 of inhalation toxicology services from LRI. Included in accounts payable are amounts due to related parties of \$308 (2005- \$513).

These transactions are measured at the exchange amount of consideration established and agreed to by the related parties.

#### 20. Financial instruments:

##### (a) Credit risk:

Credit risk results from the possibility that a loss may occur from the failure of another party to perform according to the terms of the contract. Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of cash, short-term investments and accounts receivable. Cash is maintained with a high credit quality financial institution. For accounts receivable, the Company performs periodic credit evaluations and typically does not require collateral. Allowances are maintained for potential credit losses consistent with the credit risk, historical trends, general economic conditions and other information.

##### (b) Foreign currency risk:

The Company is subject to foreign currency exchange risk as its revenues are primarily received in U.S. dollars and other currencies while a significant portion of its expenses are paid in Canadian dollars. Its consolidated profitability could therefore be affected by the Canadian/U.S. dollar exchange rate and other exchange rates relative to the Canadian dollar, which exchange rates may fluctuate over time and cannot be accurately predicted. From time to time, the Company engages in the use of derivative financial instruments to manage its currency exposure. At December 31, 2006 and 2005, the Company had not entered into any derivative financial instruments.

##### (c) Interest rate risk:

The Company's exposure to interest rate fluctuations is with respect to the capital loan in Euros from the Finnish governmental body, which bear interest at floating rates.

##### (d) Fair value:

Fair value estimates are made as of a specific point in time using available information about the financial instrument. These estimates are subjective in nature and often cannot be determined with precision.

The Company has determined that the carrying values of the Company's short-term financial assets and liabilities are reasonable estimates of their fair values due to the relatively short periods to maturity of these instruments.

The fair value of the capital loan from the Finnish governmental body approximates its carrying values because interest is based on market-related variable rates. The fair value of the other long-term debt is as follows:

	2006		2005	
	\$	\$	\$	\$
	Carrying amount	Fair value	Carrying amount	Fair value
Long-term debt in Euros (€404)	621	621	556	556
Long-term debt in Euros (€700)	1,076	1,076	964	964
Capital loan in Euros (€188)	290	217	259	259

## 21. Segment disclosures:

The Company has three reportable segments: Research Services, which was sold on August 3, 2006 (note 3), Pharma and Corporate. The activities of the operating segments are described in note 1 to these consolidated financial statements. The Corporate segment is responsible for the Company's financial and corporate direction, and also includes general expenses which cannot be directly attributed to a specific segment. The reporting on the segmented financial information does not include management fees charged by Corporate to the other segments.

Segmented financial information is as follows:

	Year ended December 31, 2006			
	\$	\$	\$	\$
	Research Services (7 months)	Pharma	Corporate	Total
Revenues	26,261	2,551	636	29,448
Direct costs	15,977	-	-	15,977
Selling, general and administrative	5,337	4,065	5,685	15,087
Research and development	-	13,066	-	13,066
Stock-based compensation	34	294	677	1,005
Amortization	1,902	1,451	449	3,802
Interest expense	345	138	1,146	1,629
Foreign exchange	25	813	292	1,130
Gain on disposal of LRI	-	-	34,149	34,149
Share in net income of investee company	-	-	300	300
Restructuring	-	4,376	-	4,376
Income tax expense (recovery)	2,962	(97)	5,187	8,052
Segment earnings (loss)	(321)	(21,555)	21,649	(227)

21. Segment disclosures (continued):

	Year ended December 31, 2005			
	Research Services	Pharma	Corporate	Total
Revenues	43,335	3,109	46	46,490
Direct costs	26,123	-	-	26,123
Selling, general and administrative	7,613	6,028	4,560	18,201
Research and development	-	9,373	-	9,373
Stock-based compensation	128	184	490	802
Amortization	2,979	1,447	205	4,631
Interest expense	762	138	916	1,816
Foreign exchange	(118)	(58)	(250)	(426)
Income tax recovery	(771)	(184)	-	(955)
Segment earnings (loss)	6,619	(13,819)	(5,875)	(13,075)

Revenues were derived from customers located in the following geographic areas:

	2006	2005
	\$	\$
United States	7,790	15,937
Denmark	5,866	8,600
Canada	3,630	6,491
Germany	2,758	3,298
Spain	687	2,910
United Kingdom	694	2,516
Sweden	1,538	2,095
Switzerland	1,823	784
Australia	342	696
Korea	291	686
Hungary	201	559
France	10	536
Belgium	512	497
Norway	329	307
Austria	221	257
Asia- Other	2,272	252
Europe- Other	484	69
	29,448	46,490

**21. Segment disclosures (continued):**

Property and equipment and intangible assets by geographic areas are as follows:

	2006	2005
	\$	\$
Finland	5,390	10,617
Canada	460	6,693
Barbados	3,952	117
Denmark	-	11,962
Hungary	-	4,878
United States		312
	<b>9,802</b>	<b>34,579</b>

	2006	2005
Segment assets:		
Pharma	11,580	12,555
Corporate	42,730	16,480
Research Services	-	44,911
	<b>54,310</b>	<b>73,946</b>

	2006	2005
	\$	\$
Expenditures for segment property and equipment and intangible assets:		
Research Services	1,912	17,167
Pharma	1,272	603
Corporate	568	79
	<b>3,752</b>	<b>17,849</b>

Expenditures for segment property and equipment for the Research Services Segment include long-lived assets purchased through the acquisition of Lab Denmark.

## 22. Foreign currency translation:

Effective July 1, 2005, the Company reclassified LAB Pharma from a self-sustaining operation to an integrated foreign operation because management determined that this subsidiary is financially and operationally interdependent with the parent company. Accordingly, the Company changed its method of translating the financial statements of this subsidiary from the current rate method to the temporal method effective July 1, 2005. Exchange gains and losses to June 30, 2005 that were deferred and accumulated in a separate component of shareholders' equity continue to be deferred. Exchange gains and losses after July 1, 2005 arising on the translation of the financial statements of LAB Pharma are included in the determination of net earnings.

## 23. Comparative figures:

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

## 24. Subsequent event:

On January 25, 2007, the Company announced the acquisition of all of the outstanding membership interests of PharmaForm L.L.C., ("PharmaForm") a privately held company headquartered in Austin, Texas. The aggregate purchase price amounted to \$15,406 (US\$13,158), including \$8,823 (US\$7,500) of cash and common shares valued at \$6,583 (US\$5,658). Under the agreement, additional consideration is payable by the Company upon completion of certain milestones relating to PharmaForm's drug development programs. These amounts are payable at the option of the vendor, either in cash or in common shares. In total, the maximum contingent consideration payable by the Company is \$15,400 (US\$13,200).

The following table summarizes the estimated fair value of the assets acquired and liabilities assumed at the date of acquisition. The Company is in the process of finalizing its valuation of the net assets acquired including the related future income tax liabilities; thus, the allocation of the purchase price is subject to final modifications.

Net assets acquired:	
	\$
Current assets, including cash of \$500	2,050
Long-term assets	15,286
Current liabilities	(675)
Long-term liabilities	(1,255)
	15,406

# General Information

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