cipher
PHARMACEUTICALS INC

2014 Second Quarter Report

STRONG PRODUCT PORTFOLIO

COMMERCIAL PRODUCTS	DIFFERENTIATION / BENEFIT	Q2 2014 HIGHLIGHTS
ABSORICA™ / EPURIS® *Molecule:* Isotretinoin *Indication:* Severe acne *U.S. market size:* US$600 million *Canadian market size:* $15 million	Provides less variability in absorption under fed and fasted conditions, as compared to existing isotretinoin products that exhibit approximately 65% reduction in absorption under fasted conditions.	Absorica continues to perform well since the launch in Q4 2012, achieving 20.3% market share by June 2014. Epuris has been on the market in Canada for nine months and achieved market share of 11.6% by June 2014. Concluded out-licensing deals in Chile (partner Andromaco) in June and in Brazil (partner Ranbaxy) in July 2014
	WHAT'S NEXT? Our partner, Ranbaxy, is marketing Absorica as its flagship dermatology product in the U.S. market. In Canada, our dedicated sales force will continue promoting Epuris with the goal of increasing market share. We are also pursuing out-licensing opportunities for the product in other regions.	
LIPOFEN® *Molecule:* Fenofibrate *Indication:* Hyperlipidemia *U.S. market size:* US$1.6 billion	A unique dosage form providing enhanced absorption under high vs. low fat fed conditions.	During Q2 2014, an authorized generic version of Lipofen was launched. The combined performance of Lipofen and the authorized generic in Q2 2014 was encouraging.
	WHAT'S NEXT? Our partner, Kowa, continues to promote Lipofen using its 250 person sales force.	
CONZIP® / DURELA® *Molecule:* Tramadol *Indication:* Moderate to moderately severe chronic pain *U.S. market size:* US$85 million *(extended-release only)* *Canadian market size:* $26 million	In addition to once-daily dosing, the product has rapid absorption and consistent absorption under fed and fasted conditions, compared with other once-daily formulations.	ConZip prescriptions increased by 11% compared to Q2 2013. Durela continued to demonstrate steady improvement. Sales were 73% higher than Q2 2013. Continued progress with Tecnofarma International, our partner in Latin America, to obtain registration of the product in that region.
	WHAT'S NEXT? Continued revenue growth in North America with our existing partners. Registration of the product in jurisdictions in Latin America by our partner Tecnofarma with initial sales expected in early 2015.	
NEW PRODUCTS		
BETESIL® PATCH *Molecule:* Betamethasone valerate *Indication:* Inflammatory skin conditions such as plaque psoriasis	The Betesil® Patch is applied once-daily to the affected region and may be cut to fit the particular size and shape of the psoriatic lesion reducing contact of the steroid with healthy areas of skin. The occlusive format provides a consistent distribution, delivery and absorption of the active ingredient and enhances the potency of the corticosteroid.	Continued progress in order to submit a regulatory package to Health Canada by Q4 2014.
	WHAT'S NEXT? Submission of a regulatory package to Health Canada.	

PORTFOLIO EXPANSION

Cipher is focused on expanding its product portfolio in 2014 and beyond. To help us accelerate this process, we plan to increase our business development resources, both internally and externally, in the first half of 2014. Priorities include:

- Leveraging our proven clinical development and licensing capabilities to in-license late-stage assets for North America.
- Leveraging our established infrastructure in Canada to add products through product development and/or acquisitions.

LETTER TO SHAREHOLDERS

Dear Shareholder:

In my first letter to shareholders as the CEO of Cipher, I'm pleased to report our second quarter results showed strong increases in revenue, earnings and cash, as our product portfolio continues to perform very well overall.

Total revenue increased 58% to $8.7 million, compared with $5.5 million in last year's second quarter. The year-over-year change mainly reflects the strong performance of Absorica™, which contributed $5.8 million of revenue in Q2 2014 versus $4.1 million in Q2 2013. In addition, the Q2 2014 results benefitted from an increase in revenue from Lipofen®, which contributed $1.9 million versus $0.8 million in Q2 2013. Revenue from our extended-release tramadol product (ConZip®/Durela®) was $0.5 million in Q2 2014, the same as in Q2 2013.

Profitability for the quarter also increased strongly, with EBITDA of $6.5 million in Q2 2014, a 86% rise over Q2 2013. Net income was $4.5 million, or $0.18 per basic share, compared with net income of $3.1 million, or $0.13 per basic share, in Q2 2013. Net income for Q2 2014 included non-cash income tax expense of $1.4 million, compared with nil in Q2 2013.

The Company's strong EBITDA performance during Q2 2014 resulted in a $5.2 million increase in cash in the period. As at June 30, 2014, Cipher had cash and cash equivalents of $39.7 million, compared with $24.2 million at year end.

PRODUCT UPDATE

Our financial results continue to be driven mainly by the performance of Absorica, which achieved 20.3% market share by June 2014, based on total isotretinoin prescriptions. The overall U.S. isotretinoin market also continues to grow, with prescriptions increasing by 9% in the 12-month period ending June 30, 2014, and by 3.3% in Q2 2014 over the comparable period in the prior year.

In the 12-month period following launch, Epuris has achieved market penetration of 11.6% and feedback from the Canadian dermatology community continues to be encouraging. In the coming quarters, we will focus on securing additional public and private coverage for the product and continuing an active marketing campaign.

Out-licensing our acne product in Latin America has been a strategic objective of the Company, and in June we completed a distribution and supply agreement with Laboratorios Andrómaco S.A. for Chile. Subsequent to quarter end, we completed a distribution and supply agreement with Ranbaxy Laboratories Ltd. for Brazil, the largest isotretinoin market in Latin America.

During Q2 2014, Cipher and its partner Kowa Pharmaceuticals agreed to preemptively launch an authorized generic version of Lipofen in advance of the expiration of the product patent in January 2015. Combined performance for the product during Q2 2014 was encouraging, and the increase in revenue over the prior year and the prior quarter reflects deliveries to wholesalers for the launch of the authorized generic.

In Q2 2014, prescriptions of ConZip increased by 11% compared to Q2 2013. In Canada, sales of Durela in Q2 2014 increased by 73% over Q2 2013.

We have a clear mandate to grow our product portfolio, and are pursuing a multi-pronged strategy:

- Using our established infrastructure in Canada to add products through product development and/or acquisitions, with a focus on dermatology;
- Using our proven clinical development capabilities to license in and develop early and late-stage specialty pharmaceutical assets for North America, and expand our commercial infrastructure in the U.S. and Canada accordingly; and
- Leveraging our regulatory approvals in U.S. and Canada to pursue licensing agreements in other markets for our isotretinoin and tramadol products, where attractive.

In executing these strategies, we will consider acquisitions of specific products and companies. With a strong balance sheet and increasing profitability, we are in an excellent position to deliver continued growth. I look forward to updating you on our progress at the end of the next quarter.

Sincerely,

Shawn Patrick O'Brien

President and Chief Executive Officer

MANAGEMENT'S DISCUSSION AND ANALYSIS

June 30, 2014

The following is a discussion and analysis of the operating results and financial position of Cipher Pharmaceuticals Inc. ("Cipher" or "the Company") for the three months ended June 30, 2014. This document should be read in conjunction with the unaudited condensed interim financial statements and the accompanying notes, which have been prepared in accordance with International Financial Reporting Standards ("IFRS"). Additional information about the Company, including the annual financial statements and Annual Information Form for the year ended December 31, 2013, is available on SEDAR at www.sedar.com.

The discussion and analysis within this MD&A are as of July 29, 2014.

Caution Regarding Forward-Looking Statements

This document includes forward-looking statements within the meaning of certain securities laws, including the "safe harbour" provisions of the Securities Act (Ontario) and other provincial securities law in Canada. These forward-looking statements include, among others, statements with respect to our objectives, goals and strategies to achieve those objectives and goals, as well as statements with respect to our beliefs, plans, objectives, expectations, anticipations, estimates and intentions. The words "may", "will", "could", "should", "would", "suspect", "outlook", "believe", "plan", "anticipate", "estimate", "expect", "intend", "forecast", "objective", "hope" and "continue" (or the negative thereof), and words and expressions of similar import, are intended to identify forward-looking statements.

By their very nature, forward-looking statements involve inherent risks and uncertainties, both general and specific, which give rise to the possibility that predictions, forecasts, projections and other forward-looking statements will not be achieved. Certain material factors or assumptions are applied in making forward-looking statements and actual results may differ materially from those expressed or implied in such statements. We caution readers not to place undue reliance on these statements as a number of important factors, many of which are beyond our control, could cause our actual results to differ materially from the beliefs, plans, objectives, expectations, anticipations, estimates and intentions expressed in such forward-looking statements. These factors include, but are not limited to; the applicability of patents and proprietary technology; patent litigation and patent infringement; regulatory approval of products in the Company's pipeline; marketing of products; meeting projected drug development timelines and goals; product liability and insurance; dependence on strategic partnerships and licensees; concentration of the Company's revenue; substantial competition and rapid technological change in the pharmaceutical industry; the the publication of negative results of clinical trials of the Company's products; the ability to access capital; the ability to attract and retain key personnel; changes in government regulation or regulatory approval processes; dependence on contract research organizations; third party reimbursement; the success of the Company's strategic investments; the achievement of development goals and time frames; the possibility of shareholder dilution; market price volatility of securities; and the existence of significant shareholders.

We caution that the foregoing list of important factors that may affect future results is not exhaustive. When reviewing our forward-looking statements, investors and others should carefully consider the foregoing factors and other uncertainties and potential events. Additional information about factors that may cause actual results to differ materially from expectations, and about material factors or assumptions applied in making forward-looking statements, may be found in the "Risk Factors" section of our Annual Information Form and under "Business Risks" and elsewhere in the following Management's Discussion and Analysis of Operating Results and Financial Position for the year ended December 31, 2013, and elsewhere in our filings with Canadian securities regulators. Except as required by Canadian securities law, we do not undertake to update any forward-looking statements, whether written or oral, that may be made from time to time by us or on our behalf; such statements speak only as of the date made. The forward-looking statements included herein are expressly qualified in their entirety by this cautionary language.

Overview

Cipher is a growing specialty pharmaceutical company with three commercial products and a fourth in development. Our product candidates are typically improved formulations of successful, currently marketed drugs. We in-license a product, manage the required clinical development and regulatory approval process, and either out-license it to a marketing partner, or, in Canada, we may market the product ourselves. For our current marketed products, we are responsible for supplying our partners with commercial product. Our core capabilities are in clinical and regulatory affairs, product licensing, supply chain management, and marketing and sales. Since the Company was founded in 2000, we have achieved final regulatory approval in the U.S. and Canada for all three of our original products and completed eight marketing partnerships, generating growing licensing revenue.

Products

LIPOFEN® (CIP-FENOFIBRATE):

Lipofen is a novel patented formulation of the active ingredient fenofibrate, which is used in the treatment of hyperlipidemia, a cholesterol disorder. Hyperlipidemia is a condition characterized by high levels of low-density lipoprotein (“LDL”) cholesterol and/or triglycerides (a type of fat found in the blood). Fenofibrate is known to lower LDL cholesterol and triglycerides and increase high-density lipoproteins (“HDL”), known as "good cholesterol". Fibrates have proven to be superior in lowering triglycerides and raising HDL levels. Lipofen targets a large and growing market. According to IMS, the hyperlipidemia market in the U.S. exceeds US$10.2 billion and is made up of three primary groups of drugs: statins, fibrates and the prescription DHA/EPA (omega 3) market. The market for existing fenofibrate formulations in the U.S. exceeded US$1.6 billion during 2013, down from US$2.0 billion the previous year. The existing Lipofen patent is listed in the FDA's Approved Drug Products List (Orange Book) and the expiry date is January 2015.

ABSORICA™/ EPURIS® (CIP-ISOTRETINOIN):

CIP-ISOTRETINOIN is an innovative formulation of the active ingredient isotretinoin, which is used in the treatment of severe acne. CIP-ISOTRETINOIN, which is based on the same oral Lidose® drug delivery system used with Lipofen, has been in-licensed from Galephar Pharmaceutical Research Inc. (“Galephar”). The Company's marketing rights to this product include the Americas and a majority of the Pacific Rim. CIP-ISOTRETINOIN provides less variability in absorption under fed and fasted conditions, as compared to existing isotretinoin products that exhibit approximately 70% reduction in absorption under fasted conditions.

The product was launched by Cipher’s U.S. distribution partner Ranbaxy Laboratories Inc. (“Ranbaxy”) in Q4 2012 under the trade name Absorica. Cipher was issued a product patent (Patent Number 7,435,427) from the U.S. Patent and Trademark Office in the fourth quarter of 2008. A second product patent (Patent Number 8,367,102) was issued in the first quarter of 2013. The two patents are formulation related patents describing the product ingredients.

According to IMS, the U.S. isotretinoin market was US$0.6 billion in 2013, an increase of 32% over the prior year, with prescriptions growing by 15% on a year-over-year basis.

CIP-ISOTRETINOIN was also approved by Health Canada in Q4 2012 under the trade name Epuris. Cipher launched the product in Canada with its own sales force in June 2013. According to IMS, the Canadian market for isotretinoin is $15 million annually.

CONZIP® / DURELA® (CIP-TRAMADOL ER):

CIP-TRAMADOL ER is a novel, biphasic, extended-release formulation of the active ingredient tramadol, which is used for the management of moderate to moderately severe pain. CIP-TRAMADOL ER uses oral controlled-release beads, a drug delivery technology licensed from Galephar. The novel formulation delivers rapid absorption, similar absorption under different dietary conditions, and 24-hour coverage, supporting ease-of-use for physicians and a high level of compliance among chronic pain sufferers.

The product was launched in the U.S. in September 2011 by Vertical Pharmaceuticals Inc. (“Vertical”) under the trade name ConZip. According to IMS, the U.S. market in 2013 for extended release formulations of tramadol exceeded US$85 million which represents 1.9% of the total tramadol immediate-release and extended-release prescription market.

The product was launched in Canada in March 2012 by Medical Futures Inc. (“Medical Futures”) under the trade name Durela. According to IMS, the Canadian market for extended-release tramadol was $27 million in 2013. Patents have been issued both in the U.S. and Canada for the product.

Growth Strategy

In addition to anticipated growth from our existing products and licensing agreements, led by Absorica, we have built a commercial sales and marketing presence in Canada and our lead product, Epuris, was launched in June 2013. This will be complemented by the Betesil Patch, should it receive Health Canada approval. In addition, Cipher plans to use its established infrastructure in Canada to add products through product development and/or acquisitions. The Company also plans to use its proven clinical development capabilities to license in and develop early and late-stage assets for North America and expand our commercial infrastructure in the U.S. and Canada accordingly. Lastly, we plan to continue to leverage our regulatory approvals in U.S. and Canada to pursue licensing agreements in other markets for our isotretinoin product.

Product Update

LIPOFEN® (CIP-FENOFIBRATE):

Lipofen is the first product from the Company's pipeline to receive U.S. Food and Drug Administration ("FDA") approval. The primary target market for the product is the United States. Cipher's U.S. marketing and distribution partner for Lipofen is Kowa Pharmaceuticals America, Inc. ("Kowa"). The agreement with Kowa, which was executed in 2007, is for a period of ten years and they have the right to extend the term for two additional two-year periods.

Lipofen was launched in the U.S. market in late 2007 and prescriptions have grown as Kowa increased coverage of the primary care physicians in its targeted regions and expanded its sales force, which has grown to approximately 250 representatives. During Q2 2014, Cipher and Kowa agreed to preemptively launch an authorized generic version of Lipofen in advance of the expiration of the product patent in January 2015. Combined performance for the product during Q2 2014 was encouraging and the increase in net revenue over the prior year and the prior quarter reflects deliveries to wholesalers for the launch of the authorized generic.

ABSORICA™/ EPURIS® (CIP-ISOTRETINOIN):

Absorica

Absorica is marketed in the U.S. by Ranbaxy Laboratories Inc. ("Ranbaxy"), a wholly owned subsidiary of Ranbaxy Laboratories Limited, under a distribution and supply agreement which was signed in 2008. The agreement provided for various milestone payments and a royalty percentage in the mid-teens on net sales.

Absorica was released in the U.S. market in late November 2012. The product has performed well since launch, with a 20.3% market share by June 2014, based on total isotretinoin prescriptions (source: IMS). Absorica achieved market share of 22% in March 2014 as a result of a temporary supply shortage of the 30 mg strength from one of the U.S. competitors.

The overall U.S. isotretinoin market continues to grow, with prescriptions increasing by 9% in the 12-month period ended June 30, 2014 and by 3.3% in Q2 2014 over the comparable period in the prior year (source: IMS). Total U.S. isotretinoin prescriptions decreased in Q2 2014 compared to Q1 2014, which is consistent with historical seasonal patterns.

In September 2013, Ranbaxy received a Paragraph IV Certification Notice of filing from Watson Laboratories, Inc. of an Abbreviated New Drug Application ("ANDA") to the FDA for a generic version of Absorica. Ranbaxy and Cipher intend to vigorously defend Absorica's intellectual property rights and pursue all available legal and regulatory pathways in defense of the product. The Markman hearing is expected to be scheduled for Q1 2015.

Absorica is currently protected by two issued patents listed in the FDA's Approved Drug Products List (Orange Book), which expire in September 2021. There are four new product patent applications pending with the U.S. Patent and Trademark Office. In addition, when Absorica was approved by the FDA, Cipher was granted a three-year market exclusivity period, which expires in May 2015.

Cipher has been advised by Ranbaxy that this development has no impact on current sales and marketing plans for the product and that Ranbaxy plans to continue to invest significantly in Absorica.

Epuris

Epuris was approved by Health Canada in Q4 2012 and launched by Cipher in June 2013. The Company has deployed a field sales force of six full-time representatives and one part-time representative. In the 12-month period following launch, Epuris has achieved market penetration of 10.4% and feedback from the Canadian dermatology community continues to be encouraging.

CONZIP® / DURELA® (CIP-TRAMADOL ER):

ConZip

ConZip, the Company's extended-release tramadol product for the treatment of moderate to moderately severe chronic pain in adults, received FDA approval in 2010. In Q2 2011, Cipher entered into a distribution and supply agreement with Vertical, a U.S.-based specialty pharmaceutical company. Cipher receives a royalty on net sales in the mid-teens and is eligible to receive future sales milestone payments of US$3.8 million, contingent upon the achievement of certain future net sales targets.

ConZip was launched by Vertical in September 2011 with a dedicated sales force of 60 representatives**.** During 2013, Vertical expanded the sales force to 75 representatives and in Q4 2013, Avista Capital Partners, a U.S.-based private equity firm, acquired a controlling equity interest in Vertical with plans to invest in additional selling resources. In Q2 2014, ConZip prescriptions increased by 11% compared to Q2 2013.

Durela

In Q3 2011, Cipher received Health Canada approval for Durela and completed a Canadian distribution and supply agreement with Medical Futures. Cipher receives a double-digit royalty on net sales and is eligible to receive future milestone payments contingent upon the achievement of cumulative net sales targets. Medical Futures launched the product in March 2012 with a dedicated sales force of 22 representatives and achieved a market share of 3.8% by the end of 2013. Building on the improved performance during the second half of 2013, sales of Durela in Q2 2014 were 73% higher than Q2 2013 and for the first half of 2014, sales were 68% higher than the comparable period in 2013.

NEW PRODUCTS AND OUT-LICENSING ACTIVITIES:

In Q3 2012, Cipher obtained exclusive license and distribution rights in Canada to market the Betesil Patch, a novel, patent-protected, self-adhesive medicated plaster for the treatment of inflammatory skin conditions such as plaque psoriasis. Based on initial feedback from Canadian dermatologists, the Betesil Patch is expected to provide distinct advantages over existing treatment options, particularly for patients who suffer from plaque psoriasis in hard to treat areas such as knees and elbows. The efficacy and safety of the Betesil Patch has been established in three successful European phase III trials, and the product is currently marketed in several European countries. Cipher is currently finalizing, with its partner Institut Biochimique SA, a regulatory package to submit to Health Canada by Q4 2014.

Cipher is actively pursuing marketing partners for CIP-ISOTRETINOIN in other territories, including Latin America. In June 2014, Cipher entered into a definitive distribution and supply agreement with Laboratorios Andrómaco S.A. ("Andrómaco") under which Cipher has granted Andrómaco the exclusive right to market, sell and distribute Cipher's isotretinoin capsules in Chile. With over 70 years of experience, Andrómaco is a leader in the production and marketing of pharmaceutical products in Chile and certain other Latin American countries. Once regulatory approval is granted, it is expected that Cipher's product will be marketed under the brand name Lisacne-CIP, replacing Andrómaco's current isotretinoin product, Lisacne. Andrómaco is majority owned by Grünenthal GmbH, Germany. Under the terms of the agreement, Cipher will supply product to Andrómaco. Product manufacturing will be fulfilled by Cipher's partner, Galephar.

Subsequent to quarter end, Cipher entered into a definitive distribution and supply agreement with Ranbaxy under which Cipher has granted Ranbaxy the exclusive right to market, sell and distribute Cipher's isotretinoin capsules in Brazil. Ranbaxy plans to promote the product through a brand dermatology division in Brazil. Cipher's isotretinoin formulation is expected to be a flagship product in Ranbaxy's dermatology franchise in Brazil, once it achieves regulatory approval. Brazil is the largest isotretinoin market in Latin America, with annual sales exceeding CDN$50 million, and the market has been growing steadily.

Under the terms of the agreement with Ranbaxy, Cipher will receive an upfront payment and is eligible for additional pre-commercial milestone payments. Cipher will supply the product to Ranbaxy and product manufacturing will be done by Cipher's partner, Galephar. Ranbaxy will be responsible for all regulatory related activities associated with gaining and maintaining regulatory approval of the product in Brazil.

In addition, the Company is seeking North American rights for other late-stage to commercial-stage product candidates in specialist driven niche markets such as dermatology.

New CEO

In late June 2014, Shawn Patrick O'Brien was appointed Chief Executive Officer of Cipher.

Mr. O'Brien has spent the past 30 years (15 based in the U.S.) in the pharmaceutical and biotechnology sectors where he has gained extensive global executive leadership experience. Mr. O'Brien is one of the three founders of AltheRx Pharmaceuticals and served as President and CEO, where he built the business and secured funding to acquire and develop a mid-stage asset from GlaxoSmithKline Inc. Previous roles include President and Chief Executive Officer of Profectus BioSciences Inc., where he secured two rounds of equity financing and a major vaccine licensing deal with Wyeth that provided Profectus with more than $100 million in non-dilutive funding. Mr. O'Brien also served as President and Chief Executive Officer of Solstice Neurosciences, Inc., which was spun out of Elan Pharmaceuticals. At Solstice, he built a fully integrated organization of more than 150 employees and raised $125 million in private financing prior to the sale of the business.

Previously, Mr. O'Brien spent 17 years with AstraZeneca Pharmaceuticals, where he held multiple senior-level positions in Canada and the U.S., most recently as Vice President of Commercial Operations for Emerging Brands. Prior to that, he was Vice President and Therapy Area Leader, Respiratory & Inflammation and Commercial & Development Group Director for the Oncology Therapeutic area, each of which had in excess of $1 billion in annual sales. Mr. O'Brien began his career at The Upjohn Company of Canada.

Review of Operating Results

REVENUES (IN THOUSANDS OF DOLLARS):

For the six months ended June 30,

	2014	2013	$ change in 2014	% change in 2014
Licensing revenue	15,776	8,752	7,024	80
Product revenue	838	88	750	852

For the three months ended June 30,

	2014	2013	$ change in 2014	% change in 2014
Licensing revenue	8,237	5,459	2,778	51
Product revenue	498	88	410	466

Licensing revenue for the quarter ended June 30, 2014 was $8.2 million compared to $5.5 million in Q2 2013. Product revenue relates to Epuris sales in Canada. The product was launched in June 2013. The performance of Absorica was the main contributor to the growth in licensing revenue. Revenue from Absorica was $5.8 million in Q2 2014 compared to $4.2 million in Q2 2013. The product continued to increase market penetration during the period, achieving a 20.3% share in June 2014. In addition, the U.S. isotretinoin market continues to grow, with 3.3% growth in Q2 2014 compared to prior year, based on total prescriptions (source: IMS).

Revenue for Lipofen was $1.9 million in Q2 2014, an increase of $1.1 million or 132% compared to Q2 2013. Results for the quarter benefitted from initial inventory load-in of the authorized generic version of the product.

Revenue from the Company’s extended-release tramadol product (ConZip and Durela) was $0.5 million in Q2 2014, compared to $0.5 million in Q2 2013.

RESEARCH AND DEVELOPMENT EXPENSE (IN THOUSANDS OF DOLLARS):

For the six months ended June 30,

	2014	2013	$ change in 2014	% change in 2014
Research and development	664	649	15	2

For the three months ended June 30,

	2014	2013	$ change in 2014	% change in 2014
Research and development	306	341	(35)	(10)

Research and development ("R&D") expense represents the cost of the Company's drug development activities. R&D expense during Q2 2014 was $0.3 million, the same amount that was reported in Q2 2013.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSE ("SG&A") (IN THOUSANDS OF DOLLARS):

For the six months ended June 30,

	2014	2013	$ change in 2014	% change in 2014
Selling, general & administrative	4,585	3,163	1,422	45

For the three months ended June 30,

	2014	2013	$ change in 2014	% change in 2014
Selling, general & administrative	2,277	1,901	376	20

SG&A expense in Q2 2014 was $2.3 million, compared to $1.9 million in Q1 2013. The year-over-year increase in SG&A in Q2 2014 was primarily a result of additional resources for business development activities as well as increased stock option expense due to the increase in the share price compared to the prior year.

AMORTIZATION OF INTANGIBLE ASSETS (IN THOUSANDS OF DOLLARS):

For the six months ended June 30,

	2014	2013	$ change in 2014	% change in 2014
Amortization of intangible assets	379	554	(175)	(32)

For the three months ended June 30,

	2014	2013	$ change in 2014	% change in 2014
Amortization of intangible assets	189	277	(88)	(32)

The Company began amortizing the intangible rights associated with CIP-TRAMADOL ER in Q3 2011, and for CIP-ISOTRETINOIN amortization began in Q1 2009. The decrease in amortization expense in Q2 2014 is a result of extending the estimated period of useful life for the tramadol product by one additional year.

Intangible assets have a finite life and are amortized using the straight-line method over their estimated period of useful life. Intangible assets are reviewed for impairment when events or other changes in circumstances indicate that the carrying amount of the assets may not be recoverable.

INTEREST INCOME (IN THOUSANDS OF DOLLARS):

For the six months ended June 30,

	2014	2013	$ change in 2014	% change in 2014
Interest income	224	115	109	95

For the three months ended June 30,

	2014	2013	$ change in 2014	% change in 2014
Interest income	121	60	61	102

Interest is earned on the Company's cash and cash equivalents balance. The increase in interest income in Q2 2014 compared to Q2 2013 was a result of higher cash balances during the period and a slight improvement in interest rates available.

EBITDA (IN THOUSANDS OF DOLLARS):

For the six months ended June 30,

	2014	2013	$ change in 2014	% change in 2014
EBITDA	11,874	5,328	6,546	123

For the three months ended June 30,

	2014	2013	$ change in 2014	% change in 2014
EBITDA	6,450	3,472	2,978	86

EBITDA is a non-IFRS Financial Measure. The term EBITDA (earnings before interest, taxes, depreciation and amortization) does not have any standardized meaning under IFRS and therefore may not be comparable to similar measures presented by other companies. Cipher defines EBITDA as earnings before interest expense, income taxes, depreciation of property and equipment, amortization of intangible assets and non-cash share-based compensation.

EBITDA in Q2 2014 was $6.5 million, an increase of $3.0 million over Q2 2013, reflecting the impact of the increase in revenue compared to Q2 2013.

INCOME TAXES:

In Q4 2013, the Company recognized a deferred tax asset on the balance sheet of $6.6 million, arising from accumulated losses carried forward from previous years, and a corresponding tax recovery on the statement of operations and comprehensive income. The Company has a history of more than two years of continuous profitability and believes that it is probable that future taxable income will be available against which tax losses can be utilized. As a result, the Company recognizes income tax expense in its statement of operations.

The Company has approximately $12.0 million of unrecognized deferred income tax assets, which have not been recognized in the financial statements. These assets consist of non-capital loss carry forwards, intangible assets and R&D expenditures which are available to reduce taxable income in future years. The Company also has approximately $3.6 million of investment tax credits on scientific research and experimental development expenditures which are available to be applied against federal taxes otherwise payable in future years.

EARNINGS PER SHARE:

For the six months ended June 30,

	2014	2013	$ change in 2014	% change in 2014
Income - in thousands of dollars	8,371	4,562	3,809	83
Basic earnings per share	0.33	0.19		
Diluted earnings per share	0.32	0.18		

For the three months ended June 30,

	2014	2013	$ change in 2014	% change in 2014
Income - in thousands of dollars	4,505	3,061	1,444	47
Basic earnings per share	0.18	0.13		
Diluted earnings per share	0.17	0.12		

Basic earnings per share is calculated using the weighted average number of shares outstanding during the period. Diluted earnings per share is calculated taking into account dilutive instruments, such as options, that are outstanding.

Net income in Q2 2014 was $4.5 million, or $0.18 per basic share, compared to net income of $3.1 million, or $0.13 per basic share in Q2 2013. The increase in net income for the quarter was a result of increases in revenue related to the strong performance of Absorica.

The weighted average number of shares outstanding for the six month period ended June 30, 2014 was 25,098,661.

Summary of Quarterly Results

QUARTERLY STATEMENTS OF INCOME (IN THOUSANDS OF DOLLARS, EXCEPT PER SHARE AMOUNTS):

For the six months ended June 30, 2014

	Q1 2014	Q2 2014	2014 YTD Total
Licensing revenue	7,539	8,237	15,776
Product revenue	340	498	838
Cost of product sold	100	149	249
Research & development	358	306	664
Selling, general and administrative	2,308	2,277	4,585
Amortization of intangible assets	190	189	379
Interest income	103	121	224
Income before income taxes	5,026	5,935	10,961
Income taxes	1,160	1,430	2,590
Income	3,866	4,505	8,371
Basic earnings per share	0.15	0.18	0.33
Diluted earnings per share	0.15	0.17	0.32

For the year ended December 31, 2013

	Q1	Q2	Q3	Q4	2013 Total
Licensing revenue	3,293	5,459	5,592	12,252	26,596
Product revenue	0	88	44	283	415
Cost of product sold	0	27	12	103	142
Research & development	308	341	388	352	1,389
Selling, general and administrative	1,262	1,901	1,660	1,391	6,214
Amortization of intangible assets	277	277	277	277	1,108
Interest income	55	60	64	74	253
Income before income taxes	1,501	3,061	3,363	10,486	18,411
Recovery of income taxes	0	0	0	6,556	6,556
Income	1,501	3,061	3,363	17,042	24,967
Basic earnings per share	0.06	0.13	0.14	0.69	1.02
Diluted earnings per share	0.06	0.12	0.13	0.66	0.97

For the year ended December 31, 2012

	Q1	Q2	Q3	Q4	2012 Total
Licensing revenue	1,811	1,629	2,118	2,900	8,458
Research & development	471	348	335	363	1,517
Selling, general and administrative	1,016	861	799	851	3,527
Amortization of intangible assets	225	245	277	278	1,025
Interest income	26	35	47	47	155
Income	125	210	754	1,455	2,544
Basic and diluted earnings per share (1)	0.01	0.01	0.03	0.06	0.10

(1) Due to rounding, earnings per share for individual quarters may not sum to earnings per share for the year

Liquidity and Capital Resources

As at June 30, 2014, the Company has cash and cash equivalents of $39.7 million, compared to $34.5 million as at March 31, 2014 and $24.2 million as at December 31, 2013. The Company's strong EBITDA performance during the second quarter resulted in the $5.2 million increase in cash in the period.

The balance of accounts receivable was $14.7 million at June 30, 2014, compared to $22.5 million as at December 31, 2013. During Q1 2014 the US$10 million milestone for Absorica was collected. The milestone was achieved in Q4 2013 and included in accounts receivable at year-end.

The balance of accounts payable and accrued liabilities was $8.2 million at June 30, 2014 compared to $12.4 million as at December 31, 2013. The decrease is primarily due to the payment during Q1 2014 of the 50% share of the US$10 million milestone to the Company's commercial partner (Galephar).

Deferred revenue relates to amounts received in advance of recognition as revenue. The balance of $3.3 million at June 30, 2014 relates to the up-front licensing payments and pre-commercialization milestone payments received by Cipher under the CIP-ISOTRETINOIN and CIP-TRAMADOL ER distribution and supply agreements, net of revenue recognized to date. The deferred revenue balance at December 31, 2013 was $4.4 million and the decrease in the first half of 2014 relates to revenue recognized during the period.

Future cash requirements will depend on a number of factors, including expenditures on R&D for product candidates, costs associated with maintaining regulatory approvals, the timing of payments received or made under licensing or other collaborative agreements, the costs involved in preparing, filing, prosecuting, maintaining, defending and enforcing patent claims and other intellectual property rights, defending against patent infringement claims, the acquisition of licenses for new products or technologies, the status of competitive products and the success of the Company in developing and maintaining markets for its products and services.

As at June 30, 2014 there are no capital lease contractual obligations. The only significant operating lease contractual obligation is the Company's office location, which expires in May 2015.

Share Capital

The Company is authorized to issue an unlimited number of preference shares, issuable in series, and an unlimited number of voting common shares. During Q2 2014, 279,392 shares were issued as a result of the exercise of stock options and 7,766 shares were issued under the employee and director share purchase plan. At June 30, 2014 the Company had 25,411,964 common shares issued and outstanding. Subsequent to the end of the quarter, 1,710 common shares were issued under the employee and director share purchase plan, bringing the total number of common shares issued and outstanding to 25,413,674 as of the date of this MD&A.

A total of 250,000 stock options were granted during Q2 2014 with an exercise price of $8.76.

Share-based compensation expense in Q2 2014 was $0.3 million, compared to $0.1 million in Q2 2013, which reflects the impact of the increase in the Company's share price on share-based compensation expense for the newly-granted stock options.

Critical Accounting Estimates

A summary of significant accounting policies is included in Note 3 of the Company's 2013 audited financial statements. Critical accounting estimates require management to make certain judgments and estimates, which may differ from actual results. Accounting estimates are based on historical experience and other factors that management believes to be reasonable under the time frame and circumstances. Changes in management's accounting estimates can have a material impact on the financial results of the Company. The Company's critical accounting estimates are described below.

INTANGIBLE ASSETS:

Management is required to estimate the recoverability of the Company's intangible assets to assess if there has been an impairment. The accounting estimates and assumptions used to determine the recoverability of these intangible assets may differ from actual results. Changes in these estimates and assumptions can have a material impact on the intangible asset balance in the financial statements.

REVENUE RECOGNITION:

Management evaluates the multiple elements and units of accounting which are included within certain licensing and distribution agreements. The recognition of revenue on up-front licensing payments and pre-commercialization amounts are over the estimated period that the Company maintains contractual obligations. The estimated periods are reviewed at least annually and are updated if expectations change as a result of licensing partner interactions, product commercial obsolescence or other factors. It is possible that these factors may cause significant changes in the Company's recognition of revenue in the future.

INCOME TAXES:

Management uses estimates when determining current and deferred income taxes. These estimates are used to determine the recoverability of tax loss carry forwards, research and development expenditures and investment tax credits.

Financial Instruments

CREDIT RISK EXPOSURE:

The only financial instruments that potentially subject the Company to credit risk are accounts receivable. The collectability of accounts receivable is reviewed on a regular basis.

FAIR VALUES OF FINANCIAL ASSETS AND LIABILITIES:

The fair values of accounts receivable, accounts payable and accrued liabilities included in the balance sheets approximate their carrying amounts due to the relatively short period of maturity of the instruments.

HEDGING ACTIVITIES:

The Company may enter into hedging activities to minimize transaction exposures and the resulting volatility in earnings. To mitigate exchange-rate risk, the Company may utilize foreign exchange forward contracts.
As of June 30, 2014, the Company had no outstanding foreign exchange forward contracts. While the Company may attempt to mitigate foreign exchange risk by engaging in foreign currency hedging activities using derivative financial instruments, it may not always be successful and it may not always be able to engage in hedging transactions in the future.

Business Risks

FINANCIAL:

As at June 30, 2014, the Company had cash and cash equivalents of $39.7 million. The Company expects these funds will be sufficient to fund current product development and operating costs.

PATENT INFRINGEMENT:

There has been substantial litigation in the pharmaceutical industry concerning the manufacture, use and sale of new products that are the subject of conflicting patent rights. Regardless of FDA approval, should anyone commence a lawsuit with respect to any alleged patent infringement by the Company, the uncertainties inherent in patent litigation make the outcome of such litigation difficult to predict.

While the Company's products are patented and listed in the FDA Orange Book, the patents can be challenged and generic products can be approved under an Abbreviated New Drug Application ("ANDA"). In the United States, under the "Hatch-Waxman Act", the FDA can approve an ANDA, for a generic version of a branded drug. In place of clinical studies, an ANDA applicant usually needs only to submit pharmacokinetic data demonstrating that its product has the same active ingredient(s) and is bioequivalent to the branded product. This is referred to as the ANDA process. The "Hatch-Waxman Act" requires an applicant for a drug that relies, at least in part, on the patent of a branded drug, to notify the sponsor of the branded drug of their application and potential infringement of a patent. Upon receipt of this notice, the sponsor of the branded drug has 45 days to bring a patent infringement suit in federal district court against the applicant seeking approval of a product covered by the patent. If such a suit is commenced and the ANDA was filed after the patent had been listed in the FDA Orange Book, then the FDA is generally prohibited from granting approval of the ANDA until the earliest of 30 months from the date the FDA accepted the application for filing, or the conclusion of litigation in the generic's favour, or expiration of the patent. The approval or launch of generic versions of any of the Company's products in any market could have an adverse effect on the Company's future revenues.

Information related to the Paragraph IV filing by Watson Laboratories, Inc. is included in a previous section of this MD&A.

CONCENTRATION OF REVENUE:

A significant proportion of the Company's revenue is currently derived from one customer. The loss of that source of revenue for any reason would have a significant impact on the future cash flow and the financial position of the Company.

PRODUCT:

There has been substantial litigation in the pharmaceutical industry concerning the manufacture, use and sale of new products that are the subject of conflicting patent rights. Regardless of FDA approval, should anyone commence a lawsuit with respect to any alleged patent infringement by the Company, the uncertainties inherent in patent litigation make the outcome of such litigation difficult to predict.

DEPENDENCE ON STRATEGIC PARTNERSHIPS AND LICENSEES:

The Company's success depends, in large measure, on its ability to conclude in-licensing, development, manufacturing, marketing, and distribution agreements with other pharmaceutical companies. Factors that may affect the success of the Company's collaborative efforts with pharmaceutical company partners include the following:

- The Company's partners may be pursuing alternative technologies or developing alternative products, either on their own or in collaboration with others, that may be competitive with the products on which they are collaborating with the Company, which could affect their commitment to the Company's product development efforts;
- The Company's technology/manufacturing partners may not be able to adequately supply its products in commercial quantities, which would adversely affect revenues;
- Reductions in marketing or sales efforts or a discontinuation of marketing or sales of the Company's products by its commercial partners may reduce future revenues, which are based on a percentage of net sales by these partners; and
- The collaboration agreements with the Company's partners can be terminated by either party in the case of a material default in the terms of the agreements. Should one of these agreements be terminated, it could be difficult for the Company to attract new partners and it may adversely affect how the Company is perceived in the business and financial communities.

The development of pharmaceutical products is a process that requires large investments and can take years to complete. Projects can be abandoned along the way or regulatory authorities can refuse to approve new products. With respect to projects the Company initiates, the Company will attempt to minimize risk through the judicious selection of product candidates and by focusing on improving products that have already been marketed.

DEPENDENCE ON CROS:

The Company's contract research organization providers ("CROs") depend on strict government regulation of the pharmaceutical research process, particularly in the U.S., where there has been a continuing trend towards increased regulation. Any changes in regulation, including a relaxation in regulatory requirements or the introduction of a simplified drug approval procedure, could materially and adversely affect the demand for the services offered by the Company. The failure by the Company or its CROs to comply with applicable regulations could result in the termination of ongoing research or the disqualification of data for submission to regulatory authorities. Furthermore, the issuance of a notice of filing by the FDA to either the Company or its suppliers based upon a material violation by the Company or its suppliers of Good Clinical Practice standards or Good Laboratory Practice standards could materially and adversely affect the Company.

The Company's ability to complete its clinical trials is also dependent on the financial viability of its CROs as any discontinuation of a CRO's business could delay or disrupt the completion of clinical trials.

REGULATION:

The cost of complying with government regulation can be substantial. Government authorities in the United States, Canada and comparable authorities in foreign countries also regulate the research and development, manufacture, testing, and safety of pharmaceutical products, as well as the approval and commercialization of such products. The regulations applicable to the Company's existing and future products may change. There can be long delays in obtaining required clearances from regulatory authorities in any country after applications are filed. Government agencies in the United States, Canada and other countries in which the Company intends to carry on business regulate pharmaceutical products intended for human use. Regulations require extensive clinical trials and other testing and government review and final approval before the Company can market its products.

Requirements for approval vary widely from country to country outside of the United States and Canada. Whether or not approved in the United States or Canada, regulatory authorities in other countries must approve a product prior to the commencement of marketing the product in those countries. The time required to obtain any such approval may be longer or shorter than in the United States and Canada.

Any failure or delay in obtaining regulatory approvals could adversely affect the market for any products the Company develops and therefore its business, results of operations, financial condition and cash flows.

Disclosure Controls and Procedures

There have been no changes in the Company's internal control over financial reporting during the most recent interim period ended June 30, 2014 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Cipher Pharmaceuticals Inc.

Condensed Interim Financial Statements

For the Three Months Ended June 30, 2014
(Unaudited)

Cipher Pharmaceuticals Inc.
Balance Sheets

As at June 30, 2014 and December 31, 2013
(in thousands of Canadian dollars - unaudited)

	Note	June 30, 2014	December 31, 2013
		$	$
ASSETS			
Current assets			
Cash and cash equivalents		39,706	24,179
Accounts receivable		14,702	22,507
Inventory		426	311
Prepaid expenses and other assets		227	391
		55,061	47,388
Property and equipment, net		26	24
Intangible assets, net	4	1,203	1,582
Deferred tax asset	10	3,966	6,556
		60,256	55,550
LIABILITIES			
Current liabilities			
Accounts payable and accrued liabilities	5	8,173	12,398
Current portion of deferred revenue		2,376	2,280
		10,549	14,678
Deferred revenue		969	2,114
		11,518	16,792
SHAREHOLDERS' EQUITY			
Share capital	6	12,639	10,696
Contributed surplus		2,761	3,095
Retained earnings		33,338	24,967
		48,738	38,758
		60,256	55,550

The accompanying notes are an integral part of these unaudited interim financial statements

Cipher Pharmaceuticals Inc.

Statements of Operations and Comprehensive Income

Three and six month periods ended June 30, 2014 and 2013
(in thousands of Canadian dollars, except per share data - unaudited)

	Note	Three months June 30, 2014	Three months June 30, 2013	Six months June 30, 2014	Six months June 30, 2013
		$	$	$	$
Revenues					
Licensing revenue		8,237	5,459	15,776	8,752
Product revenue		498	88	838	88
		8,735	5,547	16,614	8,840
Expenses					
Cost of product sold		149	27	249	27
Research and development		306	341	664	649
Selling, general and administrative		2,277	1,901	4,585	3,163
Amortization of intangible assets		189	277	379	554
Interest income		(121)	(60)	(224)	(115)
	8	2,800	2,486	5,653	4,278
Income before income taxes		5,935	3,061	10,961	4,562
Income taxes	10	1,430	-	2,590	-
Income and comprehensive income for the period		4,505	3,061	8,371	4,562
Basic earnings per share	11	0.18	0.13	0.33	0.19
Diluted earnings per share	11	0.17	0.12	0.32	0.18

The accompanying notes are an integral part of these unaudited interim financial statements

Cipher Pharmaceuticals Inc.
Statements of Changes in Equity

Six month periods ended June 30, 2014 and 2013
(in thousands of Canadian dollars - unaudited)

	Note	Share Capital	Contributed Surplus	Retained Earnings (Deficit)	Total Shareholders' Equity
		$	$	$	$
Balance, January 1, 2014		10,696	3,095	24,967	38,758
Income and comprehensive income for the period		-	-	8,371	8,371
Exercise of stock options		1,850	(846)	-	1,004
Shares issued under the share purchase plan		93	-	-	93
Share-based compensation - stock option plan		-	512	-	512
Balance, June 30, 2014		12,639	2,761	33,338	48,738
Balance, January 1, 2013		50,339	33,227	(71,160)	12,406
Income and comprehensive income for the period		-	-	4,562	4,562
Exercise of stock options		26	(14)	-	12
Shares issued under the share purchase plan		93	-	-	93
Share-based compensation - stock option plan		-	189	-	189
Reduction of stated capital	7	(41,160)	(30,000)	71,160	-
Balance, June 30, 2013		9,298	3,402	4,562	17,262

The accompanying notes are an integral part of these unaudited interim financial statements

Cipher Pharmaceuticals Inc.
Statements of Cash Flows

Three and six month periods ended June 30, 2014 and 2013
(in thousands of Canadian dollars - unaudited)

	Note	Three months June 30, 2014	Three months June 30, 2013	Six months June 30, 2014	Six months June 30, 2013
		$	$	$	$
Cash provided by (used in)					
Operating activities					
Income for the period		4,505	3,061	8,371	4,562
Items not affecting cash:					
Depreciation of property and equipment		4	4	8	9
Amortization of intangible assets	4	189	277	379	554
Share-based compensation - share purchase plan	6	9	9	14	14
Share-based compensation - stock option plan		313	121	512	189
Deferred tax	10	1,430	-	2,590	-
		6,450	3,472	11,874	5,328
Changes in non-cash operating items:					
Accounts receivable		(448)	(2,720)	7,805	(4,877)
Inventory		(75)	(328)	(115)	(328)
Prepaid expenses and other assets		26	69	164	142
Accounts payable and accrued liabilities		(1,007)	1,236	(4,225)	2,712
Deferred revenue		(500)	(533)	(1,049)	(1,131)
Net cash generated from operating activities		4,446	1,196	14,454	1,846
Investing activities					
Purchase of property and equipment		(8)	-	(10)	(5)
Financing activities					
Proceeds from shares issued under the share purchase plan	6	52	49	79	79
Proceeds from exercise of stock options		718	12	1,004	12
Net cash generated from financing activities		770	61	1,083	91
Increase in cash and cash equivalents		5,208	1,257	15,527	1,932
Cash and cash equivalents, beginning of period		34,498	16,518	24,179	15,843
Cash and cash equivalents, end of period		39,706	17,775	39,706	17,775

The accompanying notes are an integral part of these unaudited interim financial statements

(in thousands of Canadian dollars, except per share amounts - unaudited)

1 NATURE OF OPERATIONS

Cipher Pharmaceuticals Inc. ("Cipher" or "the Company") is a specialty pharmaceutical company focused on commercializing novel formulations of successful, currently marketed drugs. The Company's strategy is to in-license products that incorporate proven drug delivery technologies and advance them through the clinical development and regulatory approval process, after which the products are out-licensed to marketing partners or, in Canada, may be marketed by the Company itself. Cipher is incorporated under the Business Corporations Act of Ontario and is located at 5650 Tomken Boulevard, Mississauga, Ontario.

2 BASIS OF PREPARATION

These condensed interim financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB"), applicable to the preparation of interim financial statements, including IAS 34 and Interim Financial Reporting. These condensed interim financial statements should be read in conjunction with the Company's annual financial statements for the year ended December 31, 2013, which were prepared in accordance with IFRS as issued by the IASB. The Board of Directors approved these unaudited financial statements on July 29, 2014.

Accounting standards issued but not yet adopted

IFRS 15 *Revenue from Contracts with Customers* (IFRS 15): This standard replaces IAS 11 *Construction Contracts*, IAS 18 *Revenue* and IFRIC 13 *Customer Loyalty Programmes*. This standard outlines a single comprehensive model for entities to account for revenue arising from contracts with customers. The latest date of mandatory implementation of IFRS 15 is January 1, 2017. The Company has not yet evaluated the impact on the financial statements.

3 FINANCIAL INSTRUMENTS

Under certain agreements, the Company has the right to set-off financial assets with financial liabilities with respect to advances, rebates and licensing payments. At June 30, 2014, the Company had gross financial assets of $790 and gross financial liabilities of $5,927 related to the same counterparty. The net amount of $5,137 owing to the counterparty has been recorded in accounts payable and accrued liabilities at June 30, 2014 (gross financial assets of $902 and gross financial liabilities of $4,232 for a net amount of $3,330 owing at June 30, 2013).

4 INTANGIBLE ASSETS

The Company has entered into agreements with Galephar Pharmaceutical Research Inc. ("Galephar") for the rights to package, test, obtain regulatory approvals and market certain products in various countries. In accordance with the terms of the agreements, the Company has acquired certain product rights. The recoverability of these product rights is dependant upon sufficient revenues being generated from the related products. The Company is currently amortizing the product rights related to CIP-ISOTRETINOIN and CIP-TRAMADOL ER. In accordance with these agreements, after certain prescribed thresholds are achieved, the Company pays Galephar a 50% share of all amounts received, after deducting product-related expenses under licensing and distribution agreements.

5 ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

	As at June 30, 2014	As at Dec 31, 2013
Trade accounts payable	$ 7,497	$ 11,627
Accrued liabilities	676	771
	$ 8,173	$ 12,398

6 SHARE CAPITAL

Authorized share capital

The authorized share capital consists of an unlimited number of preference shares, issuable in series, and an unlimited number of voting common shares, with no par value.

Issued share capital

The following is a summary of the changes in share capital from January 1, 2013 to June 30, 2014:

	Number of common shares (in thousands)	Amount $
Balance outstanding - January 1, 2013	24,435	50,339
Options exercised in 2013	503	1,335
Shares issued in 2013 under the share purchase plan	38	182
Reduction of stated capital (note 7)	0	(41,160)
Balance outstanding - December 31, 2013	24,976	10,696
Options exercised in Q1 2014	145	530
Shares issued in Q1 2014 under the share purchase plan	4	32
Options exercised in Q2 2014	279	1,320
Shares issued in Q2 2014 under the share purchase plan	8	61
Balance outstanding - June 30, 2014	25,412	12,639

Share purchase plan

During the quarter ended June 30, 2014, 7,766 shares were issued under the Employee and Directors Share Purchase Plan (14,345 in Q2 2013). Included in share-based compensation expense is $9 ($9 in Q2 2013) which is the discount on the shares issued under the share purchase plan during the period.

Stock option plan

The following is a summary of the changes in the stock options outstanding from January 1, 2013 to June 30, 2014:

	Number of options (in thousands)	Weighted average exercise price $
Balance outstanding - January 1, 2013	1,786	3.36
Granted in 2013	342	1.43
Exercised in 2013	(504)	1.87
Cancelled in 2013	(5)	1.48
Balance outstanding - December 31, 2013	1,619	2.68
Granted in Q1 2014	266	8.08
Exercised in Q1 2014	(145)	1.98
Granted in Q2 2014	250	8.76
Exercised in Q2 2014	(279)	2.57
Cancelled in Q2 2014	(120)	5.22
Balance outstanding - June 30, 2014	1,591	4.43

At June 30, 2014, 866,466 options were fully vested and exercisable (1,467,841 at June 30, 2013).

During the three months ended June 30, 2014, the Company granted 250,000 stock options under the stock option plan, with an exercise price of $8.76, 25% of which vest on June 30 of each year for the next four years, commencing in 2015, and expire in 2024. Total compensation cost for these stock options is estimated to be $1,654, which will be recognized on a graded basis over the vesting period of the stock options.

The stock options were valued using the Black-Scholes option pricing model, at $6.62 per option, with the following assumptions. Expected volatility is based on the Company's historical volatility, while estimated forfeitures are not considered significant.

Risk-free interest rate	1.76%
Expected life	6.6 years
Expected volatility	87.6%
Expected dividend	Nil

(in thousands of Canadian dollars, except per share amounts - unaudited)

7 REDUCTION OF STATED CAPITAL

On May 3, 2013, by way of a special resolution of the shareholders of the Company, the legal stated capital in the common shares of the Company was reduced by $71,160 which represented the deficit of the Company as at December 31, 2012. The Company has reclassified the shareholders' equity portion of the balance sheet with a reduction in deficit by $71,160 and a corresponding reduction of contributed surplus by $30,000 and share capital by $41,160.

8 EXPENSES BY NATURE

	Three Months June 30, 2014	Three Months June 30, 2013	Six Months June 30, 2014	Six Months June 30, 2013
Employees salaries and other short term benefits	$ 765	$ 692	$ 1,481	$ 1,281
Directors fees	97	67	216	143
Share-based compensation	322	130	526	203
Depreciation of property and equipment	4	4	8	9
Amortization of intangible assets	189	277	379	554
Professional and consulting fees	527	878	1,041	1,428
Contract sales	246	66	486	62
Facility rent	18	18	37	37
Cost of inventory expensed	149	27	249	27
Severance costs	-	-	987	-
Foreign exchange (gain) loss	138	(12)	(452)	(47)
Other expenses, net of interest income	344	340	695	581
	$ 2,800	$ 2,486	$ 5,653	$ 4,278

9 COMPENSATION OF KEY MANAGEMENT

Key management includes directors and executives of the Company. The compensation paid or payable to key management for services is shown below:

	Three Months June 30, 2014	Three Months June 30, 2013	Six Months June 30, 2014	Six Months June 30, 2013
Salaries and short-term employee benefits, including bonuses	$ 395	$ 374	$ 764	$ 722
Directors fees	97	67	216	143
Share-based compensation	290	117	474	183
Severance costs	-	-	987	-
	$ 782	$ 558	$ 2,441	$ 1,048

(in thousands of Canadian dollars, except per share amounts - unaudited)

10 INCOME TAXES

Income tax expense is recognized based on the best estimate of the weighted average annual income tax rate expected for the full financial year.

Income tax expense as reported differs from the amount that would be computed by applying the combined Canadian federal and provincial statutory income tax rates to income before income taxes. The reasons for the differences are as follows:

	Three Months June 30, 2014	Six Months June 30, 2014
Income before income taxes	$ 5,935	$ 10,961
Tax provision at the statutory income tax rate of 26.5%	$ 1,573	$ 2,905
Permanent differences	80	132
Temporary differences	(223)	(447)
Income tax expense	$ 1,430	$ 2,590
Current income tax expense	$ -	$ -
Deferred income tax expense	1,430	2,590
	$ 1,430	$ 2,590

For the period ended June 30, 2013, income tax expense was not recorded on the statement of operations and comprehensive income.

11 EARNINGS PER SHARE

Earnings per share is calculated using the weighted average number of shares outstanding. The weighted average number of shares outstanding for the three and six month periods ended June 30, 2014 was 25,202,425 and 25,098,661 respectively (for the three and six month periods ended June 30, 2013 - 24,466,697 and 24,453,802 respectively).

Diluted earnings per share is calculated using the weighted average number of shares outstanding taking into consideration the weighted average impact of dilutive securities, such as stock options. The dilutive weighted average for the three and six month periods ended June 30, 2014 was 26,119,274 and 26,074,755 respectively (for the three and six month periods ended June 30, 2013 - 25,349,227 and 25,215,368 respectively).

12 SEGMENTED INFORMATION

The Company's operations are categorized into one industry segment, being specialty pharmaceuticals. All of the Company's assets, including capital and intangible assets, are in Canada. All product revenue is derived from Canada, while virtually all licensing revenue is derived from the United States.

CORPORATE DIRECTORY

DIRECTORS AND OFFICERS

Shawn Patrick O'Brien
President and Chief Executive Officer

Norman Evans, C.A.
Chief Financial Officer

Gerald McDole
Chair of the Board

Stefan Aigner, M.D., CFA
Director

William Claypool, M.D.
Director

John Mull, M.D., F.R.C.P. (C)
Director

Stephen R. Wiseman, C.A.
Director

Thomas Wellner
Director

SENIOR MANAGEMENT

Shawn Patrick O'Brien
President and Chief Executive Officer

Norman Evans, C.A.
Chief Financial Officer

Joan Chypyha
Vice President, Marketing and Sales

SHAREHOLDER INFORMATION

Stock Exchange Listing
The Company's common shares are listed on the Toronto Stock Exchange under the symbol "DND".

Shareholder Inquiries
Inquiries regarding change of address, transfer requirements or lost certificates should be directed to the Company's transfer agent.

Transfer Agent
Computershare Investor Services Inc.
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North Tower
Toronto, Ontario M5J 2Y1
T: 1·800·564·6253
www.computershare.com/service

Legal Counsel
Goodmans LLP

Auditors
PricewaterhouseCoopers LLP

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