Phylogica Limited

ACN 098 391 961

Half-Year Financial Report

31 December 2005

Phylogica Limited
ACN 098 391 961

Directors

Mr Joachim von Roy
Non-executive Chairman

Mr Harry Karelis
Non-executive Director

Mr Bruce McHarrie
Non-executive Director

Dr Saliba Sassine
Non-executive Director

Dr Stewart Washer
Executive Director

Dr Paul Watt
Executive Director

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Company Secretary

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770 Canning Highway
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Auditors
KPMG
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Perth
Western Australia 6000

Bankers
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Subiaco Branch
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Subiaco
Western Australia 6008

Incorporated in Western Australia, October 2001
Listed on the Australian Stock Exchange (ASX)
Home Exchange: Perth
Code: PYC ordinary shares
PYCO options $0.25 expiring 31/08/2007

Phylogica Limited
Directors' report

The directors present their report on Phylogica Limited (referred to in these financial statements as "the Company" or "Phylogica") together with the financial report for the half-year ended 31 December 2005 and the review report thereon.

Directors

The Directors of the Company at any time during or since the end of the half-year are:

Non-executive
Mr Joachim von Roy
Mr Harry Karelis
Mr Bruce McHarrie
Dr Saliba Sassine

Executive
Dr Stewart Washer
Dr Paul Watt

Unless otherwise indicated, all Directors held their position as a Director throughout the entire half year and up to the date of this report.

Review of operations

The principal activity of Phylogica during the period was the discovery and development of novel therapeutics directed at proteins and their interactions.

Activities continue to progress rapidly for Phylogica with the past 6 months seeing important validation of the technology and promising research results. The Company's share price regained ground during the period as a result and closed at 24.5 cents on 31 December 2005.

In February 2006, the Company listed 10,832,769 options on the Australian Stock Exchange which are exercisable at $0.25 on or before 31 August 2007.

The Company recorded a loss of $2,012,997 for the six months to 31 December 2005. Expenditure continues to be line with budget.

Highlights of the period include:

- Approval of Phylomer® patents in the major markets of the USA and Europe.
- Establishment of a pipeline of drug candidates for diabetes, asthma, stroke, burns injury and development of candidates for rheumatoid arthritis and other inflammatory diseases.
- Granting of $2.3 million by the Australian Government through its Commercial Ready Grant program to Phylogica which will enable the acceleration of its rheumatoid arthritis program in collaboration with world experts at the University of Melbourne.
- Collaborations with internationally renowned scientists including former Australian of the Year Dr Fiona Wood.
- Exciting results from the collaboration with the McComb Foundation on a new drug to accelerate the healing process and reduce scarring from burns.

Review of operations (continued)

Phylogica continues to build on its strategy of collaboration with internationally recognised centres of excellence announcing further collaborations since 31 December 2005. In January 2006 Phylogica announced that it would be working with Canadian company Alexa Biosensors to determine if its novel screening technology can effectively analyse Phylomer® drug candidates. If successful, it has the potential to accelerate the drug discovery program. March 2006 saw agreements signed with the Garven Institute of Medical Research to develop novel Phylomer® drugs for diabetes and with the Baker Heart Research Institute to develop a Phylomer® drug that could improve outcomes of heart surgery.

Lead Auditor's Independence Declaration under Section 307C of the Corporations Act 2001

The lead auditor's independence declaration is set out on page 3 and forms part of the Directors' report for the half-year ended 31 December 2005.

Signed in accordance with a resolution of the directors:

Bruce McHarrie
Director

Perth
15 March 2006

KPMG

Lead Auditor's Independence Declaration under Section 307C of the Corporation Act 2001

To: the directors of Phylogica Limited

I declare that, to the best of my knowledge and belief, in relation to the review for the half-year ended 31 December 2005 there have been:

(i) no contraventions of the auditor independence requirements as set out in the Corporations Act 2001 in relation to the review; and

(ii) no contraventions of any applicable code of professional conduct in relation to the review.

KPMG

KPMG

T R Hart
Partner

Perth
Dated: 15 March 2006

Phylogica Limited
Condensed interim income statement

For the half year ended 31 December 2005

	Note	31 Dec 2005	31 Dec 2004
		$	$
Grant income		**119,084**	-
Interest		**132,442**	11,894
Salary recovered from partner		**21,684**	-
Gross profit		**273,210**	11,894
Research expenses		**814,881**	62,599
Administrative expenses		**362,189**	391,353
Depreciation expense		**7,507**	3,994
Intellectual property expenses		**315,764**	23,065
Impairment of intellectual property	2	**466,278**	-
Share-based payment expense		**191,900**	-
Other operating expenses		**413,588**	-
Loss before income tax		**(2,298,897)**	(469,117)
Income tax (expense)/benefit	4	**285,900**	-
Loss for the period attributable to the members of Phylogica Limited	3	**(2,012,997)**	(469,117)
		Cents	**Cents**
Basic earnings per share		**(1.9)**	**(1.1)**

Diluted earnings per share are not shown because potential ordinary shares on issue at the comparative balance dates are not considered dilutive.

The income statement is to be read in conjunction with the notes to the interim financial statements set out on pages 8 to 17.

Phylogica Limited
Condensed balance sheet

For the half year ended 31 December 2005

	Note	31 Dec 2005 $	30 June 2005 $
Current assets			
Cash and cash equivalents		**4,145,193**	5,505,128
Trade and other receivables		**345,624**	50,407
Other		**23,956**	22,388
Total current assets		**4,514,773**	5,577,923
Non-current assets			
Property, plant and equipment	5	**64,352**	40,294
Intangible assets	2	-	466,278
Total non-current assets		**64,352**	506,572
Total assets		**4,579,125**	6,084,495
Current Liabilities			
Trade and other payables		**256,901**	227,296
Non Interest-bearing liabilities		**15,721**	28,709
Employee benefits	10	**20,210**	14,757
Deferred government grants		**278,508**	32,851
Total current liabilities		**571,340**	303,613
Total liabilities		**571,340**	303,613
Net assets		**4,007,785**	5,780,882
Equity			
Issued capital	3	**7,768,889**	7,720,889
Equity component of share based payments		**249,573**	57,673
Accumulated losses		**(4,010,677)**	(1,997,680)
Total equity attributable to members of Phylogica Limited		4,007,785	**5,780,882**

The balance sheet is to be read in conjunction with the notes to the interim financial statements set out on pages 8 to 17.

Phylogica Limited
Condensed interim statement of cash flows

For the half year ended 31 December 2005

	Note	31 Dec 2005 $	31 Dec 2004 $
Cash flows from operating activities			
Grants received		**364,740**	45,335
Cash paid to suppliers and employees		**(1,787,566)**	(397,565)
Cash generated from operations		**(1,422,826)**	(352,230)
Interest received		**119,456**	11,894
Net cash from operating activities		**(1,303,370)**	(340,336)
Cash flows from investing activities			
Acquisition of property, plant and equipment	5	**(31,565)**	(8,183)
Acquisition of other investments		**-**	(129,463)
Net cash from investing activities		**(31,565)**	(137,646)
Cash flows from financing activities			
Proceeds from the issue of share capital	2	**-**	75,000
Repayment of borrowings		**(5,000)**	-
Payment of transaction costs		**(20,000)**	(135,628)
Net cash from financing activities		**(25,000)**	(60,628)
Net decrease in cash and cash equivalents		**(1,359,935)**	(538,610)
Cash and cash equivalents at 1 July		**5,505,128**	791,227
Cash and cash equivalents at 31 December		**4,145,193**	252,617

This statement of cash flows is to be read in conjunction with the notes to the interim financial statements set out on pages 8 to 17.

Phylogica Limited
Condensed statement of changes in equity

For the half year ended 31 December 2005

	Note	**31 Dec 2005 $**	31 Dec 2004 $
Total equity at the beginning of the year		**5,780,882**	546,048
Share options issued		**191,900**	-
Net income recognised directly in equity		**191,900**	-
Loss for the period		**(2,012,997)**	(469,117)
Total recognised income and expense for the period		**(3,959,785)**	(469,117)
Issue of share capital	*3*	**100,000**	75,000
Share capital transaction costs	*3*	**(52,000)**	(135,628)
Total equity at the end of the half year		**4,007,785**	16,303

This statement of changes in equity is to be read in conjunction with the notes to the interim financial statements set out on pages 8 to 17.

Notes to the condensed interim financial statements

1. Significant accounting policies

Phylogica is a company domiciled in Australia. The condensed interim financial report of the Company for the six months ended 31 December 2005 was authorised for issue by the directors on 9 March 2006.

(a) Statement of compliance

The condensed interim financial report is a general purpose financial report which has been prepared in accordance with Australian Accounting Standards, Urgent Issues Group (UIG) Interpretations adopted by the Australian Accounting Standards Board ("AASB") and the Corporations Act 2001.

International Financial Reporting Standards ("IFRS") form the basis of Australian Accounting Standards adopted by the AASB, and for the purpose of this report are called Australian equivalents to IFRS ("AIFRS"), to distinguish from previous Australian GAAP.

This is the Company's first AIFRS condensed interim financial report for part of the period covered by the first AIFRS annual financial report and AASB 1 *First time adoption of Australian equivalents to International Financial Reporting Standards*. The condensed interim financial report does not include all of the information required for a full annual financial report.

The interim financial report is to be read in conjunction with the most recent annual financial report, however, the basis of their preparation is different to that of the most recent annual financial report due to the first time adoption of AIFRS. This report must also be read in conjunction with any public announcements made by Phylogica Limited during the half year in accordance with continuous disclosure obligations arising under the Corporations Act 2001.

An explanation of how the transition to AIFRS has affected the reported financial position, financial performance and cash flows of the Company is provided in note 12. This note includes reconciliations of equity and profit or loss for comparative periods reported under Australian GAAP (previous GAAP) to those reported for those periods under AIFRS.

(b) Basis of Preparation

The financial report is presented in Australian dollars.

The financial report is prepared on the historical cost basis.

The financial report has been prepared on an ongoing concern basis which assumes the settlement of liabilities and the realisation of assets in the normal course of business. The ability of the Company to continue as a going concern beyond the 2006 financial year is dependant upon successful project outcomes and the ability to manage expenditure within the budgeted range.

The preparation of an interim financial report in conformity with AASB 134 *Interim Financial Reporting* requires management to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expenses. These estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of making the judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

This condensed interim financial report has been prepared on the basis of AIFRS in issue that are effective or available for early adoption at the Company's first AIFRS annual reporting date, 30 June 2006. Based on these AIFRS, the Board of Directors have made assumptions about the accounting policies expected to be adopted when the first AIFRS annual financial report is prepared for the year-ended 30 June 2006.

All recently issued or amended Australian Accounting Standards which are not yet effective have not been early adopted for the half year ended 31 December 2005, and they are not expected to result in significant accounting policy or disclosure changes.

Notes to the condensed interim financial statements (continued)

(b) Basis of preparation (continued)

The Australian Accounting Standards and UIG Interpretations that will be effective or available for voluntary early adoption in the annual financial statements for the period ended 30 June 2006 are still subject to change and therefore cannot be determined with certainty. Accordingly, the accounting policies for that annual period that are relevant to this interim financial information will be determined only when the first AIFRS financial statements are prepared at 30 June 2006

The accounting policies have been applied consistently throughout the Company for purposes of this condensed interim financial report. They also have been applied in preparing an opening AIFRS balance sheet at 1 July 2004 for the purposes of the transition to Australian Accounting Standards – AIFRS as required by AASB 1.

(c) Foreign currency

Transactions in foreign currencies are translated at the foreign exchange rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies at the balance sheet date are translated to Australian dollars at the foreign exchange rate ruling at that date. Foreign exchange differences arising on translation are recognised in the income statement.
Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated using the exchange rate at the date of the transaction. Non-monetary assets and liabilities denominated in foreign currencies that are stated at fair value are translated to Australian dollars at foreign exchange rates ruling at the dates the fair value was determined.

(d) Property, plant and equipment

(i) Owned assets

The Company holds no property. Items of plant and equipment are stated at cost less accumulated depreciation (see below) and impairment losses (see accounting policy j).

(ii) Leased assets

Leases in terms of which the Company assumes substantially all the risks and rewards of ownership are classified as finance leases. The Company has no finance leases. Leases other than finance leases are classified as operating leases and are accounted for as described in accounting policy n (i).

(ii) Depreciation

Depreciation is charged to the income statement on a straight-line basis over the estimated useful lives of each part of an item of property, plant and equipment. Land is not depreciated. The estimated useful lives in the current and comparative periods are as follows:

- Office equipment 2-10 years
- Research equipment 3 years

The residual value, if not insignificant, is reassessed annually.

(e) Intangible assets

The intangible asset of intellectual property is stated at cost less accumulated amortisation (accounting policy h) and impairment loss (see accounting policy j).

(f) Research and development

Expenditure on research activities, undertaken with the prospect of gaining new scientific or technical knowledge and understanding, is recognised in the income statement as an expense as incurred. The Company does not currently undertake development activities as defined in AASB 138 *Intangible Assets* and therefore has not capitalised development expenditure.

Notes to the condensed interim financial statements (continued)

(g) Trade and other receivables

Trade and other receivables are stated at their cost less impairment losses (see accounting policy j) less provision for doubtful debts. Trade receivables are due for settlement in no more than 30 days and the notional amount is deemed to reflect fair value.

(h) Amortisation

Amortisation is charged to the income statement on a straight line basis over the estimated useful lives of the intangible assets which was assessed to be 3 years.

(i) Cash and cash equivalents

Cash and cash equivalents comprise cash balances and short term deposits with an original maturity of four months or less.

(j) Impairment

The carrying amounts of the Company's assets, other than deferred tax assets (see accounting policy q), are reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists, the asset's recoverable amount is estimated (see accounting policy j (i)).

An impairment loss is recognised whenever the carrying amount of an asset exceeds its recoverable amount. Impairment losses are recognised in the income statement unless the asset has previously been revalued, in which case the impairment loss is recognised as a reversal to the extent of that previous revaluation with any excess recognised through the income statement.

(i) Calculation of recoverable amount

Impairment of receivables is not recognised until objective evidence is available that a loss event has occurred. Significant receivables are individually assessed for impairment.

The recoverable amount of other assets is the greater of their fair value less costs to sell and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

(ii) Reversals of impairment

An impairment loss in respect of a receivable carried at amortised cost is reversed if the subsequent increase in recoverable amount can be related objectively to an event occurring after the impairment loss was recognised. In respect of other assets, an impairment loss is reversed if there has been a change in estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the asset's carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised.

(k) Share capital

(i) Earnings per share

Basic earnings per share (EPS) is calculated by dividing the income or loss attributable to the members of the company for reporting period, after exclusion of any costs of servicing equity other than ordinary shares, by the weighted average number of ordinary shares outstanding during the half year, adjusted for any bonus elements.

Diluted EPS adjusts the figures used in the determination of basic EPS to take into account the after tax effect of financing costs associated with the dilutive potential ordinary shares and the weighted average number of shares assumed to have been issued for no consideration in relation to dilutive potential ordinary shares adjusted for any bonus elements.

Notes to the condensed interim financial statements (continued)

(k) Share capital (continued)

(ii) Transaction costs
Transaction costs of an equity transaction are accounted for as a deduction from equity, net of any related income tax benefit.

(l) Employee benefits

(i) Long-term service benefits
The Company's net obligation in respect of long-term service benefits is the amount of future benefit that employees have earned in return for their service in the current and prior periods. The obligation is calculated using expected future increases in wage and salary rates including related on-costs and expected settlement dates, and is discounted using the rates attached to the Commonwealth Government bonds at the balance sheet date which have maturity dates approximating to the terms of the Company's obligations.

(ii) Share options granted before 7 November 2002 and/or vested before 1 January 2005
No expense is recognised in respect of these options. The shares are recognised when the options are exercised and the proceeds received allocated to share capital.

(iii) Share options granted after 7 November 2002 and vesting after 1 January 2005
The share option programme allows the Company's employees to acquire shares in the Company. The fair value of options granted is recognised as an employee expense with a corresponding increase in equity. The fair value is measured at grant date and spread over the period during which the recipients become unconditionally entitled to the options. The fair value of the options granted is measured using a Black-Scholes option pricing model, taking into account the terms and conditions upon which the options were granted, the share price at grant date, expected volatility of the underlying share, the non tradeable nature of the option and the risk free interest rate for the term of the option. The amount recognised as an expense is adjusted to reflect the actual number of share options that vest, except where forfeiture is only due to share prices not achieving the threshold for vesting.

(iv) Wages, salaries, annual leave and non-monetary benefits
Liabilities for employee benefits for wages, salaries and annual leave represent present obligations resulting from employees' services provided to reporting date, calculated at undiscounted amounts based on remuneration wage and salary rates that the Company expects to pay as at reporting date including related on-costs such as workers' compensation insurance and payroll tax.

No provision is made for non vesting sick leave as the anticipated pattern of future sick leave taken indicates that accumulated non-vesting sick leave will never be paid.

(m) Provisions
A provision is recognised in the balance sheet when the Company has a present legal or constructive obligation as a result of a past event, and it is probable that an outflow of economic benefits will be required to settle the obligation. If the effect is material, provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and, when appropriate, the risks specific to the liability.

(n) Trade and other payables
Trade and other payables are stated at cost. Liabilities are recognised for amounts to be paid in the future for goods or services received. Trade accounts payable are unsecured and normally settled within 30 days of recognition.

Notes to the condensed interim financial statements (continued)

(o) Revenue

(i) Goods sold and services rendered
Revenues are recognised at fair value of the consideration received net of the amount of Goods and Services Tax (GST) payable to the taxation authority.

(ii) Interest
Interest income is recognised in the income statement as it accrues, using the effective interest method.

(ii) Government grants
Government grant income is recognised in the balance sheet initially as deferred income when there is reasonable assurance that it will be received and that the Company will comply with the conditions attaching to it. Grants that compensate the Company for expenses incurred are recognised as revenue in the income statement on a systematic basis in the same periods in which the expenses are incurred.

(p) Expenses

(i) Operating lease payments
Payments made under operating leases are recognised in the income statement on a straight-line basis over the term of the lease.

(q) Income tax
Income tax on the income statement for the periods presented comprises current and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised directly in equity, in which case it is recognised in equity.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantially enacted at the balance sheet date, and any adjustment to tax payable in respect of previous years.

Deferred tax is provided using the balance sheet liability method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes.

A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised. Deferred tax assets are reduced to the extent that it is no longer probable that the related tax benefit will be realised.

(r) Segment reporting
The Company comprises a single business segment comprising discovery and development of novel therapeutics and a single geographical location being Australia. The segment details are therefore fully reflected in the results and balances reported in the condensed interim income and balance sheet statements.

(s) Goods and services tax
Revenue, expenses and assets are recognised net of the amount of goods and services tax (GST), except where the amount of GST incurred is not recoverable from the taxation authority. In these circumstances, the GST is recognised as part of the cost of acquisition of the asset or as part of the expense.

Receivables and payables are stated with the amount of GST included. The net amount of GST recoverable from, or payable to, the taxation authority is included as a current asset or liability in the statement of financial position.

Notes to the condensed interim financial statements (continued)

(s) Goods and services tax (continued)

Cash flows are included in the statement of cash flows on a gross basis. The GST component of cash flows arising from investing and financing activities which are recoverable from, or payable to, the taxation authority, are classified as operating cash flows.

2 Loss from ordinary activities

The recoverable amount of intellectual property has been determined by assessing its value is use. Delays in the anticipated commercialisation of capitalised intellectual property costs have resulted in future cash flows not being able to be reliably estimated. Accordingly, the $466,278 of capitalised intellectual property has been expensed in this period as an impairment loss in accordance with accounting policy j.

3 Issued capital and accumulated losses

(i) Issued and paid up capital

	31 Dec 2005	30 June 2005
108,363,938 ordinary shares fully paid	**7,768,889**	7,720,889

The following movements in ordinary shares were recorded from 1 July 2004:

	Number of shares	$
Balance brought forward as at 1 July 2004	43,592,479	898,732
Issue of shares for cash	1,000,000	75,000
Transaction costs	-	(135,628)
Balance as at 31 December 2004	44,592,479	838,104
Issue of shares for cash	63,271,459	7,350,000
Transaction costs	-	(467,215)
Balance as at 30 June 2005	107,863,938	7,720,889
Issue of shares for technology licence	500,000	100,000
Transaction costs	-	(52,000)
Balance carried forward as at 31 December 2005	108,363,938	7,768,889

(ii) Accumulated losses

	31 Dec 2005 $	31 Dec 2004 $
Loss for the period	**(2,012,997)**	(469,117)
Equity component of share based payments	**191,900**	-
Movement in accumulated losses for the period	**(1,821,097)**	(469,117)

(iii) Options

900,000 options to acquire ordinary shares were issued during the half year ended 31 December 2005 under and in accordance with the Phylogica Employee Share Option Plan (ESOP). One third vested on the grant date and up to one third will vest on each of the first two anniversaries of issue in a proportion to be determined by performance assessed against key performance indicators set 12 months prior to the vesting date.
5,750,000 options to acquire ordinary shares were issued to directors during the half year ended 31 December 2005 in accordance with a resolution passed by shareholders at the Company's Annual General Meeting in November 2005.

Total number of options on issue as at 31 December is 20,774,435. All have an exercise price of $0.25. 14,724,435 expire 31 August 2007 and the remaining 6,050,000 expire 30 June 2010.

Notes to the condensed interim financial statements (continued)

4 Income tax expense/benefit

The company is eligible for the research and development tax refund for the year ended 30 June 2005 of $285,900 based on its research and development concession application lodged with AusIndustry.

5 Property, plant and equipment

Acquisitions and disposals
During the six months ended 31 December 2005, the Company acquired assets with a cost of $31,565 (six months ended 31 December 2004: $8,183).

6 Segment information

The Company comprises a single business segment comprising discovery and development of novel therapeutics and a single geographical location being Australia. The segment details are therefore fully reflected in the results and balances reported in the condensed interim income and balance sheet statements.

7 Events subsequent to balance date

Subsequent to the condensed interim balance sheet and up to the date of this report, there has not arisen any item, transaction or event of a material and unusual nature likely, in the opinion of the directors of the Company, to affect significantly the operations of the Company, the results of those operations, or the state of the affairs of the Company in future financial years.

8 Contingent liabilities and contingent assets

There are no known significant liabilities or contingent assets as at the date of this report.

9 Earnings per share

Basic earnings per share
The calculation of basic earnings per share for the six months ended 31 December 2005 was based on the loss attributable to ordinary shareholders of $2,012,997 (six months ended 31 December 2004: $469,117) and a weighted average number of ordinary shares outstanding during the six months ended 31 December 2005 of 108,195,460 (six months ended 31 December 2004: 44,201,175), calculated as follows:

(i) Profit attributable to ordinary shareholders

	31 Dec 2005	31 Dec 2004
Loss for the period:	**$**	$
Basic earnings	**(2,012,997)**	(469,117)

(ii) Weighted average number of ordinary shares

	31 Dec 2005	31 Dec 2004
Issued ordinary shares at 1 July 2005	**107,863,938**	43,592,479
Effect of shares issued	**331,522**	608,696
Weighted average number of ordinary shares at 31 December 2005	**108,195,460**	44,201,175

Options on issue are exercisable at 25 cents per share and are therefore considered non dilutive. Accordingly, diluted earnings and diluted earnings per share have not been calculated.

Notes to the condensed interim financial statements (continued)

10 Employee Benefits

(i) Details of total employee benefits as at balance sheet date

	31 Dec 2005 $	30 June 2005 $
Liability for annual leave	**20,210**	14,757
Total employee benefits	**20,210**	14,757

(ii) Share-based payments

On 25 November 2005, the Company's shareholders ratified the granting of 900,000 options under the ESOP that entitles key management personnel and senior employees to purchase shares in the Company. The terms and conditions of the ESOP are disclosed in the Offer Information Statement released to the Australian Stock Exchange on 19 October 2005. In accordance with the ESOP, options are exercisable at the market price of the shares at the date of grant and expire 30 June 2010.

(iii) Fair value of share options and assumptions

	31 Dec 2005	30 June 2005
Fair value at measurement date	**$0.04**	$0.02
Share price	**$0.16**	$0.20
Exercise price	**$0.25**	$0.25
Expected volatility (expressed as weighted average volatility used in the modelling under the Black Scholes formula)	**40%**	25%
Option life (expressed as weighted average life used in the modelling under the Black Scholes formula)	**1678 days**	892 days
Expected dividends	**Nil**	Nil
Risk-free interest rate (based on national government bonds)	**5.34**	5.28
Discount factor for lack of negotiability	**20%**	30%

The expected volatility is based on the historic volatility (calculated based on the weighted average remaining life of the share options), adjusted for any expected changes to future volatility due to publicly available information.

Up to one third of options granted to key management personnel under the ESOP will vest on each of the first two anniversaries of issue in a proportion to be determined by performance assessed against key performance indicators set 12 months prior to the vesting date. This condition is not taken into account in the fair value at grant date measurement.

11 Key management personnel expense

Key management personnel receive compensation in the form of short-term employee benefits, post-employment benefits and equity compensation benefits (see note 10). Key management personnel received total compensation of $416,380 for the six months ended 31 December 2005 (six months ended 31 Dec 2004: $174,242). Total remuneration is included in share based payment expense, administration expenses, research and development expenses and other operating expenses in the income statement.

Notes to the condensed interim financial statements (continued)

12 Explanation of transition to AIFRS

As stated in note 1(a), these are the Company's first condensed interim financial statements for part of the period covered by the first AIFRS annual financial statements prepared in accordance with Australian Accounting Standards – AIFRS.

The accounting policies in note 1 have been applied in preparing the condensed interim financial statements for the six months ended 31 December 2005, the comparative information for the six months ended 31 December 2004, the financial statements for the year ended 30 June 2005 and the preparation of an opening AIFRS balance sheet at 1 July 2004 (the Company's date of transition).

In preparing its opening AIFRS balance sheet, comparative information for the six months ended 31 December 2004 and financial statements for the year ended 30 June 2005, the Company has adjusted amounts reported previously in financial statements prepared in accordance with its old basis of accounting (previous GAAP).

An explanation of how the transition from previous GAAP to AIFRS has affected the Company's financial position, financial performance and cash flows is set out in the following table and the notes that accompany the table.

(i) Financial position

In the following table, individual assets and liabilities are unaffected by the transition and therefore the constituent asset and liability figures under previous AGAAP as at 1 July 2004 and December 2004 remain the same as previously reported and therefore have been excluded from the table.

(ii) Financial performance

The only expense or revenue item in the income statement that has been affected by the transition is the share based payment expense item which has been increased to reflect the fair value of share based payments by $57,673 for the financial year ended 30 June 2005 with the corresponding credit going against accumulated losses. On the basis that no revenue item or any other expense item is affected by the transition, an abridged version of the income statement is reflected in the table.

(iii) Cashflows

There are no adjustments required between the statement of cash flows prepared under AIFRS and the previous AGAAP.

Notes to the condensed interim financial statements (continued)

12 Explanation of transition to AIFRS (continued)

Impact of AIFRS transition on Income statement:

	Previous AGAAP	Effect of transition to AIFRS	AIFRS	Previous AGAAP	Effect of transition to AIFRS	AIFRS
	Six months ended 31 December 2004 in $			Year Ended 30 June 2005 in $		
Revenues from ordinary activities	11,894	-	11,894	163,850	-	163,850
Expenses other than share based payment expenses	(481,011)	-	(481,011)	(1,751,173)	-	(1,751,173)
Share based payment expenses	-	-	-		(57,673)	(57,673)
Loss before tax	**(469,117)**	**-**	**(469,117)**	**(1,587,593)**	**(57,673)**	**(1,644,996)**
Income tax expense	-	-	-	-	-	-
Loss after tax	**(469,117)**	**-**	**(469,117)**	**(1,587,593)**	**(57,673)**	**(1,644,996)**

Impact of AIFRS transition balance sheet:

	Previous AGAAP	Effect of transition to AIFRS	AIFRS	Previous AGAAP	Effect of transition to AIFRS	AIFRS	Previous AGAAP	Effect of transition to AIFRS	AIFRS
	1 July 2004 balances in $			31 December 2004 balances in $			30 June 2005 balances in $		
Equity									
Issued capital	898,732	-	898,732	838,104	-	838,104	7,720,889	-	7,778,562
Accumulated losses	(352,684)	-	(352,684)	(821,800)	-	(821,800)	(1,940,007)	-	(1,997,680)
Total equity	**546,048**	**-**	**546,048**	**16,304**	**-**	**16,304**	**5,780,882**	**-**	**5,780,882**

Directors' declaration

In the opinion of the directors of Phylogica Limited (the Company)

1. the financial statements and notes set out on pages 4 to 17, are in accordance with the Corporations Act 2001 including:
   (a) giving a true and fair view of the financial position of the Company as at 31 December 2005 and of its performance, as represented by the results of its operations and cash flows for the half-year ended on that date; and

   (b) complying with Australian Accounting Standard AASB 134 *Interim Financial Reporting* and the Corporations Regulations 2001; and

2. there are reasonable grounds to believe that the company will be able to pay its debts as and when they become due and payable.

Signed in accordance with a resolution of the directors:

Bruce McHarrie
Director

Perth
15 March 2006

KPMG

Independent review report to the members of Phylogica Limited

Scope

The financial report and directors' responsibility

The financial report comprises the condensed interim income statement, balance sheet, statement of changes in equity, statement of cash flows, accompanying notes to the financial statements, and the directors' declaration for Phylogica Limited ("the Company"), for the half-year ended 31 December 2005.

The directors of the Company are responsible for the preparation and true and fair presentation of the financial report in accordance with the Corporations Act 2001. This includes responsibility for the maintenance of adequate accounting records and internal controls that are designed to prevent and detect fraud and error, and for the accounting policies and accounting estimates inherent in the financial report. The directors are also responsible for preparing the relevant reconciling information regarding adjustments required under the Australian Accounting Standard AASB 1 *First-Time Adoption of Australian equivalents to International Financial Reporting Standards.*

Review approach

We conducted an independent review in order for the Company to lodge the financial report with the Australian Securities and Investments Commission. Our review was conducted in accordance with Australian Auditing Standards applicable to review engagements.

We performed procedures in order to state whether on the basis of the procedures described anything has come to our attention that would indicate the financial report does not present fairly, in accordance with the Corporations Act 2001, Australian Accounting Standard AASB 134 *Interim Financial Reporting* and other mandatory financial reporting requirements in Australia, a view which is consistent with our understanding of the Company's financial position, and of its performance as represented by the results of its operations and cash flows.

We formed our statement on the basis of the review procedures performed, which were limited primarily to:

- enquiries of company personnel; and
- analytical procedures applied to the financial data.

While we considered the effectiveness of management's internal controls over financial reporting when determining the nature and extent of our procedures, our review was not designed to provide assurance on internal controls.

The procedures do not provide all the evidence that would be required in an audit, thus the level of assurance is less than given in an audit. We have not performed an audit and, accordingly, we do not express an audit opinion.

A review cannot guarantee that all material misstatements have been detected.

Statement

Based on our review, which is not an audit, we have not become aware of any matter that makes us believe the half-year financial report of Phylogica Limited is not in accordance with:

a) the Corporations Act 2001, including:

   i. giving a true and fair view of the Company's financial position as at 31 December 2005 and of its performance for the half-year ended on that date; and

   ii. complying with Australian Accounting Standard AASB 134 *Interim Financial Reporting* and the Corporations Regulations 2001; and

b) other mandatory financial reporting requirements in Australia.

KPMG

KPMG

T R Hart
Partner

Perth
Dated: 15 March 2006