Phylogica Limited

ACN 098 391 961

Financial Report

30 June 2006

Phylogica Limited

ACN 098 391 961

Directors

Mr Joachim von Roy
Independent Non-executive Chairman

Mr Harry Karelis
Non-executive Director

Mr Bruce McHarrie
Non-executive Director

Dr Saliba Sassine
Independent Non-executive Director

Dr Stewart Washer
Executive Director

Dr Paul Watt
Executive Director

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Graeme Boden
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Security Transfer Registrars Pty Ltd
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Applecross
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Facsimile:
Email: registrar@securitytransfer.com.au

Auditors
KPMG
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08 9315 2333

Bankers
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464 Hay Street
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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

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 year ended 30 June 2006 and the audit report thereon.

Directors

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

Non-executive

Mr Joachim von Roy Independent Non –Executive Chairman	60	Appointed 24th August 2004. Current term ends November 2007. Joachim (Aki) von Roy was the founding CEO of CoDa Therapeutics Ltd and of Proacta Therapeutics Ltd, both private biotechnology companies based in New Zealand. He also serves on a number of boards of both commercial and not-for-profit organisations based in Australia, New Zealand and the United States. Before founding the consulting firm of RvR Associates in 1997, Mr von Roy was president of Bristol-Myers Squibb, Europe, an organisation with sales of US$2.2billion and more than 7,500 employees. Previously he was with Schering AG as Assistant to the Board of Management in the United Kingdom, moved to Managing Director in New Zealand, then to Scandinavia and subsequently to the United States to introduce Schering's first product since 1945. He ultimately co-headed the pharmaceutical division of Schering AG in Germany. He went on to join Squibb-von Heyden as President, Germany, later taking on responsibility for Austria, Switzerland and Eastern Europe as well. It was shortly after the merger of Bristol-Myers Squibb that he was appointed President, Europe. Directorships which he currently holds include: Genesis Research Corporation Ltd, Biomatters Ltd, Phytomedics Inc. Corra Life Sciences Inc. Directorships relinquished during the last three years were with Proacta Corporation Ltd and Dentman AG.
Mr Harry Karelis BSc(Hons) MBA F.Fin CFA FAICD Non-executive Director	36	Appointed 25 January 2005. Current term ends January 2008. Mr Karelis is the founder and Managing Director of Titan BioVentures Management Pty Ltd. Titan is the investment manager of BioTech Capital Ltd (one of the largest life-science focused private equity funds in Australia) and Harry was instrumental in the establishment and ongoing management of this company. BioTech Capital is considered a leading life sciences fund in Australia. Harry has led investments in drug discovery, regenerative medicine, medical devices and several other technology platform areas.

		Mr Karelis graduated from The University of Western Australia with Bachelors and Honours in Science majoring in Biochemistry and Microbiology as well as a Masters in Business Administration. He is a Fellow of the Financial Services Institute of Australia, a Fellow of the Australian Institute of Company Directors and has qualified as a Chartered Financial Analyst (CFA) from the CFA Institute in the United States. Prior to establishing BioTech Capital, Mr Karelis worked in the financial services industry with roles in financial analysis and funds management both in Australia and overseas. He has diversified experience in the financial services sector including fundamental analysis, funds management and private equity investing. He has also been a successful angel investor in several biotechnology companies and sits on the boards of several private and public life-science companies. In 2004 he co-founded Gateway Capital Ltd as a specialist life-science investment bank focused on commercialising promising early stage technologies. Mr Karelis has been a director of Biotech Capital Ltd since 18 May 2000 and of Stem Cell Sciences plc since 23 July 2003. He was a director of Clinical Cell Culture Ltd for the period 13 August 2003 to 22 October 2004.
Mr Bruce McHarrie BCom CA Non-executive Director	48	Appointed 9 August 2002. Current term ends November 2007. Mr McHarrie has been in the biotechnology industry for over 12 years. Currently he is the Chief Financial Officer at the Telethon Institute for Child Health Research (the Institute), responsible for the executive management of the Institute with a particular focus on commercialisation activities. Mr McHarrie joined the Institute in 1999 after returning to Perth from the United Kingdom where he was Assistant Director in the Bioscience Unit at Rothschild Asset Management. The Bioscience Unit focused on investing in biotechnology and healthcare companies from the early start-up stage through to the publicly listed stage. In this capacity Mr McHarrie was invited to join the board of a number of United Kingdom based biotechnology companies. Prior to joining Rothschild Asset Management, Mr McHarrie was with Coopers and Lybrand in London servicing a client base primarily in the financial services industry. He holds a Bachelor of Commerce Degree from the University of Western Australia and qualified as a Chartered Accountant with Deloitte.
Dr Saliba Sassine BEc(Hons) PhD Independent Non-executive Director	52	Appointed 9th October 2001. Current term ends November 2006. He is Executive Chairman of Allegra Capital Pty Ltd, a niche investment bank focused on biotechnology, renewable energy and natural resources. Dr Sassine is an economist with many years experience in the management of publicly listed and privately-held, emerging and innovative technology and

		natural resources companies. Dr Sassine has held positions at Chairman or CEO level in a number of technology and emerging companies and has directed and advised on the activities of a number of start-up and early stage enterprises at pre and post-IPO. He has served as Chairman of the Western Australian State Branch of the Australian Biotechnology Association (now AusBiotech) and was previously a member of the national board directors of AusBiotech. Dr Sassine has also worked as a senior ministerial and government adviser in Australia and represented the State Government on a number of state and national advisory boards and committees. Dr Sassine is a Senior Associate of the Financial Services Institute of Australasia and is a member of the Advisory Board of the Institute of Entrepreneurial Management and Innovation in the Business School at the University of Western Australia. He is a past director of the Art Gallery of Western Australia, and has served as Chairman of the Artrage Festival, Chairman of the Perth Institute of Contemporary Arts Limited and Chairman of the Chrissie Parrott Dance Company. Dr Sassine is currently a director of Visiomed Group Ltd, Chairman of Integrated Forestry Holdings Ltd, and Chairman of Helicon Group Ltd. Board positions that he has relinquished during the last three years were with Swiftel Ltd and KLM Group Ltd.

Non-executive

Dr Stewart Washer BSc (Hons) PhD Executive Director, Chief Executive Officer (CEO) and Managing Director	37	Appointed 25 January 2005. The position of Managing Director is not subject to retirement by rotation. Dr Washer has over 12 years of senior executive and board experience in commercial technology companies in healthcare, food, agricultural and environmental sectors. He has extensive international capital experience, having raised over $38 million in private shareholder and government funds. Dr Washer was Chief Executive Officer of Celentis Ltd, prior to his appointment at Phylogica and managed the commercialisation of intellectual property from the largest Crown Research Institute in New Zealand with 650 scientists and $130 million in revenues. During this time he formed and governed a number of successful biotechnology company spin-offs that employed over 100 staff and realised profitable annual product revenues of $30 million per annum. Before this he was based in Australia where he also formed a number of successful biotechnology companies. He is presently also a director of Genesis Research Corporation Ltd.
Dr Paul Watt BSc(Hons) D Phil Executive Director Chief Scientific Officer	41	Appointed 9 August 2002. Current term ends November 2007. Dr Watt is Director of Research & Development and the Chief Scientific Officer (CSO). As a top graduate from the University of Western Australia, Dr Watt won a Commonwealth Overseas

		Scholarship and completed his doctorate at the University of Oxford. After completing Post Doctoral appointments at Oxford and Harvard Universities, he returned to Perth in 1996 as a scientist at the Telethon Institute for Child Health Research (the Institute). He now holds an appointment at the Institute as honorary Research Fellow. Specialising in biotechnology, he has attracted over $2.5 million in research funding from Australia and the United States for the technology underpinning Phylogica Ltd. Appointed by the University of Western Australia as adjunct Associate Professor, Dr Watt has published widely in high impact journals and has filed 13 patent applications for the products of his research work. He is also director of InfaMed Ltd, a public medical devices company, founded by him, which was acquired by an ASX listed biotechnology company, Visiomed Group Limited, of which he is a non-executive director.

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

Company Secretary

Mr Graeme Boden BEc(Hons) FAICD FCPA Company Secretary	57	Appointed 9 October 2001. Mr Boden was appointed to the position of Company Secretary at incorporation. He has held company secretarial positions for 25 years and has over 15 years experience as a director or secretary of ASX listed companies.

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

PRINCIPAL ACTIVITIES

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

OPERATING RESULTS

The Company's operating loss after tax for the financial period ended on 30 June 2006 was $3,991,475 (2005 loss: $1,644,996).

The Company's net assets at 30 June 2006 were $2,114,304 (2005: $5,780,882).

DIVIDENDS PAID OR PROPOSED

No dividends have been paid or declared by the Company since the end of the previous financial year.

REVIEW OF OPERATIONS, LIKELY DEVELOPMENTS AND EXPECTED RESULTS

The year ended 30 June 2006 saw Phylogica make a loss of $3,991,475. The nature of the Company's business is such that future performance will depend upon the success of its technologies and their amenity to commercialisation. The ability of the Company to continue as a going concern is also reliant upon the capital raising as discussed on page 6 (Significant events subsequent to balance date).

Phylogica's science continued to progress rapidly, with the past 12 months seeing important validation of the technology and promising research results.

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 that 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.
- Commercial collaboration signed in March 2006 with Opsona Therapeutics, a leader in the immunology field.
- Fee for service agreement with Johnson and Johnson Research to develop novel compounds.

The Directors do not consider that forecasting future performance is anything other than speculative, as it will depend upon the success of the Company's further development and commercialisation of its intellectual property into drug candidates or licensing opportunities.

INTERESTS IN THE SECURITIES OF THE COMPANY

The relevant interest of each director in the shares, debentures, interests in registered schemes and rights or options over such instruments issued by the Company corporate, as notified by the directors to the Australian Stock Exchange in accordance with S205G(1) of the Corporations Act 2001, at the date of this report is as follows:

	Ordinary Shares	Options
J von Roy	670,000	750,000
H Karelis	29,166,667	-
B McHarrie	1,838,238	-
S Sassine	5,264,713	-
S Washer	2,654,118	3,333,333
P Watt	4,472,790	2,000,000

SIGNIFICANT CHANGES IN THE STATE OF AFFAIRS

On 25 November 2005, the Company's shareholders ratified the granting of 900,000 options under the Employee Share Option Plan (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 price determined by the Board with regard to the market value of the shares when it resolves to offer the options and expire 30 June 2010.

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. These options were granted during the capital raising of June 2004.

SIGNIFICANT EVENTS SUBSEQUENT TO BALANCE DATE

On 21 September 2006, the Company announced the appointment of corporate advisory firm Cygnet Capital Pty Ltd to raise additional capital. The raising comprises:

- An underwritten placement of $1,500,000, subject to an underwriting agreement that contains certain conditions precedent and standard termination clauses.
- A shareholder purchase plan to shareholders registered as at 28 September 2006. Each shareholder will be eligible to apply for up to $5,000 worth of shares, with the total raising limited to $2,250,000 million, approximately 60% of the maximum which could be raised.

The price of both issues will be a 20% discount to the volume weighted average price on the five days prior to share allotment and the issues are scheduled to close on the 18th of October.

The funds anticipated to be raised are intended to be sufficient to ensure significant milestones are met and to fund several key international deals.

INTERESTS IN CONTRACTS OR PROPOSED CONTRACTS WITH THE COMPANY

There are no contracts or proposed contracts with the Company in which any director has an interest, other than contracts of executive employment for Dr S Washer and Dr P Watt.

UNISSUED SHARES UNDER OPTION

At 30 June 2006, ordinary shares of the Company under option were 21,686,102 exercisable on or before 31 August 2007 or 30 June 2010.

	Exercisable at $0.25	Exercisable at $0.30	Total
Number of options issued 30 June 2006	21,166,102	520,000	21,686,102
Number of options vested 30 June 2006	20,566,102	173,334	20,739,436

These options do not entitle the holder to participate in any share issue of the Company or any other body corporate.

DIRECTORS' MEETINGS

During the financial period, eleven directors' meetings were held. The number of meetings in which directors were in attendance is as follows:

	Directors' Meetings		Audit Committee		Remuneration Committee	
	A	B	A	B	A	B
J von Roy	11	9			2	2
H Karelis	11	10	3	3		
B McHarrie	11	11	3	3	2	2
S Sassine	11	11	3	3		
S Washer	11	11			2	2
P Watt	11	9				

A = Number of Meetings held while in office
B = Meetings attended

INDEMNIFICATION AND INSURANCE OF DIRECTORS AND OFFICERS

The Company has agreed to indemnify the current directors and company secretary of the Company against all liabilities to another person (other than the Company or a related body corporate) that may arise from their position as directors in, or secretary of, the Company, except where the liability arises out of conduct involving a lack of good faith. The agreement stipulates that the Company will meet the full amount of any such liabilities, including costs and expenses.

Since the end of the previous financial year, the Company has paid insurance premiums of $21,225 in respect of directors' and officers' liability and legal expenses' insurance contracts, for current and former directors and officers, including executive officers of the Company and directors, executive officers and secretaries of any controlled entities.

The insurance premiums relate to:

- costs and expenses incurred by the relevant officers in defending proceedings, whether civil or criminal and whatever their outcome
- other liabilities that may arise from their position, with the exception of conduct involving a wilful breach of duty or improper use of information or position to gain a personal advantage.

The insurance policy does not contain details of the premiums paid in respect of individual officers of the Company and the Company reimbursement component.

NON-AUDIT SERVICES

During the year, KPMG, the Company's auditor, has performed certain other services in addition to their statutory duties. The board has considered these non-audit services and is satisfied that their provision by the auditor is compatible with and did not compromise the auditor independence requirements of the Corporations Act 2001 because the services provided do not undermine the general principles relating to auditor independence, as they did not involve reviewing or auditing the auditor's own work, acting in a management or decision making capacity for the Company, acting as an advocate for the Company, or jointly sharing in risks and rewards.

KPMG received, or are due to receive, the following amounts for the provision of the listed services:

Statutory audit services	$28,000
Government grant audit services	$4,500
Tax advisory services	$2,825
	$35,325

ENVIRONMENTAL REGULATION AND PERFORMANCE

The Company does not hold any permits in relation to environmental discharge and does not handle or store hazardous materials.

CORPORATE GOVERNANCE

Since the introduction of the ASX Corporate Governance Council's *Principles of Good Corporate Governance and Best Practice Recommendations* (ASX Principles and Recommendations), Phylogica Limited (the Company) has made it a priority to adopt systems of control and accountability as the basis for the administration of corporate governance. Some of these policies and procedures are summarised in this report. Commensurate with the spirit of the ASX Principles and Recommendations, the Company has followed each recommendation where the Board has considered the recommendation to be an appropriate benchmark for corporate governance practices, taking into account factors such as the size of the Company and the Board, resources available and activities of the Company. Where, after due consideration, the Company's corporate governance practices depart from the ASX Principles and Recommendations, the Board has offered full disclosure of the nature of, and reason for, the adoption of its own practice.

Further information about the Company's corporate governance practices is set out on the Company's website at www.phylogica.com. In accordance with the ASX Principles and Recommendations, information published on the Company's website includes charters (for the board and its sub-committees), the Company's code of conduct and other policies and procedures relating to the Board and its responsibilities.

EXPLANATIONS FOR DEPARTURES FROM BEST PRACTICE RECOMMENDATIONS

Principle 2
Recommendation 2.1: A majority of the Board should be independent directors

Notification of departure
The Board does not have a majority of independent directors. It currently comprises 2 independent and 4 non-independent directors.
Explanation for departure
The Board considers that its current structure is appropriate given the small size of the Company and the early stage of development of its key projects. Further, the Board considers the current directors provide the necessary diversity of skills and experience needed to serve the Company's interests at this time. The Board has an independent director, Mr von Roy, as Chairman. Further, the Board notes only two of the six directors are executive, therefore the majority of directors on the Board do not have a role in the day-to-day management of the Company, nor do those directors participate in the preparation of the accounts. The Board will continue to monitor the effectiveness of its structure and will make any changes as are deemed desirable as the Company continues to grow.

Principle 2
Recommendation 2.4: The Board should establish a nomination committee

Notification of departure:
No separate nomination committee has been established

Explanation for departure:
The full Board considers those matters that would usually be the responsibility of a nomination committee. The Board considers that no efficiencies or other benefits would be gained by establishing a separate nomination committee. The Board has adopted a Nomination Committee Charter, which it applies when convening as the nomination committee.

Recommendation: 4.3:Audit committee be composed of majority of independent directors and independent Chairperson

Notification of departure:
The audit committee does not meet the requirements for composition. There is only 1 independent member of the audit committee and the Chairperson is not independent.

Explanation for departure:
Due to the current structure of the Board, Dr Sassine and Messrs McHarrie and Karelis are the most appropriate members to serve on the Audit Committee. Although there is another independent member of the Board, Mr von Roy, the Board considers that it would not be suitable for him to sit on the Audit Committee as he resides in New Zealand. The Board considers the composition of the Audit Committee satisfactory to ensure the integrity of the financial accounts, particularly as neither of the non-independent members is involved in preparing the financial reports, nor holds an executive position. Mr McHarrie is the CFO of the Telethon Institute which has a 19% shareholding and has contracts with the Company. Mr Karelis is a shareholder in a company which has a 27% shareholding in the Company. Both of these interests are aligned with all shareholders interest in ensuring integrity of the Company's financial information.

NOMINATION COMMITTEE

The full Board carries out the function of the nomination committee. During the reporting period, the Board had discussions regarding the composition of the Board and the composition of the Scientific Advisory Board. These discussions took place on 4 occasions with a majority of the Board being present.

AUDIT COMMITTEE

The audit committee comprises of Mr McHarrie (Chair), Dr Sassine and Mr Karelis. The audit committee met three times during the reporting period and all committee members were present.

All members of the audit committee possess financial expertise by virtue of their academic qualifications and career history in executive financial roles. Details of their qualifications and experience are set out in the Director's report.

REMUNERATION COMMITTEE

Company's remuneration policies

Details of remuneration, including the Company's policy on remuneration, are contained in the "Remuneration Report" which forms of part of the Directors' report.

Names of remuneration committee members and their attendance at committee meetings

Name	No. of meetings held	No. of meetings attended
Mr Joachim (Aki) von Roy	2	2
Dr Stewart Washer	2	2
Mr Bruce McHarrie	2	2

OTHER

Skills, experience, expertise and term of office of each director

A profile of each director containing the skills, experience, expertise and term of office of each director is set out in the Directors' report.

Identification of independent directors

In considering independence of directors, the Board refers to the criteria for independence as recommended by the ASX. To the extent that it is necessary for the Board to consider issues of materiality, the Board refers to the thresholds for qualitative and quantitative materiality as adopted by the Board and contained in the Statement of Board and Management Functions, which is disclosed in full on the Company's website.

Applying the independence criteria, the Board considers that Mr Joachim (Aki) von Roy and Dr Saliba Sassine are independent.

Statement concerning availability of independent professional advice

If a director considers it necessary to obtain independent professional advice to properly discharge the responsibility of his/her office as a director, then, provided the director first obtains approval for incurring such expense from the chairperson, the Company will pay the reasonable expenses associated with obtaining such advice.

Confirmation whether performance evaluation of the Board and its members have taken place and how conducted

During the reporting period, an evaluation of the Board and its members was carried out. The evaluation process was an internal self assessment based on questions and an analysis of answers with round table discussions. All members of the Board and the Chief Operating Officer, Dr Greg Pullen, participated in the assessment.

Existence and terms of any schemes for retirement benefits for non-executive directors

There are no termination or retirement benefits for non-executive directors, other than the statutory superannuation contribution paid in relation to directors' fees.

REMUNERATION REPORT

Principles of compensation - audited

Key management personnel have authority and responsibility for planning, directing and controlling the activities of the Company, including directors of the Company and other executives. Key management personnel includes all S300A directors and one of the most highly remunerated executives for the Company.

Remuneration levels for key management personnel of the Company are set competitively to attract and retain appropriately qualified and experienced directors and senior executives. The remuneration committee has researched information from companies of similar size or stage of development in the technology sector to assess the level of remuneration which would be competitive.

The remuneration structures for executives are designed to attract suitably qualified candidates, reward the achievement of strategic objectives and achieve the broader outcome of the creation of value for shareholders. The remuneration structures take into account the executives' capability and experience, level of responsibility and ability to contribute to the Company's performance, including, in particular, the establishment of revenue streams and growth in the Company's share price.

Fixed Remuneration - audited

Fixed remuneration consists of a base salary (calculated on a total cost basis, including any fringe benefits tax related to employee benefits) as well as employer contributions to superannuation funds. Remuneration levels are reviewed annually by the remuneration committee through a process that considers individual and company achievement. The Company Secretary's time and other services are contracted from a company of which he is the principal and there is no performance component in fees paid.

Performance linked remuneration - audited

Performance linked remuneration included short term incentives (STI), in the form of cash bonuses paid only upon the achievement of predetermined Key Performance Indicators (KPI), and long term incentives (LTI) provided as options over ordinary shares in the Company. In the case of Executive Directors, the number and conditions of the options are approved by the shareholders in general meetings. In the case of other executives, option remuneration is under the rules of the Employee Share Option Plan.

Short term incentives (STI) - audited

The remuneration committee or the Chief Executive Officer (CEO), as appropriate, has set KPIs in conjunction with each of the executive directors or senior executives.

Each of the Company's employees is set KPIs and a bonus is payable on achievement of these KPIs. This is either an amount equal to 15% of the base salary or a fixed sum per KPI determined at the beginning of the financial year. The objectives include such targets as: control of actual expenditure to budget, successful negotiation of commercial deals, achieving project milestones on time and publication of significance in a scientific journal.

The proportion of the maximum bonus to be allocated to each KPI is set in advance, ranging between 10% and 40% of the total for each of four or five KPIs. At the end of the year, the remuneration committee or CEO assesses the extent to which KPIs have been achieved and the aggregate achievement of all set KPIs for the individual determines the bonus to be paid.

Long term incentives (LTI) - audited

The Employee Share Option Plan (ESOP) was established during the 2006 financial year and is open to all employees. Options are granted for no consideration. Options are granted for a three year period. One third of those options allocated will vest immediately and one third will vest on each of the two subsequent anniversaries of issue. The exercise price of the ESOP options is set in July for the following fiscal year on the basis of the volume average weighted price of trading in June. Allocations made during the year were 900,000 options exercisable at $0.25 and 520,000 options exercisable at $0.30, all expiring 30 June 2010. Of these allocations, one third vested during the year.

In November 2005, the shareholders also granted options to the two executive directors, Dr Washer and Dr Watt, vesting immediately, with the intent of aligning the interests of those directors more closely and completely with the interests of shareholders. Dr Washer received 3,000,000 options and Dr Watt 2,000,000 options. They are exercisable at $0.25 and expire 30 June 2010.

The Company was listed in March 2005 so there is only a short history of the remuneration structure. The directors consider that the Company's progress to date and the share price levels achieved do not provide any indication that the remuneration structure is inappropriate given the objectives set out earlier in this report.

Consequences of performance on shareholders' wealth – unaudited

The Board has regard to a broad range of factors in considering the Company's performance and how best to generate shareholder value. These include financial factors and others that relate to the scientific progress of the Company's projects, grants awarded, deals concluded, staff development etc. the Board has some but not absolute regard to the Company's result and cash consumption during the year. It does not utilise earnings per share as a performance measure nor does it contemplate consideration of any dividends in the short to medium term given that efforts are being expended to build the business and generate self sustaining revenue streams. The Company is of the view that any adverse movement in the Company's share price should not be taken into account in assessing the performance of employees other than the CEO for whom the Company's share price is included within the overall measure of performance against individual objectives.

Service agreements - unaudited

The four senior executives of the Company, who are full time employees, each have employment contracts for a term of two years. Either party may terminate the agreement without cause by giving written notice of three months. There is no termination fee payable other than during the term of notice.

The Company Secretary provides services through a company of which he is the principal and the fees paid are time based and paid monthly. There is no contractual arrangement, and therefore no financial commitment, for the Company.

Non-executive directors - audited

The aggregate remuneration of all non-executive directors was set at $200,000 per annum at the annual general meeting held on 26 November 2004. The base fee for a director is presently $25,000 pa and for the chairman $45,000 pa. The Company makes contributions at the statutory minimum rate to superannuation funds nominated by directors, in addition to the base fee.

Directors' fees cover all main board activities and committee memberships.

In 2006, the Chairman received an allocation of 750,000 options on the same terms as the executive directors ratified by shareholders in November 2005. These options are exercisable at $0.25 and expire 30 June 2010.

Equity Instruments

All options refer to options over ordinary shares of Phylogica Limited which are exercisable on a one for one basis.

Options over equity instruments granted as compensation - audited

Details on options over ordinary shares in the Company that were granted as compensation to each key management person during the reporting period and details on options that were vested during the reporting period are as follows:

Directors	Number of options granted during 2006	Grant date	Vested during the year	Fair value per option at grant date ($)	Exercise price per option ($)	Expiry date
Mr J von Roy	750,000 (1)	25 November 2005	750,000	0.04	0.25	30 June 2010
Dr S Washer	3,000,000 (1)	25 November 2005	3,000,000	0.04	0.25	30 June 2010
Dr P Watt	2,000,000 (1)	25 November 2005	2,000,000	0.04	0.25	30 June 2010
Executives						
Dr G Pullen	600,000(2)	25 November 2005	200,000	0.04	0.25	30 June 2010

No options were granted as compensation to key management personnel in the year ended 30 June 2005.

No options have been granted since the end of the year. The options were provided at no cost to the recipients.

(1) These options expire on 30 June 2010. They are exercisable at the discretion of the individual until this date. For options granted in the current year, the earliest exercise date was 25 November 2005.

(2) These options have been issued under the Company's Employee Share Option Plan (ESOP). They expire on the earlier of their expiry date or termination of the individual's employment. They are exercisable at the discretion of the individual until they expire. For options granted in the current year, the earliest exercise date was 25 November 2005.

Further details, including grant dates and exercise dates regarding options granted to executives under the ESOP are in note 17 to the financial statements.

Modification of terms of equity-settled share based payment transactions (including options granted as compensation to a key management person) have been altered or modified by the Company during the reporting period or the prior period.

Exercise of options granted as compensation - audited

During the reporting period, no options previously granted as compensation were exercised.

Analysis of options over equity instruments granted as compensation – unaudited

Details of the vesting profile of the options granted as remuneration to each director of the Company and all of the Company's executives are shown below:

Options granted

Directors	Number	Date	% vested in year	Forfeited in year	Financial years in which grant vests	Value yet to vest (1)
Mr J von Roy	750,000	25 November 2005	100%	-%	1 July 2005	750,000
Dr S Washer	3,000,000	25 November 2005	100%	-%	1 July 2005	3,000,000
Dr P Watt	2,000,000	25 November 2005	100%	-%	1 July 2005	2,000,000
Executives						
Dr G Pullen	200,000	25 November 2005	100%	-%	1 July 2005	200,000
	200,000	25 November 2005	-%	-%	1 July 2006	200,000
	200,000	25 November 2005	-%	-%	1 July 2007	200,000
Ms R Kumar	100,000	25 November 2005	100%	-%	1 July 2005	100,000
	100,000	25 November 2005	-%	-%	1 July 2006	100,000
	100,000	25 November 2005	-%	-%	1 July 2007	100,000

(1) there are no conditions attached to the options that would reduce the amount that vests.

Analysis of options over equity instruments granted as compensation – unaudited

The movement during the reporting period, by value, of options over ordinary shares in the Company held by each Company director and all the Company executives is detailed below:

Value of Options

Directors	Granted in year ($) (1)	Exercised in year ($)	Forfeited in year ($)	Total option value in year ($)
Mr J von Roy	24,000	-	-	24,000
Dr S Washer	96,000	-	-	96,000
Dr P Watt	64,000	-	-	64,000
Executives				
Dr G Pullen	19,200	-	-	19,200
Ms R Kumar	6,400	-	-	6,400

(1) The value of options granted in the year is the fair value of the options calculated at grant date using a Black-Scholes pricing model. The total value of the options granted is included in the table above. The amount is allocated to remuneration over the vesting period (ie in years 1 July 2005 to 1July 2007).

Directors' and executive officers' remuneration - audited

Details of the nature and amount of each major element of remuneration of each director, each of the four executive employees of the Company and the company secretary are as follows.

		Short term employee benefits		Post Employment Benefits	Share-based payments			
	Year	Salary & fees $	STI cash bonus $	Superannuation benefits $	Value of options $	Total $	Proportion of remuneration performance related (%)	Value of options as proportion of remuneration (%)
Directors								
Non-executive								
Mr J von Roy	2006	45,000	-	4,050	24,000	73,050	-	32.9
	2005	22,500	-	2,025	-	24,525	-	-
Mr H Karelis	2006	25,000	-	2,250	-	27,250	-	-
	2005	10,887	-	980	-	11,867	-	-
Mr B McHarrie	2006	25,000	-	2,250	-	27,250	-	-
	2005	12,500	-	1,125	-	13,625	-	-
Dr S Sassine	2006	27,250	-	-	-	27,250	-	-
	2005	13,625	-	-	-	13,625	-	-
Executive								
Dr S Washer, Chief Executive Officer	2006	179,440	71,450 (2)	60,360	96,000	407,250	17.5	23.6
	2005	178,333	20,000 (1)	16,050	-	214,383	9.3	-
Dr P Watt, Chief Scientific Officer	2006	150,000	36,000 (2)	13,500	64,000	263,500	13.7	24.3
	2005	117,951	20,000 (1)	10,616	-	148,567	13.5	-
Dr G Pullen, Chief Operating Officer (4)	2006	184,000	60,000	16,560	6,400	266,960	22.5	2.4
Total Key Management Personnel	**2006**	**635,690**	**167,450**	**98,970**	**190,400**	**1,092,510**	**15.3**	**17.4**
	2005	355,796	40,000	30,796	-	426,592	9.4	-
Other Executive								
Ms R Kumar	2006	85,000	21,674 (2)	8,625	3,200	118,499	18.3	2.7
	2005	73,348	10,000 (1)	6,601	-	89,949	11.1	-
Secretary								
Mr G Boden	2006	60,191	-	-	-	60,191	-	-
	2005	99,435	-	-	-	99,435	-	-

Notes:

(1) The bonuses paid during 2005 were upon the achievement of listing on ASX and represented 100% of the incentive available.

(2) Bonuses of $189,124 in 2006 included $51,412 relating to the previous year for KPIs achieved and were determined after the date of the last Directors' report and thus included in the current year. The proportion of performance related remuneration had that amount been included in the year to which it related, would therefore be 10.8% (2006) and 16.5% (2005).

(3) The Company pays an insurance premium for company reimbursement and directors' and officers' liability insurance as a combined amount. The portion of the premium which relates to directors and officers has not been included as part of remuneration.

(4) Dr G Pullen commenced with the Company on 1 July 2005

Lead Auditor's Independence Declaration

The lead auditor's independence declaration is set out on page 17 and forms part of the Directors' report for the year ended 30 June 2006.

Signed in accordance with a resolution of the directors:

Stewart Washer
Director

Perth
28 September 2006

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

To: the directors of Phylogica Limited

I declare that, to the best of my knowledge and belief, in relation to the audit for the financial year ended 30 June 2006 there have been:

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

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

KPMG

KPMG

T R HART
Partner

Perth
28 September 2006

Phylogica Limited
Income statement

For the year ended 30 June 2006

	Note	**2006**	2005
		$	$
Government grant income	*2*	**488,702**	52,556
Contract research costs		**(1,376,369)**	(317,104)
Personnel expenses	*3*	**(1,500,624)**	(752,081)
Depreciation, amortisation and impairment	*4*	**(484,413)**	(62,240)
Professional services		**(314,712)**	(324,889)
Travel and accommodation		**(352,625)**	(196,745)
Licenses		**(154,876)**	-
Intellectual property maintenance		**(300,057)**	(36,241)
Laboratory consumables		**(137,232)**	-
Occupancy costs		**(86,061)**	(16,249)
Other operating expenses	*5*	**(291,042)**	(103,297)
Loss before financing income		**(4,509,309)**	(1,756,290)
Interest income		**231,821**	111,294
Loss after financing income		**(4,277,488)**	(1,644,996)
Income tax (expense)/benefit	*6*	**286,013**	-
Loss for the year attributable to the members of Phylogica Limited	*18(ii)*	**(3,991,475)**	(1,644,996)

		Cents	**Cents**
Basic earnings per share	*19*	**(3.69)**	**(2.60)**
Diluted earnings per share	*19*	**(3.69)**	**(2.60)**

The income statement is to be read in conjunction with the notes to the financial statements set out on pages 22 to 38.

Phylogica Limited
Balance sheet

For the year ended 30 June 2006

	Note	2006 $	2005 $
Current assets			
Cash and cash equivalents	7	**2,638,872**	5,505,128
Trade and other receivables	8	**77,427**	50,407
Other	9	**41,517**	22,388
Total current assets		**2,757,816**	5,577,923
Non-current assets			
Property, plant and equipment	10	**74,397**	40,294
Intangible assets	11	**-**	466,278
Total non-current assets		**74,397**	506,572
Total assets		**2,832,213**	6,084,495
Current Liabilities			
Trade and other payables	12	**370,749**	227,296
Non interest-bearing liabilities	13	**12,704**	28,709
Employee benefits	17	**189,270**	14,757
Deferred government grants		**145,186**	32,851
Total current liabilities		**717,909**	303,613
Total liabilities		**717,909**	303,613
Net assets		**2,114,304**	5,780,882
Equity			
Issued capital	18(i)	**7,820,452**	7,720,889
Accumulated losses	18(ii)	**(5,706,148)**	(1,940,007)
Total equity attributable to members of Phylogica Limited		**2,114,304**	5,780,882

The balance sheet is to be read in conjunction with the notes to the financial statements set out on pages 22 to 38.

Phylogica Limited
Statement of cash flows

For the year ended 30 June 2006

	Note	2006 $	2005 $
Cash flows from operating activities			
Government grants received		**601,035**	85,408
Cash paid to suppliers and employees		**(3,911,470)**	(1,556,811)
Cash generated from operations		**(3,310,435)**	(1,471,403)
Interest received		**216,092**	140,003
Income taxes rebated		**286,013**	-
Net cash used in operating activities	*20*	**(2,808,330)**	(1,331,400)
Cash flows from investing activities			
Acquisition of property, plant and equipment	*10*	**(52,489)**	(41,297)
Acquisition of intangible assets		**-**	(183,414)
Net cash used in investing activities		**(52,489)**	(224,711)
Cash flows from financing activities			
Proceeds from the issue of share capital	*18*	**52,083**	7,428,500
Repayment of borrowings		**(5,000)**	(552,145)
Payment of transaction costs	*18*	**(52,520)**	(606,343)
Net cash from/(used in) financing activities		**(5,437)**	6,270,012
Net increase/ (decrease) in cash and cash equivalents		**(2,866,256)**	4,713,901
Cash and cash equivalents at 1 July		**5,505,128**	791,227
Cash and cash equivalents at 30 June	*7*	**2,638,872**	5,505,128

This statement of cash flows is to be read in conjunction with the notes to the financial statements set out on pages 22 to 38.

Phylogica Limited
Statement of changes in equity

For the year ended 30 June 2006

	Note	**2006** **$**	2005 $
Total equity at the beginning of the year		**5,780,882**	546,048
Loss for the period		**(3,991,475)**	(1,644,996)
Issue of share capital		**152,083**	7,425,000
Share capital transaction costs		**(52,520)**	(602,843)
Share based payments expense for the period		**225,334**	57,673
Total equity at the end of the year		**2,114,304**	5,780,882

This statement of changes in equity is to be read in conjunction with the notes to the financial statements set out on pages 22 to 38.

1. Significant accounting policies

Phylogica is a company domiciled in Australia. The financial report of the Company for the financial year ended 30 June 2006 was authorised for issue by the directors on 28 September 2006.

(a) Statement of compliance

The financial report is a general purpose financial report which has been prepared in accordance with Australian Accounting Standards (AASBs) 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 (AASBs) adopted by the AASB, and for the purpose of this report are called Australian equivalents to IFRS (AIFRS) to distinguish from previous Australian GAAP. The financial report of the Company also comply with IFRS and interpretations adopted by the International Accounting Standards Board.

This is the Company's first financial report prepared in accordance with Australian Accounting Standards, being AIFRS and IFRS, and AASB 1 First-Time Adoption of Australian Equivalents to International Financial Reporting Standards has been applied. 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 25.

(b) Basis of preparation

The financial report is presented in Australian dollars.

The financial report is prepared on the historical cost basis.

The Company has elected to early adopt the following accounting standards and amendments:

- AASB 119 *Employee Benefits* (December 2004)
- AASB 2004-3 *Amendments to Australian Accounting Standards* (December 2004) amending AASB 1 *First time Adoption of Australian Equivalents to International Financial Reporting Standards* (July 2004), AASB 101 *Presentation of Financial Statements* and AASB 124 *Related Party Disclosures*

The following standards and amendments were available for early adoption but have not been applied by the Company in these financial statements:

- AASB 7 *Financial instruments: Disclosure* (August 2005) replacing the presentation requirements of financial instruments in AASB 132. AASB 7 is applicable for annual reporting periods beginning on or after 1 January 2007.
- AASB 2005-9 *Amendments to Australian Accounting Standards* (September 2005) requires that liabilities arising from the issue of financial guarantee contracts are recognised in the balance sheet. AASB 2005-9 is applicable for annual reporting periods beginning on or after 1 January 2006.
- AASB 2005-10 *Amendments to Australian Accounting Standards* (September 2005) makes consequential amendments to AASB 132 *Financial Instruments: Disclosures and Presentation*, AASB 101 *Presentation of Financial Statements*, AASB 114 *Segment Reporting*, AASB 117 *Leases*, AASB 133 *Earnings per Share*, AASB 139 *Financial Instruments: Recognition and Measurement*, AASB 1 *First-time Adoption of Australian Equivalents to International Financial Reporting Standards*, AASB 4 *Insurance Contracts*, AASB 1023 *General Insurance Contracts* and AASB 1038 *Life Insurance Contracts*, arising from the release of AASB 7. AASB 2005-10 is applicable for annual reporting periods beginning on or after 1 January 2007.

The Company plans to adopt AASB 7, AASB 2005-9 and AASB 2005-10 in the 2007 financial year. The initial application of AASB 7 and AASB 2005-10 is not expected to have an impact on the financial results of the Company as the standard and the amendment are concerned only with disclosures.

The quantification of the impact of adoption of AASB 2005-9 is not known or reasonably estimable in the current financial year as an exercise to quantify the financial impact has not been undertaken by the Company to date.

The accounting policies set out below have been applied consistently to all periods presented in the financial report and in preparing an opening AIFRS balance sheet at 1 July 2004 for the purposes of the transition to Australian Accounting Standards – AIFRS.

1. Significant accounting policies

(b) Basis of preparation (cont.)

Estimates and Judgements

The preparation of a financial report in conformity with Australian Accounting Standards requires management to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expenses. The 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. These accounting policies have been consistently applied by each entity in the consolidated entity.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period, or in the period of the revision and future periods if the revision affects both current and future periods.

Judgements made by management in the application of Australian Accounting Standards that have a significant effect on the financial report and estimates with a significant risk of material adjustment in the next year are discussed in note 4(ii).

Going Concern

The financial report has been prepared on a going concern basis which assumes the settlement of liabilities and the realisation of assets in the normal course of business.

In order to fund the desired level of future research and to pursue the objectives of the company, additional capital will be required during the 2007 financial year. Note 15 discloses information in relation to capital raisings to be concluded by mid October 2006.

(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 p(i).

1. Significant accounting policies (cont.)

(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 plant and equipment. The estimated useful lives in the current and comparative periods are as follows:

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

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

(e) Intangible assets

The intangible asset of intellectual property evidenced by patent costs, is stated at cost less accumulated amortisation (accounting policy h) and impairment loss (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.

(g) Trade and other receivables
Trade and other receivables are stated at their amortised cost less impairment losses (see accounting policy j). 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 (2005: 3 years).

(i) Cash and cash equivalents
Cash and cash equivalents comprise cash balances and short term deposits with an original maturity of three 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.

1. Significant accounting policies (cont.)

(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 interest recognised 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.

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

(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, annual leave and sick leave that are expected to be settled within 12 months of the reporting date represent present obligations resulting from employees' services provided to reporting date, are 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.

1. Significant accounting policies (cont.)

(iv) Wages, salaries, annual leave and non-monetary benefits (cont.)
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.

(v) Defined contribution superannuation funds
Obligations for contributions to defined contribution superannuation funds are recognised as an expense in the income statement as incurred.

(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 their amortised 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.

(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 in 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.

1. Significant accounting policies (cont.)

(q) Income tax (cont.)

The following temporary differences are not provided for: initial recognition of goodwill, the initial recognition of assets or liabilities that affect neither accounting nor taxable profit, and differences relating to investments in subsidiaries to the extent that they will probably not reverse in the foreseeable future. The amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of assets and liabilities, using tax rates enacted or substantively enacted at the balance sheet date.

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 income statement and balance sheet.

(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 balance sheet

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 Government grant income

The Company has been awarded 2 government grants and these are recognised as revenue in the income statement in the same period as which the related expenses are incurred. $409,287 was recognised in the year ended 30 June 2006 (2005: $52,556). Future income under these grants will be received only if the Company continues to meet the conditions of the grant agreement. $72,220 was also received through the Export Market Development Grant Scheme (2005: Nil) and $7,195 from the Synapse Art and Science Artists Residencies Program (2005: Nil), both of which have been recorded as income in the period of receipt.

3 Personnel expenses

	2006	2005
	$	**$**
Wages and salaries	**1,102,428**	610,744
Other associated staff costs	**64,170**	26,331
Contributions to defined contribution superannuation funds	**80,891**	42,576
Increase in annual leave provision	**27,801**	14,757
Share based compensation	**225,334**	57,673
	1,500,624	752,081

4 Depreciation, amortisation and impairment

		2006 $	2005 $
Depreciation of equipment		**18,135**	5,036
Amortisation of patents		**-**	37,266
Impairment of intellectual property	*(ii)*	**466,278**	19,938
		484,413	62,240

(ii) The recoverable amount of intellectual property has been determined by assessing its value in use. Uncertainties as to the timing of 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.

5 Other expenses

	2006 $	2005 $
Workplace administration	**21,130**	25,543
Subscriptions	**33,294**	18,777
Insurance	**33,465**	16,710
Corporate expenses	**88,874**	1,065
Conferences	**63,667**	27,686
Advertising	**19,928**	-
Other	**30,684**	13,516
	291,042	103,297

6 Income Tax

(i) Income tax expense/(benefit)

		2006 $	2005 $
The prima facie tax on the operating loss is reconciled to the income tax provided in the accounts as follows:			
Prima facie tax benefit on operating loss before income tax at 30%		**(1,283,246)**	(476,197)
Tax effect of permanent differences		**(50,200)**	(41,737)
Current period deferred income tax not recognised		**242,707**	(38,493)
Current period tax losses and temporary benefits not brought to account		**1,090,739**	556,427
Australian Taxation office rebate	*(iii)*	**(286,013)**	-
Income tax expense/(benefit) attributable to operating loss before income tax		**(286,013)**	-

(ii) Unrecognised deferred tax asset

Deferred tax assets have not been recognised in respect of the following items:

	2006 $	2005 $
Deductible temporary differences	**242,707**	(38,492)
Tax losses	**1,352,307**	792,727
	1,595,014	754,235

The deductible temporary differences and tax losses do not expire under current tax legislation. Deferred tax assets have not been recognised in respect of these items because it is not probable that future taxable profit will be available against which the Company can utilise the benefits from.

(iii) In May 2006, the Company received a cash rebate of $286,013 from the Australian Taxation Office in respect of its eligible research and development expenditure under the R&D tax concession scheme.

7 Cash and cash equivalents

	2006	2005
	$	$
Bank balances	**338,872**	205,128
Bank bills	**2,300,000**	5,300,000
Cash and cash equivalents in the statement of cashflows	**2,638,872**	5,505,128

8 Trade and other receivables

GST receivable	**66,177**	37,511
Sundry debtors	**11,250**	12,896
	77,427	50,407

9 Other assets

Prepayments	**41,517**	22,388
	41,517	22,388

10 Property, plant and equipment

Office and laboratory equipment at cost	**99,294**	47,292
Accumulated depreciation	**(24,897)**	(6,998)
	74,397	40,294

Reconciliation

Carrying amount at the beginning of the year	**40,294**	4,033
Acquisitions	**52,489**	41,297
Disposals	**(251)**	-
Depreciation	**(18,135)**	(5,036)
	74,397	40,294

11 Intangible assets

Intellectual property

Patents and patent applications at cost	**514,766**	514,766
Accumulated amortisation	**(48,488)**	(48,488)
Impairment losses	**(466,278)**	-
	-	466,278

Reconciliation

Carrying amount at the beginning of the year	**466,278**	340,068
Acquisitions	**-**	183,414
Impairment losses	**(466,278)**	(19,938)
Amortisation	**-**	(37,266)
	-	466,278

12 Trade and other payables

Trade payables	**220,909**	17,024
Accrued expenses	**123,594**	175,772
Other	**26,246**	34,500
	370,749	227,296

13 Non interest bearing liabilities

	2006	2005
	$	$
Unearned interest income	**12,704**	28,709
	12,704	28,709

14 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 income statement and balance sheet.

15 Events subsequent to balance date

On 21 September 2006, the Company announced the appointment of corporate advisory firm Cygnet Capital Pty Ltd to raise additional capital. The raising comprises:

- An underwritten placement of $1,500,000, subject to an underwriting agreement that contains certain conditions precedent and standard termination clauses.
- A shareholder purchase plan to shareholders registered as at 28 September 2006. Each shareholder will be eligible to apply for up to $5,000 worth of shares, with the total raising limited to $2,250,000 million, approximately 60% of the maximum which could be raised.

The price of both issues will be a 20% discount to the volume weighted average price on the five days prior to share allotment and the issues are scheduled to close on the 18th of October.

The funds anticipated to be raised are intended to be sufficient to ensure significant milestones are met and to fund several key international deals.

16 Contingent liabilities and contingent assets

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

17 Employee benefits

	2006	2005
	$	$
Liability for annual leave	**42,558**	14,757
Incentive provision	**146,712**	-
	189,270	14,757
Number of employees at year end	**8**	4

Remuneration for all employees other than non executive directors includes an at risk performance component. Provision has been made at 30 June 2006 for amounts payable in respect of performance for the financial year as determined by the Board on an employee by employee basis against agreed criteria. A reconciliation of movement for the year in employee provisions is as follows:

	Annual Leave	**Incentive Provision**
	$	**$**
Balance as 1 July	14,757	-
Payments made	(47,327)	(53,412)
Charges raised	75,128	200,124
Balance at the end of the year	42,558	146,712

17 Employee benefits (cont.)

(i) 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. Further issue of options to 30 June 2006 total 520,000. The terms and conditions of the ESOP are disclosed in the Offer Information Statement released to the Australian Stock Exchange on 19 October 2005.

The shareholders also granted options at this time to the two executive directors, Dr Washer and Dr Watt, vesting immediately, with the intent of aligning the interests of those directors more closely and completely with the interests of shareholders. Dr Washer received 3,000,000 options and Dr Watt 2,000,000 options. They are exercisable at $0.25 and expire 30 June 2010.

An allocation of 750,00 options to the Chairman was ratified by the shareholders at the same time. They have the same terms as those allocated to the executive directors. These options are exercisable at $0.25 and expire 30 June 2010.

(ii) Fair value of share options and assumptions

All options refer to options over ordinary shares of Phylogica Ltd which are exercisable on a one for one basis. The options have been issued either under the ESOP or to directors as ratified in the Annual General Meeting on 25 November 2005. The fair value of the options is calculated at balance date using a Black–Scholes pricing model and allocated to each reporting period in accordance with the vesting profile of the options. The value recognised is the portion of the fair value of the options allocated to the reporting period. The factors and assumptions used in determining the fair value on grant date of options issued during the financial year as follows:

Number and recipient/s of options	Grant Date	Expiry Date	Fair Value per Option	Exercise Price	Price of shares on grant date	Risk Free Interest Rate (%)	Estimated Volatility (%)	Number vested at 30 June 2006
3,000,000 CEO (i)	25-Nov-05	30-Jun-10	$0.04	$0.25	$0.16	5.34	40.0	3,000,000
750,000 Chairman (i)	25-Nov-05	30-Jun-10	$0.04	$0.25	$0.16	5.34	40.0	750,000
2,000,000 CSO (i)	25-Nov-05	30-Jun-10	$0.04	$0.25	$0.16	5.34	40.0	2,000,000
900,000 ESOP (ii)	25-Nov-05	30-Jun-10	$0.04	$0.25	$0.16	5.34	40.0	300,000
180,000 ESOP (ii)	17-Feb-06	30-Jun-10	$0.19	$0.30	$0.25	5.21	79.2	60,000
300,000 ESOP (ii)	1-Mar-06	30-Jun-10	$0.24	$0.30	$0.30	5.22	79.2	100,000
40,000 ESOP (ii)	26-Apr-06	30-Jun-10	$0.46	$0.30	$0.64	5.67	79.2	13,334

In the table above, the following vesting profiles have been adopted:
(i) vest immediately
(ii) one third vests immediately and one third vests on each of the two subsequent anniversaries.

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. A discount factor of 20% for the lack of negotiability has been applied.

No employee options were exercised during the year.

18 Issued capital and accumulated losses

(i) Issued and paid up capital

	2006	2005
	$	$
108,572,271 (2005: 107,863,938) ordinary shares fully paid	**7,820,452**	7,720,889

Movements in issued capital during the year

Ordinary Shares

Shares issued during the year	2006 Shares	2006 $	2005 Shares	2005 $
Opening balance	107,863,938	7,720,889	43,592,479	898,732
Shares converted from Class A Performance Shares	-	-	7,604,792	-
Shares issued at $0.075	-	-	31,000,000	2,325,000
Shares issued at $0.15	-	-	666,667	100,000
Shares issued at $0.20	-	-	25,000,000	5,000,000
Option premium	-	-	-	3,500
Share issue costs	-	(52,520)	-	(606,343)
Shares issued for technology licence at $0.20	500,000	100,000	-	-
Share options exercised at $0.25	208,333	52,083	-	-
	108,572,271	7,820,452	107,863,938	7,720,889

Terms and Conditions
Holders of ordinary shares are entitled to receive dividends as declared from time to time and are entitled to one vote per share at shareholders' meetings.
In the event of winding up of the Company, ordinary shareholders rank after all other shareholders, and creditors and are fully entitled to any proceeds of liquidation.

The shares have no par value.

(ii) Accumulated losses

	2006 $	2005 $
Opening balance	**(1,940,007)**	(352,684)
Loss for the period	**(3,991,475)**	(1,644,996)
Share based compensation	**225,334**	57,673
Balance at the end of the year	**(5,706,148)**	(1,940,007)

(iii) Options

Options issued during the year

	2006	2005
(a) Options exercisable at $0.30 on or before 30 June 2010:		
Balance at beginning of year	**-**	-
Issued during the year*	**520,000**	-
Balance at end of year	**520,000**	-

* 173,334 options vested on issue

18 Issued capital and accumulated losses (cont.)

(iii) Options (cont.)

Options issued during the year

	2006	2005
(b) Options exercisable at $0.25 on or before 30 June 2010:		
Balance at beginning of year	**-**	-
Issued during the year*	**6,650,000**	-
Balance at end of year	**6,650,000**	-

* 6,050,000 options vested on issue

	2006	2005
(c) Options exercisable at $0.25 on or before 31 August 2007:		
Balance at beginning of year	**14,724,435**	17,530,822
Issued during the year	**-**	7,333,333
Exercised during the year	**(208,333)**	-
Surrendered during the year	**-**	(10,139,720)
Balance at end of year	**14,516,102**	14,724,435
(d) Conditional options exercisable at $0.25 on or before 15 September 2007:		
Balance at beginning of year	**-**	10,139,720
Issued during the year	**-**	-
Surrendered during the year	**-**	(10,139,720)
Balance at end of year	**-**	-
Total options on issue	**21,686,102**	14,724,435

19 Earnings per share

(i) Loss attributable to ordinary shareholders

	2006 **$**	2005 $
Loss for the period:		
Basic earnings	**(3,991,475)**	(1,644,996)
Diluted earnings*	**(3,701,022)**	(1,644,996)

(ii) Weighted average number of ordinary shares

	2006	2005
Weighted average number of shares used for basic earnings per share	**108,150,011**	63,302,446

*As the Company incurred a loss for the year ended 30 June 2006, the options on issue have an antidilutive effect therefore the diluted earnings per share is equal to the basic earnings per share.

20 Note to the statement of cash flows

Reconciliation of loss after income tax to net cash used in operating activities:

	2006	2005
	$	$
Operating loss after income tax	**(3,991,475)**	(1,644,996)
Depreciation	**18,135**	5,036
Amortisation	**-**	37,266
Impairment loss	**466,278**	19,938
Share based payment expense	**225,334**	57,673
Share issue in exchange for licence	**100,000**	-
Increase in provisions for employee entitlements	**174,513**	14,757
Increase/(decrease) in payables	**245,034**	213,479
(Increase)/decrease in receivables & prepayments	**(46,149)**	(34,553)
Net cash used in operating activities	**(2,808,330)**	(1,331,400)

21 Financial instruments

(i) Interest rate risk

The Company's exposure to interest rate risks and the effective weighted average interest rates of financial assets and financial liabilities are as follows:

	Floating interest rate		**Non-interest bearing**		**Total**		**Effective interest rate (%)**	
(a) Assets	**2006**	**2005**	**2006**	**2005**	**2006**	**2005**	**2005**	**2006**
Cash	2,638,872	5,505,128	-	-	2,638,872	5,505,128	5.65	5.73
Receivables & other	-	-	118,944	72,795	118,944	72,795		
Total Financial Assets	2,638,872	5,505,128	118,944	72,795	2,757,816	5,577,923		
(b) Liabilities								
Trade creditors and accruals	-	-	370,749	227,296	370,749	227,296		
Other	-	-	347,160	76,317	347,160	76,317		
Total Financial Liabilities	-	-	717,909	303,613	717,909	303,613		

(ii) Credit risk

Management has a credit policy in place and the exposure to credit risk is monitored on an ongoing basis. The Company undertakes due diligence prior to entering into any collaboration, co-development or licensing agreement with a counterparty that exposes the Company to credit risk.

(iii) Net fair values of financial assets and liabilities

For receivables and payables with a remaining life of less than one year, the notional amount is deemed to reflect fair value. All other receivables and payables are discounted to determine fair value.

(iv) Foreign exchange risk

The Company is exposed to foreign currency risk on income and purchases that are denominated in a currency other than the AUD. The value of transactions are not of a level that Management warrant entering into forward exchange contracts and so are translated into AUD at the foreign exchange rate ruling at the date of the transaction. As at the reporting date there were no amounts receivable or payable unhedged in foreign currencies.

22 Commitments

Future operating lease commitments not provided for in the financial statements and payable:

	2006	2005
	$	$
Within one year	**36,000**	36,000
One year or later and no later than five years	**-**	36,000
Later than five years	**-**	-
	36,000	72,000

The Company leases office space under a two year non-cancellable lease, with an option to renew for a further two years.

23 Related parties

(i) Key management personnel compensation

Disclosures of remuneration policies, service contracts, details of remuneration and other equity instruments are included in the Remuneration Report on pages 10 to 15. The following were key management personnel of the Company at any time during the reporting period and unless otherwise indicated, were directors or executives for the entire period:

Non –executive directors	**Executive directors**
Mr J von Roy	Dr S Washer
Mr S Sassine	Dr P Watt
Mr H Karelis	**Executive**
Mr B McHarrie	Dr G Pullen (Chief Operating Officer)

The key management personnel compensation included in ‘personnel expenses’ (see note 3) are as follows:

	2006	2005
	$	$
Short-term employee benefits	**803,140**	395,796
Post-employment benefits	**98,970**	30,796
Share based payment	**190,400**	-
Total compensation	**1,092,510**	426,592

Apart from details disclosed in this note, no director has entered into a material contract with the Company since the end of the previous financial year and there were no material contracts involving directors’ interests existing at year-end.

A number of key management persons, or their related parties, hold positions in other entities that result in them having control or significant influence over the financial or operating policies of those entities.

A number of these entities transacted with the Company or its subsidiaries in the reporting period. The terms and conditions of the transactions with management persons and their related parties were no more favourable than those available, or which might reasonably be expected to be available, on similar transactions to non-director related entities on an arm’s length basis.

23 Related parties (cont.)

(i) Key management personnel compensation (cont.)

The aggregate amounts recognised during the year relating to key management personnel and their related parties were as follows:

Key management persons	Transaction	Note	2006 $	2005 $
Mr H Karelis	Share issue costs	(a)	**20,000**	-
Mr B McHarrie	Contract research services	(b)	**939,576**	249,418

(a) Due diligence cost associated with the share issue in February 2005 were reimbursed to Biotech Capital Ltd, of which Mr Karelis is a director.

(b) The Telethon Institute of Child Heath Research, of which Mr McHarrie is the Chief Financial Officer, has signed a Research and Development agreement with the Company for provision of services in developing the Company's technology. Service fees were billed based on normal market rates for such services and were due and payable under normal payment terms.

Amounts payable to key management personnel at reporting date arising from these transactions were as follows:

	2006 $	2005 $
Current payables		
Trade creditors	**91,894**	-
Accrued expenses	**-**	101,152
Total	**91,894**	101,152

(iii) Options over equity instruments

The movement during the reporting period in the number of options over ordinary shares in the Company held, directly, indirectly or beneficially, by each key management person, including their related parties, is as follows:

Directors	Held as at 1 July 2005	Granted as compensation	Exercised	Other changes	Held at 30 June 2006	Vested during the year	Vested and exercisable at 30 June 2006
Mr J von Roy	-	750,000	-	-	750,000	750,000	750,000
Dr S Washer	333,333	3,000,000	-	-	3,333,333	3,000,000	3,333,333
Dr P Watt	-	2,000,000	-	-	2,000,000	2,000,000	2,000,000
Executives							
Dr G Pullen	-	600,000	-	-	600,000	200,000	200,000

Directors	Held as at 1 July 2004	Granted as compensation	Exercised	Other changes*	Held at 30 June 2005	Vested during the year	Vested and exercisable at 30 June 2005
Mr J von Roy	-	-	-	-	-	-	-
Dr S Washer	-	-	-	333,333	333,333	333,333	333,333
Dr P Watt	-	-	-	-	-	-	-
Executives							
Dr G Pullen	-	-	-	-	-	-	-

*Dr Washer received options in his capacity as an investor prior to commencing employment with the Company.

23 Related parties (cont.)

(iv) Equity holdings and transactions

The movement during the reporting period in the number of ordinary shares in the Company held, directly, indirectly or beneficially, by each key management person, including their related parties, is as follows:

Directors	Held at 1 July 2005	Purchases	Held at 30 June 2006
Mr J von Roy	670,000	-	670,000
Mr H Karelis	29,166,667	-	29,166,667
Mr B McHarrie	1,838,238	-	1,838,238
Mr S Sassine	5,264,713	-	5,264,713
Dr S Washer	2,600,000	34,118	2,634,118
Dr P Watt	4,444,123	28,667	4,472,790
Executives			
Dr G Pullen	-	-	-

In addition to the above, and subsequent to reporting date, a further 20,000 shares was acquired by an entity Dr S Washer has an indirect interest in, to bring the total number of shares in which he has an interest directly, indirectly or beneficially to 2,654,118.

24 Auditor's remuneration

	2006	2005
	$	$
Audit services		
Auditors of the Company – KPMG Australia		
Audit of financial reports	**28,000**	15,000
Other regulatory audit services	**4,500**	-
	32,500	15,000
Non audit services		
Auditors of the Company – KPMG Australia		
Taxation services		
Investigating accountant's report	**2,825**	2,680
Research grant application	**-**	8,000
Research grant application	**-**	57,000
	2,825	67,680

25 Explanation of transition to AIFRS

As stated in note 1(a), these are the Company's first financial statements for 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 financial statements for the year ended 30 June 2006, the comparative information 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 and comparative information 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.

25 Explanation of transition to AIFRS (cont.)

(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 June 2005 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.

Impact of AIFRS transition balance sheet:	**Previous AGAAP**	**Effect of transition to AIFRS**	**AIFRS**	**Previous AGAAP**	**Effect of transition to AIFRS**	**AIFRS**
	2005	2005	2005	2004	2004	2004
	$	$	$	$	$	$
Equity						
Issued capital	7,720,889	-	7,720,889	898,732	-	898,732
Accumulated losses	(1,940,007)	-	(1,940,007)	(352,684)	-	(352,684)
Total equity	**5,780,882**	**-**	**5,780,882**	546,048	-	546,048

Impact of AIFRS transition on Income statement:	**Previous AGAAP**	**Effect of transition to AIFRS**	**AIFRS**
	2005	2005	2005
	$	$	$
Revenues from ordinary activities	163,850	-	163,850
Expenses other than share based payment expenses	(1,751,173)	-	(1,751,173)
Share based payment expenses		(57,673)	(57,673)
Loss before tax	**(1,587,323)**	**(57,673)**	**(1,644,996)**
Income tax expense	-	-	-
Loss after tax	**(1,587,323)**	**(57,673)**	**(1,644,996)**

Directors' declaration

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

(a) the financial statements and notes and the audited remuneration disclosures that are contained in the Remuneration Report in the Directors' Report, set out on pages 18 to 38, are in accordance with the Corporations Act 2001, including:

(i) giving a true and fair view of the financial position of the Company as at 30 June 2006 and of their performance, as represented by the results of their operations and their cash flows, for the financial year ended on that date; and

(ii) complying with Australian Accounting Standards and the Corporations Regulations 2001; and

(b) The audited remuneration disclosures of the Remuneration Report in the Directors' Report report comply with Australian Accounting Standard AASB 124 Related Party Disclosures; and

(c) there are reasonable grounds to believe that the Company will be able to pay its debts as and when they become due and payable.

2 The directors have been given the declarations by the chief executive officer and chief financial officer for the financial year ended 30 June 2006 pursuant to Section 295A of the Corporations Act 2001.

Dated at Perth this 28th day of September, 2006

Signed in accordance with a resolution of the directors:

Stewart Washer
Executive Director

KPMG

Independent audit report to members of Phylogica Limited

Scope

The financial report, remuneration disclosure and directors' responsibility

The financial report comprises the income statement, statement of changes in equity, balance sheet, statement of cash flows, accompanying notes to the financial statements, and the directors' declaration for Phylogica Limited (the "Company"), for the year ended 30 June 2006.

As permitted by the Corporations Regulations 2001, the Company has disclosed information about the remuneration of directors and executives ("remuneration disclosures"), required by Australian Accounting Standard AASB 124 *Related Party Disclosures*, under the heading "Remuneration report" in the directors' report and not in the financial report.

The Remuneration report also contains information not required by Australian Accounting Standard AASB 124 which is not subject to our audit.

The directors of the Company are responsible for the preparation and true and fair presentation of the financial report and the Remuneration 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 the adjustments required under the Australian Accounting Standard AASB 1 *First-time Adoption of Australian equivalents to International Financial Reporting Standards.* The directors are also responsible for the remuneration disclosures contained in the directors' report.

Audit approach

We conducted an independent audit in order to express an opinion to the members of the Company. Our audit was conducted in accordance with Australian Auditing Standards in order to provide reasonable assurance as to whether the financial report is free of material misstatement and the remuneration disclosures comply with AASB 124. The nature of an audit is influenced by factors such as the use of professional judgement, selective testing, the inherent limitations of internal control, and the availability of persuasive rather than conclusive evidence. Therefore, an audit cannot guarantee that all material misstatements have been detected.

We performed procedures to assess whether in all material respects the financial report presents fairly, in accordance with the Corporations Act 2001, Australian Accounting Standards 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 and whether the remuneration disclosures comply with Australian Accounting Standard AASB 124.

We formed our audit opinion on the basis of these procedures, which included:

- examining, on a test basis, information to provide evidence supporting the amounts and disclosures in the financial report, and
- assessing the appropriateness of the accounting policies and disclosures used and the reasonableness of significant accounting estimates made by the directors.

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

Audit opinion

In our opinion:

(1) the financial report of Phylogica Limited is in accordance with:

a) the *Corporations Act 2001*, including:

i) giving a true and fair view of the Company's financial position as at 30 June 2006 and of their performance for the financial year ended on that date; and;

ii) complying with Australian Accounting Standards and the Corporations Regulations 2001; and

b) other mandatory financial reporting requirements in Australia; and

(2) the remuneration disclosures that are contained in the remuneration report in the directors' report and identified as audited, comply with Australian Accounting Standard AASB 124 *Related Party Disclosures.*

KPMG

KPMG

T R HART
Partner

Perth
28 September 2006