VIRAGEN INC
Form 10-Q
November 05, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(***Mark One***)

FOR THE QUARTER ENDED SEPTEMBER 30, 2004

OR

( ) TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission File Number 001-15823

VIRAGEN, INC.
(Exact name of registrant as specified in its charter)

Delaware	**59-2101668**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

865 SW 78th Avenue, Suite 100, Plantation, Florida 33324
(Address of principal executive offices)

(954) 233-8746
(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No [ ]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes [X] No [ ]

As of November 4, 2004, there were 36,568,385 shares of the registrant s common stock outstanding, par value $0.01.

VIRAGEN, INC. AND SUBSIDIARIES

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PART I. FINANCIAL INFORMATION

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VIRAGEN, INC. AND SUBSIDIARIES

CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended September 30,	
	2004	**2003**
Product sales	$ 30,417	$ 51,606
Costs and expenses		
Cost of sales	476,260	369,007
Research and development	1,090,869	814,422
Selling, general and administrative	1,813,519	1,466,263
Amortization of intangible assets	40,380	37,413
Interest expense	1,286,259	1,791,632
Other expense (income), net	37,688	(223,224)
Loss before income taxes and minority interest	(4,714,558)	(4,203,907)
Income tax benefit	10,957	10,957
Minority interest in net loss of subsidiary	382,711	289,697
Net loss	(4,320,890)	(3,903,253)
Deduct required dividends on convertible preferred stock, Series A	537	662
Net loss attributable to common stock	$ (4,321,427)	$ (3,903,915)
Basic and diluted net loss per share of common stock, after deduction for required dividends on convertible preferred stock	$ (0.12)	$ (0.14)
Weighted average common shares basic and diluted	36,568,385	27,336,080

See notes to consolidated condensed financial statements which are an integral part of these statements.

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VIRAGEN, INC. AND SUBSIDIARIES

CONSOLIDATED CONDENSED BALANCE SHEETS

	September 30, 2004	June 30, 2004
	(Unaudited)	
ASSETS		
Current assets		
Cash and cash equivalents	$ 11,976,882	$ 22,753,271
Short-term investments	5,398,208	
Accounts receivable	22,318	31,788
Inventories	3,544,610	3,477,214
Prepaid expenses	1,304,568	1,353,350
Other current assets	763,290	1,022,356
Total current assets	23,009,876	28,637,979
Property, plant and equipment		
Land, building and improvements	3,842,605	3,805,834
Equipment and furniture	5,609,413	5,520,677
Construction in progress	1,917,970	1,861,846
	11,369,988	11,188,357
Less accumulated depreciation	(4,565,680)	(4,362,976)
	6,804,308	6,825,381
Goodwill	10,574,815	10,295,140
Developed technology, net	1,836,664	1,828,122
Deposits and other assets	455,207	633,374
	$ 42,680,870	$ 48,219,996
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities		
Accounts payable	$ 742,562	$ 814,253
Accrued expenses and other liabilities	842,558	1,411,458
Line of credit and short term borrowings	230,355	1,076,645
Current portion of long-term debt	35,391	153,723
Total current liabilities	1,850,866	3,456,079
Convertible notes and debentures	13,258,163	12,490,919

Long-term debt, less current portion	663,585	1,072,087
Deferred income tax liability	489,411	500,368
Royalties payable	107,866	107,866
Minority interest in subsidiary	1,200,202	1,403,096
Commitments		
Stockholders equity		
Convertible 10% Series A cumulative preferred stock, $1.00 par value. Authorized 375,000 shares; 2,150 and 2,250 issued and outstanding at September 30, 2004 and June 30, 2004, respectively. Liquidation preference value: $10 per share, aggregating $21,500 at September 30, 2004 and $22,500 at June 30, 2004	2,150	2,250
Common stock, $.01 par value. Authorized 100,000,000 shares; 36,568,385 issued and outstanding at September 30, 2004 and June 30, 2004	365,685	365,685
Capital in excess of par value	146,235,660	146,337,835
Accumulated deficit	(124,791,690)	(120,470,263)
Accumulated other comprehensive income	3,298,972	2,954,074
Total stockholders equity	25,110,777	29,189,581
	$ 42,680,870	$ 48,219,996

See notes to consolidated condensed financial statements which are an integral part of these statements.

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VIRAGEN, INC. AND SUBSIDIARIES

CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS
(Unaudited)

	Three Months Ended September 30,	
	2004	**2003**
OPERATING ACTIVITIES		
Net loss	$ (4,320,890)	$(3,903,253)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	197,834	215,709
Amortization of intangible assets	40,380	37,413
Amortization of fees paid with common stock	30,000	
Unrealized losses on foreign exchange remeasurement	242,280	
Compensation expense on stock options and warrants		21,415
Minority interest in net loss of subsidiary	(382,711)	(289,697)
Amortization of discount on convertible debentures and promissory notes	767,244	1,524,628
Amortization of deferred financing costs	116,677	223,083
Deferred income tax benefit	(10,957)	(10,957)
Increase (decrease) relating to operating activities from:		
Accounts receivable	9,470	(48,334)
Inventories	(67,396)	(151,070)
Prepaid expenses	268,782	68,755
Other current assets	44,061	12,249
Accounts payable	(84,934)	(959,363)
Accrued expenses and other liabilities	(554,037)	(237,898)
Net cash used in operating activities	(3,704,197)	(3,497,320)
INVESTING ACTIVITIES		
Purchase of short-term investments	(5,519,700)	
Additions to property, plant and equipment	(98,694)	(44,038)
Proceeds from sale of property, plant and equipment	24,738	
Net cash used in investing activities	(5,593,656)	(44,038)
FINANCING ACTIVITIES		
Proceeds from private placements of common stock, net		4,764,940
Payments on lines of credit and short term promissory notes, net	(791,570)	(205,792)
Payments on long-term debt	(560,086)	(8,050)
Payments on convertible debentures		(23,649)
Repurchase of preferred stock shares, Series A	(1,000)	
Proceeds from exercise of debt and equity offering warrants		1,312,241

Net cash (used in) provided by financing activities	(1,352,656)	5,839,690
Effect of exchange rate fluctuations on cash and cash equivalents	(125,880)	140,911
(Decrease) increase in cash and cash equivalents	(10,776,389)	2,439,243
Cash and cash equivalents at beginning of period	22,753,271	5,942,501
Cash and cash equivalents at end of period	$ 11,976,882	$ 8,381,744

During the three months ended September 30, 2004 and September 30, 2003, we had the following non-cash financing activities:

	Three Months Ended September 30,	
	2004	**2003**
Purchase of insurance with notes payable	$	$ 301,570
Conversion of convertible debentures and accrued interest into common stock		3,341,602

See notes to consolidated condensed financial statements which are an integral part of these statements.

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VIRAGEN, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
(Unaudited)

NOTE A OVERVIEW AND BASIS OF PRESENTATION

We are a biopharmaceutical company engaged in the research, development, manufacture and sale of a natural human alpha interferon product indicated for treatment of a broad range of viral and malignant diseases. We are also developing innovative technologies aimed at improving the manufacturing processes used to manufacture certain medical therapies and we are developing novel therapeutics for the treatment of cancer. Specifically, we are primarily focused on three fields of research and development:

Human leukocyte derived interferon natural alpha interferon derived from human white blood cells for the treatment of a wide range of viral and malignant diseases.

Avian transgenics technologies designed to produce protein-based drugs inside the egg whites of transgenic developed chickens.

Oncological therapies therapeutic proteins and peptides for the treatment of targeted cancers.

We own approximately 81.2% of Viragen International, Inc. We operate primarily through Viragen International, Inc., and its wholly owned subsidiaries, ViraNative AB (ViraNative), a company located in Umea, Sweden, and Viragen (Scotland) Limited (Viragen (Scotland)), a company located near Edinburgh, Scotland. ViraNative and Viragen (Scotland) house our manufacturing and research laboratory facilities.

On June 15, 2004, we effected a 1-for-10 reverse split of our outstanding common stock. All share and per share information herein have been restated to retroactively reflect this reverse stock split

The accompanying unaudited interim consolidated condensed financial statements include Viragen, Inc., Viragen International, Inc. and all subsidiaries, including those operating outside the United States of America. All significant intercompany balances and transactions have been eliminated. Minority interest in net loss of subsidiary represents the minority stockholders share of the net loss of Viragen International. These statements have been prepared in conformity with accounting principles generally accepted in the United States, consistent in all material respects with those applied in our Annual Report on Form 10-K for the fiscal year ended June 30, 2004, filed with the Securities and Exchange Commission.

The accompanying unaudited interim consolidated condensed financial statements for Viragen, Inc. have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, certain information and footnote disclosures normally included in financial statements included in our Annual Report on Form 10-K have been condensed or omitted. The accompanying unaudited interim consolidated condensed financial statements should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations contained in this report and the audited consolidated financial statements and accompanying notes included in our Annual Report on Form 10-K for the fiscal year ended June 30, 2004.

The preparation of financial statements in accordance with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of income and expenses during the reporting period. The accounting estimates that require management s most difficult and subjective judgments include: the assessment of recoverability of goodwill and long-lived assets; and the valuation of inventories. Actual results could differ materially from those estimates.

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VIRAGEN, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)
(Unaudited)

NOTE A OVERVIEW AND BASIS OF PRESENTATION (Continued)

The interim financial information is unaudited, but, in the opinion of management, reflects all adjustments, including normal recurring adjustments, considered necessary for a fair presentation of results of the interim periods presented. Operating results for the three months ended September 30, 2004 are not necessarily indicative of the results that may be expected for the fiscal year ending June 30, 2005.

During the three months ended September 30, 2004 we incurred a loss of approximately $4,321,000. During the fiscal years ended June 30, 2004, 2003 and 2002, we incurred significant losses of approximately $18,177,000, $17,349,000 and $11,089,000, respectively, and had an accumulated deficit of approximately $124,792,000 as of September 30, 2004. We have cash and short-term investments totaling approximately $17,375,000 and working capital of approximately $21,159,000 at September 30, 2004. We anticipate additional future losses as we commercialize our natural human alpha interferon product and conduct additional research and development activities and clinical trials to obtain additional regulatory approvals. We believe we have sufficient cash to support operations, including those of our subsidiaries, through at least December 31, 2005. However, we will require substantial additional funding to support our operations subsequent to December 31, 2005. If we are unable to generate sufficient cash flows from operations, our plans include seeking additional capital through equity and debt financings. No assurance can be given that additional capital will be available when required or upon terms acceptable to us.

NOTE B STOCK-BASED COMPENSATION

As currently permitted under Statement of Financial Accounting Standards (SFAS) No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure,* which amended SFAS No. 123, *Accounting for Stock-Based Compensation*, our employee stock option plans are accounted for under Accounting Principles Board Opinion No. 25 (APB No. 25), *Accounting for Stock Issued to Employees*, and related interpretations. Compensation expense for stock option grants is recognized if the exercise price is less than the fair value of our common stock on the grant date. See Note L for proposed pronouncement.

The following table illustrates the effect on net loss and net loss per common share if we had applied the fair value method to measure stock-based compensation as required under the disclosure provisions of SFAS No. 123:

	Three Months Ended September 30,	
	2004	**2003**
Net loss as reported	$(4,320,890)	$(3,903,253)
Stock based compensation determined under the fair value method	(29,148)	(13,160)
Pro forma net loss	(4,350,038)	(3,916,413)
Deduct preferred stock dividends, Series A	537	662

Pro forma net loss attributable to common stock	$(4,350,575)	$(3,917,075)
Loss per common share after deduction of required dividends on convertible preferred stock:		
Basic and diluted as reported	$ (0.12)	$ (0.14)
Basic and diluted pro forma	$ (0.12)	$ (0.14)

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VIRAGEN, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)
(Unaudited)

NOTE B STOCK BASED COMPENSATION (Continued)

The effects of applying SFAS No. 123 and SFAS No. 148 on pro forma disclosures of net loss and net loss per common share for the three months ended September 30, 2004 and 2003, are not likely to be representative of the pro forma results of net loss and net loss per common share in future periods since the number of options to be issued under our stock option plans is not known and the assumptions used to determine the fair value of stock options can vary significantly.

NOTE C SHORT-TERM INVESTMENTS

We invest excess cash in highly liquid instruments with maturities of less than twelve months as of the date of purchase. At September 30, 2004, our short-term investments totaling approximately $5,398,000 consisted of UK Pound Sterling denominated certificates of deposit with maturities of six and nine months. During the three months ended September 30, 2004, we recognized a net remeasurement loss totaling approximately $121,000 related to these short-term investments.

NOTE D INVENTORIES

Inventories consist of raw materials and supplies, work in process, and finished product. Finished product consists of purified natural human alpha interferon. Costs of raw materials and supplies are determined on a first-in, first-out basis. Costs of work in process and finished product, consisting of raw materials, labor and overhead, are recorded at a standard cost (which approximates actual cost). Excess/idle capacity costs represent fixed production costs incurred at our Swedish manufacturing facility, which were not absorbed as a result of the suspension of routine manufacturing. Excess/idle capacity costs are expensed in the period in which they are incurred and are included in cost of sales.

Our inventories are stated at the lower of cost or market (estimated net realizable value). If the cost of the inventories exceeds their expected market value, provisions are recorded currently for the difference between the cost and the market value. These provisions are determined based on estimates. The valuation of our inventories also requires us to estimate excess inventories and inventories that are not saleable. The determination of excess or non-saleable inventories requires us to estimate the future demand for our product and consider the shelf life of the inventory. If actual demand is less than our estimated demand, we could be required to record inventory reserves, which would have an adverse impact on our results of operations.

Inventories consisted of the following at September 30, 2004 and June 30, 2004:

	September 30, 2004	June 30, 2004
Finished product	$1,030,741	$1,038,944
Work in process	2,235,231	2,176,116
Raw materials and supplies	278,638	262,154

Total inventories	$3,544,610	$3,477,214

Certain raw materials used in the manufacture of our natural human alpha interferon product, including human white blood cells, are only available from a limited number of suppliers. We are dependent on our suppliers to allocate a sufficient portion of their capacity to meet our needs.

VIRAGEN, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)
(Unaudited)

NOTE E GOODWILL AND OTHER INTANGIBLE ASSETS

On September 28, 2001, Viragen International, Inc., our majority owned subsidiary, acquired all of the outstanding shares of BioNative AB (BioNative), a privately held biotechnology company located in Umeå, Sweden. Subsequent to the acquisition, BioNative was renamed ViraNative. The initial purchase consideration consisted of 2,933,190 shares of Viragen International common stock. In January 2002, ViraNative achieved two milestones defined in the acquisition agreement. As a result, the former shareholders of ViraNative were issued an additional 8,799,570 shares of Viragen International common stock.

The goodwill reported in our balance sheets as of September 30, 2004 and June 30, 2004 arose from Viragen International s acquisition of ViraNative and the subsequent achievement of the milestones. Subsequent to the initial recording of goodwill, the gross carrying amount has increased by approximately $2,987,000 as a result of foreign currency fluctuations between the U.S. dollar and the Swedish Krona. The following table reflects the changes in the carrying amount of goodwill for the three months ended September 30, 2004:

Balance as of June 30, 2004	$10,295,140
Foreign exchange adjustment	279,675
Balance as of September 30, 2004	$10,574,815

In accordance with Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Other Intangible Assets,* goodwill is not amortized but is reviewed for impairment on an annual basis or sooner if indicators of impairment arise. We periodically evaluate that acquired business for potential impairment indicators. Our judgments regarding the existence of impairment indicators are based on legal factors, market conditions, and the operational performance of the acquired business. As of April 1, 2004, we evaluated our goodwill for impairment with the assistance of an independent valuation firm. The impairment review indicated that our goodwill was not impaired. Future changes in the estimates used to conduct the impairment review, including revenue projections or market values, could cause our analysis to indicate that our goodwill is impaired in subsequent periods and result in a write-off of a portion or all of our goodwill.

The developed technology intangible asset reported in our balance sheets as of September 30, 2004 and June 30, 2004 arose from Viragen International s acquisition of ViraNative. A detail of our developed technology intangible asset as of September 30, 2004 and June 30, 2004 is as follows:

	September 30, 2004	June 30, 2004
Developed technology	$2,330,096	$2,268,472
Accumulated amortization	(493,432)	(440,350)

Developed technology, net	$1,836,664	$1,828,122

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VIRAGEN, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)
(Unaudited)

NOTE E GOODWILL AND OTHER INTANGIBLE ASSETS (Continued)

Our developed technology consists of the production and purification methods developed by ViraNative prior to the acquisition by Viragen International. This technology was complete and ViraNative had been selling the resultant natural interferon product prior to the acquisition by Viragen International. Developed technology was recorded at its estimated fair value at the date of acquisition. Subsequent to the initial recording of this intangible asset, the gross carrying amount has increased by approximately $680,000 as a result of foreign currency fluctuations between the U.S. dollar and the Swedish Krona.

Developed technology is being amortized over its estimated useful life of approximately 14 years. The 14-year life assigned to this asset was determined using a weighted average of the remaining lives of the patents on the various components of the production and purification processes.

NOTE F CONVERTIBLE NOTES AND DEBENTURES

Details of our convertible notes and debentures outstanding at September 30, 2004 and June 30, 2004 are as follows:

	September 30, 2004	June 30, 2004
Outstanding principal	$20,000,000	$20,000,000
Less discounts	(6,741,837)	(7,509,081)
	$13,258,163	$12,490,919

At September 30, 2004 and June 30, 2004, the convertible notes and debentures balance consists of the 7% convertible notes issued on June 18, 2004 totaling $20 million.

June 2004 Convertible Notes

On April 1, 2004, we entered into purchase agreements for the issuance and sale of 7% convertible notes and common stock purchase warrants in the aggregate amount of $20 million. The notes were placed with a group of new and returning institutional investors. The $20 million purchase price for the notes and warrants was placed in escrow pending satisfaction of all conditions precedent to closing, including receipt of stockholder approval for the sale of the notes and warrants, as well as a one for ten reverse split of our common stock. On June 11, 2004 our stockholders voted to approve the sale of the notes and a one for ten reverse split of our common stock. On June 18, 2004, we completed the sale of the notes and warrants. Under the terms of these agreements, we received approximately $18.96 million, net of finder s fees and legal expenses. These agreements also provided for the issuance to the purchasers of an aggregate of 5,357,051 three-year common stock purchase warrants exercisable at $1.819 per share. In connection with the April 1, 2004 purchase agreements, we paid a finder s fee of 5% or $1 million and issued the finder 80,000 three-year common stock purchase warrants exercisable at a price of $1.516 per share.

These convertible notes mature on March 31, 2006. Interest is payable quarterly commencing July 1, 2004. Quarterly interest payments are payable in cash or, at our option, in shares of our common stock based upon the average market price of our common stock during the 20 consecutive trading days prior to and including the interest payment date, subject to certain conditions.

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VIRAGEN, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)
(Unaudited)

NOTE F CONVERTIBLE NOTES AND DEBENTURES (Continued)

The notes are convertible immediately by the investors, in whole or in part, into shares of our common stock at a conversion price equal to $1.516. This conversion price is subject to reductions if we enter into additional financing transactions for the sale of our stock below the market price or below the conversion price.

These notes may be prepaid at 110% of their face amount, plus the issuance to note holders of additional warrants to purchase the number of shares of our common stock into which the notes would otherwise have been convertible, at an exercise price equal to the prevailing conversion price of the notes. If issued on prepayment, the warrants may be exercised for the period that would have been the remaining life of the notes had they not been prepaid. Commencing one year after issuance, we also have the right to require note holders to convert their notes, subject to certain limitations; provided that our common stock has traded at 200% or more of the conversion price of the notes on each of the 30 trading days ending five days prior to the date fixed for conversion.

The warrants issued in connection with the notes are exercisable during the three year period ending June 18, 2007 and can be exercised on a cashless basis whereby the holder may surrender a number of warrants equal to the exercise price of the warrants being exercised. The relative fair value of these warrants was calculated to be approximately $3,264,000 using a Black-Scholes valuation model. The relative fair value of these warrants was recorded as a discount on the principal amount of the notes and is amortized to interest expense using the effective interest rate method over the life of the notes. For the three months ended September 30, 2004, we recognized approximately $328,000 as non-cash interest expense from the amortization of the discount that arose from the issuance of the warrants.

As a result of the common stock purchase warrants issued in connection with the notes and the calculated effective conversion price of the notes, a beneficial conversion amount of approximately $4,372,000 was calculated and recorded as a discount on the principal amount of the notes at the date of issuance. For the three months ended September 30, 2004, we recognized approximately $439,000 as non-cash interest expense from the amortization of the discount that arose from the beneficial conversion feature.

We incurred costs of approximately $1,161,000 in connection with the notes and warrants, which primarily consisted of the finder s fees, the fair value of warrants issued to the finder, and legal and accounting expenses. These costs will be amortized to interest expense over the life of the notes using the effective interest rate method. For the three months ended September 30, 2004, we recognized approximately $117,000 as interest expense from the amortization of these debt issuance costs.

As of September 30, 2004, the entire principal amount of these convertible notes of $20 million remained outstanding. The amount of interest paid on these notes for the three months ended September 30, 2004 totaled $350,000. All common stock purchase warrants issued in connection with this transaction remain unexercised as of September 30, 2004.

Resale of the shares issuable upon conversion or payment of the notes and upon exercise of warrants are registered under our Form S-3 registration statement (File No. 333-117338) filed with the Securities and Exchange Commission, which was declared effective on July 28, 2004.

VIRAGEN, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)
(Unaudited)

NOTE F CONVERTIBLE NOTES AND DEBENTURES (Continued)

June 2003 Convertible Debentures

On June 27, 2003, we entered into a securities purchase agreement with five unrelated institutional investors. The securities purchase agreement provided for the purchase and sale of our convertible debentures in the aggregate amount of approximately $5.55 million. Under the terms of the agreement, Viragen received approximately $4.55 million, net of original issue discounts of $661,333, and a 6.5% finder s fee and legal expenses. This agreement also provided for the issuance to the purchasers of an aggregate of 1,354,664 five-year common stock purchase warrants exercisable at a price of $1.722 per share. In connection with the June 2003 securities purchase agreement, we also issued the finder 19,571 five-year common stock purchase warrants exercisable at a price of $1.722 per share.

These convertible debentures were to mature on September 1, 2005, and were payable, without interest, in 24 equal payments of principal commencing September 1, 2003. In lieu of interest, the debentures provided for an original issue discount equal to $661,333, the equivalent of 10% interest over the two year life of the debenture. For the three months ended September 30, 2003, we recognized approximately $243,000 as interest expense from the amortization of the original issue discount. The debentures were convertible immediately by the investors, in whole or in part, into shares of our common stock at a conversion price equal to $3.17, which was subsequently reduced to $2.24 as a result of our September 2003 financing transaction.

The warrants issued in connection with these debentures are exercisable during the five year period ending June 1, 2008 and can be exercised on a cashless basis whereby the holder may surrender a number of warrants equal to the exercise price of the warrants being exercised. The relative fair value of these warrants was calculated to be approximately $1,381,000 using a Black-Scholes valuation model. The relative fair value of these warrants was recorded as a discount on the principal amount of the debentures and was amortized to interest expense using the effective interest rate method over the life of the debentures. For the three months ended September 30, 2003, we recognized approximately $507,000 as non-cash interest expense from the amortization of the discount that arose from the issuance of the warrants.

As a result of the common stock purchase warrants issued in connection with these debentures and the calculated effective conversion price of the debentures, a beneficial conversion amount of approximately $689,000 was calculated and recorded as a discount on the principal amount of the debentures at the date of issuance. As a result of a subsequent financing transaction entered into in September 2003, the conversion price of these debentures was reduced from $3.17 to $2.24. Due to this reduction in the conversion price of these debentures, additional beneficial conversion of approximately $1,382,000 was calculated and recorded as a discount on the principal amount of the debentures. These discounts were amortized to interest expense using the effective interest rate method over the life of the debentures. For the three months ended September 30, 2003, we recognized approximately $253,000 as non-cash interest expense from the amortization of the discount that arose from the beneficial conversion feature.

We incurred costs of approximately $369,000 in connection with the debentures issued in the June 27, 2003 agreement, which primarily consisted of the finder s fees, the fair value of warrants issued to the finder, and legal and accounting expenses. These costs were amortized to interest expense over the life of the debentures using the effective interest rate method. For the three months ended September 30, 2003, we recognized approximately $135,000 as interest expense from the amortization of these debt issuance costs.

VIRAGEN, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)
(Unaudited)

NOTE F CONVERTIBLE NOTES AND DEBENTURES (Continued)

As of December 31, 2003, these convertible debentures had been satisfied and no further amounts were due as the purchasers had converted approximately $5.5 million of principal resulting in the issuance of approximately 2.34 million shares of our common stock and we repaid approximately $65,000 of principal in cash. Warrants to purchase 315,305 shares of our common stock issued in connection with this transaction remain unexercised as of September 30, 2004.

Resale of the shares issuable upon conversion or payment of the debentures and upon exercise of warrants are registered under our Form S-3 registration statement (File No. 333-107176) filed with the Securities and Exchange Commission, which was declared effective on August 1, 2003.

April 2003 Convertible Debentures, as Amended

On April 16, 2003, we entered into a securities purchase agreement with three unrelated institutional investors. This agreement was amended on May 8, 2003 and May 16, 2003, to among other things, include an additional unrelated institutional investor. The securities purchase agreement, as amended, provided for the purchase and sale of our convertible debentures in the aggregate amount of approximately $3.8 million. Under the terms of the agreement, we received approximately $3.1 million, net of original issue discounts of $453,395, a 6.5% finder s fee, and legal expenses. This agreement also provided for the issuance to the purchasers of an aggregate of 3,171,200 three-year common stock purchase warrants exercisable at a price of $0.625 per share.

In connection with the April 2003 debentures, we also issued the finder 13,408 three-year common stock purchase warrants exercisable at a price of $0.625 per share.

These convertible debentures were to mature on July 1, 2005, and were payable, without interest, in 24 equal payments of principal commencing August 1, 2003. The debentures were convertible immediately, in whole or in part, by the purchasers into shares of our common stock at a conversion price equal to $2.00 per share.

The warrants issued in connection with the April 16, 2003 securities purchase agreement and the amendments dated May 8, 2003 and May 16, 2003, were exercisable during the three year period ending April 2006. The relative fair value of these warrants was calculated to be approximately $800,000 using a Black-Scholes valuation model. The relative fair value of the warrants was recorded as a discount on the principal amount of the debentures and was amortized to interest expense using the effective interest rate method over the life of the debentures. For the three months ended September 30, 2003, we recognized approximately $268,000 as non-cash interest expense from the amortization of the discount that arose from the issuance of these warrants. As of September 30, 2003, the entire initial discount resulting from the issuance of the warrants had been fully amortized to interest expense.

As a result of the common stock purchase warrants issued along with the April 2003 debentures and the calculated effective conversion price of the debentures, a beneficial conversion amount of approximately $335,000 was calculated and recorded as a discount on the principal amount of the debentures at the date of issuance. This discount was amortized to interest expense using the effective interest rate method over the life of the debentures. For the three months ended September 30, 2003, we recognized approximately $120,000 as non-cash interest expense from the amortization of the discount that arose from the beneficial conversion. As of September 30, 2003, the entire initial discount resulting from the beneficial conversion feature had been fully amortized to interest expense.

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NOTE F CONVERTIBLE NOTES AND DEBENTURES (Continued)

We incurred costs of approximately $301,000 in connection with the April 2003 convertible debentures, which primarily consisted of the finder s fees, the fair value of warrants issued to the finder, and legal and accounting expenses. These costs were amortized to interest expense over the life of the debentures using the effective interest rate method. For the three months ended September 30, 2003, we amortized approximately $88,000 to interest expense. As of September 30, 2003, these debt issuance costs had been fully amortized to interest expense.

As of September 30, 2003, the purchasers had converted the entire principal balance on the April 2003 debentures resulting in the issuance of approximately 1.9 million shares of our common stock. In addition, all common stock purchase warrants issued in connection with this transaction have been exercised.

Resale of the shares issued upon conversion or payment of the debentures and upon exercise of warrants are registered under our Form S-3 registration statement (File No. 333-105668) filed with the Securities and Exchange Commission, which was declared effective on June 9, 2003.

August 2002 Note, as Amended

During August 2002, we executed a $500,000, 90 day Note with Isosceles Fund Limited. The Note bore interest at 8% and was secured by 250,000 shares of our common stock. In connection with this transaction, we issued 5,387 common stock purchase warrants exercisable at $5.30 per share for a period of three years. In November 2002, the Note was amended to eliminate the fixed maturity date and make the Note payable within three business days following demand. The Note was also amended to provide for conversion of outstanding principal and interest into shares of our common stock at a price of $1.75 per share in lieu of cash at Isosceles option. As a result of our subsequent financing transactions, this conversion price was reduced to $0.56. Since Isosceles did not elect to convert the Note within 90 days of the amendment, we issued Isosceles 11,650 warrants at $2.50 per share, 11,650 warrants at $3.00 per share, 11,650 warrants at $3.50 per share, 40,625 warrants at $5.00 per share and 37,500 warrants at $6.00 per share. The warrants were exercisable for a three-year period. The fair value of the warrants, which was calculated to be $67,845, was charged to interest expense at the time of issuance. As a result of subsequent financing transactions, the exercise price of these warrants was reduced to $0.56. As a result of the stock purchase warrants issued and the calculated effective conversion price of the Note, a beneficial conversion amount of approximately $485,000 was calculated and charged to interest expense. All of these items charged to interest expense were non-cash items.

During the three months ended September 30, 2003, we issued 960,000 shares upon conversion of the principal of the August 2002 Note and accrued interest totaling approximately $536,000. No further amounts are due on this Note. In addition, Isosceles converted all 118,462 warrants issued in connection with this Note resulting in net proceeds to us of approximately $66,300. Resale of the shares issued upon conversion of the Isosceles Note and exercise of warrants issued in connection with this Note as amended are registered under our Form S-3 registration statement (File No. 333-106536) filed with the Securities and Exchange Commission, which was declared effective on July 11, 2003.

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VIRAGEN, INC. AND SUBSIDIARIES
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NOTE G DEBT

Line of Credit and Short Term Borrowings

Our Swedish subsidiary maintains an overdraft facility, denominated in Swedish Krona, with a bank in Sweden. In July 2004, the terms of this overdraft facility were renegotiated to provide for a reduced interest rate and a reduction in the maximum borrowing capacity. Maximum borrowing capacity on this overdraft facility was approximately $817,000 as of September 30, 2004 compared to $1.1 million at June 30, 2004. Borrowings outstanding under this facility are at a floating rate of interest, which was approximately 5.25% at September 30, 2004 compared to 7.4% at June 30, 2004. The facility renews annually and was renewed in December 2003. Outstanding borrowings under this agreement were approximately $49,000 and $807,000 as of September 30, 2004 and June 30, 2004, respectively. The overdraft facility is secured by certain assets of ViraNative including inventories and accounts receivable.

During June 2004, we obtained short term financing of approximately $270,000 for the purchase of certain corporate insurance policies. Outstanding borrowings under this arrangement bear interest at an effective rate of 5.19%. Principal and interest payments of approximately $31,000 are payable in nine equal monthly installments. The outstanding balance on this short term borrowing was approximately $181,000 and $270,000 as of September 30, 2004 and June 30, 2004, respectively.

Long-Term Debt

Our Swedish subsidiary has a 25-year mortgage with a Swedish bank obtained to purchase one of our facilities in Sweden. The outstanding principal balance on this loan, which is payable in Swedish Krona, was approximately $699,000 and $689,000 at September 30, 2004 and June 30, 2004, respectively. This loan carries a floating rate of interest which was approximately 5.25% at September 30, 2004 and June 30, 2004. We are required to make quarterly payments of principal and interest of approximately $12,000 under this agreement. This loan matures in September 2024 and is secured by the related land and building, including improvements, with a carrying value of approximately $2.8 million as of September 30, 2004.

Under the terms of a loan with a Swedish governmental agency that was obtained for the purposes of conducting clinical trials, we were required to make quarterly payments of principal and interest of approximately $34,000. The loan carried a floating rate of interest at the Stockholm interbank offered rate (STIBOR) 90 plus 7%, which was approximately 10.60% as of June 30, 2004. This loan had an outstanding balance, which was payable in Swedish Krona, of approximately $537,000 at June 30, 2004. On September 30, 2004, we paid the entire outstanding principal including accrued interest on this loan. No amounts are due on this loan as of September 30, 2004.

NOTE H CAPITAL STOCK

On June 11, 2004, our stockholders approved an amendment to our Articles of Incorporation to effect a 1-for-10 reverse split of our outstanding common stock and change the number of shares of common stock that Viragen is authorized to issue to 100 million. All share and per share information herein have been restated to retroactively reflect this reverse stock split.

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VIRAGEN, INC. AND SUBSIDIARIES
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NOTE H CAPITAL STOCK (Continued)

As of November 4, 2004, there were 22,040,445 shares of our common stock issuable upon exercise or conversion of the following securities:

Convertible preferred stock, Series A	916
Officers, employees, and directors options (exercisable at an average price of $6.40 through March 2014)	409,800
Consultant warrants (exercisable at an average price of $23.26 through February 2009)	181,100
Debt and equity offering warrants (exercisable at an average price of $1.98 through June 2008)	8,256,012
Convertible notes (convertible at $1.516 through March 2006)	13,192,617
	22,040,445

NOTE I COMPREHENSIVE LOSS

Comprehensive loss is comprised of our net loss and other comprehensive income. Other comprehensive income refers to revenue, expenses, gains and losses that under accounting principles generally accepted in the United States are included in comprehensive loss but are excluded from net loss as these amounts are recorded directly as an adjustment to stockholders equity. Our other comprehensive income consists of foreign currency translation adjustments. The following table sets forth the computation of comprehensive loss for the periods indicated:

	Three Months Ended September 30,	
	2004	**2003**
Net loss	$(4,320,890)	$(3,903,253)
Other comprehensive income:		
Currency translation adjustment	344,898	685,927
Comprehensive loss	$(3,975,992)	$(3,217,326)

NOTE J ROYALTY AGREEMENT

In November 1986, we entered into a royalty agreement with Medicore, Inc. with respect to interferon, transfer factor and products using interferon and transfer factor. The agreement was subsequently amended in November 1989 and May 1993. The amended agreement provides for a maximum cap on royalties to be paid to Medicore of $2,400,000. It includes a schedule of royalty payments of:

5% of the first $7,000,000 of sales,

4% of the next $10,000,000, and

3% of the next $55,000,000

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VIRAGEN, INC. AND SUBSIDIARIES
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NOTE J ROYALTY AGREEMENT (Continued)

These royalties are to be paid until the total of $2,400,000 is achieved. The amended agreement also states that royalties of approximately $108,000 previously accrued prior to May 1993 under the agreement are payable to Medicore as the final payment. From May 1993 through September 2001, we paid royalties under the amended agreement totaling approximately $70,000.

Royalties owed to Medicore of approximately $90,000, based on our natural human alpha interferon sales from October 1, 2001 through June 30, 2003, are payable in three installments: $30,000 was payable by August 1, 2003; $30,000 was payable by August