NovaBay Pharmaceuticals, Inc.
Form 10-Q
November 14, 2013

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2013

OR

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

For the transition period from to

Commission file number 001-33678

NOVABAY PHARMACEUTICALS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**68-0454536**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

5980 Horton Street, Suite 550, Emeryville CA 94608

(Address of principal executive offices) (Zip Code)

Registrant's Telephone Number, Including Area Code: (510) 899-8800

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 No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting company
(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2). Yes No

As of November 11, 2013, there were 39,397,734 shares of the registrant's common stock outstanding.

NOVABAY PHARMACEUTICALS, INC.

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Unless the context requires otherwise, all references in this report to “we,” “our,” “us,” the “Company” and “NovaBay” refer to NovaBay Pharmaceuticals, Inc. and its subsidiaries.

PART I

FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

NOVABAY PHARMACEUTICALS, INC.

(a development stage company)

CONSOLIDATED BALANCE SHEETS

(in thousands, except per share data)	**September 30,** 2013 (unaudited)	**December 31,** 2012 (Note 2)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 6,934	$ 12,735
Short-term investments	3,885	4,135
Accounts receivable	272	943
Inventory	63	23
Prepaid expenses and other current assets	330	445
Total current assets	11,484	18,281
Property and equipment, net	687	891
Other assets	74	63
TOTAL ASSETS	$ 12,245	$ 19,235
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Current liabilities:		
Accounts payable	$ 1,013	$ 455
Accrued liabilities	1,842	1,497
Deferred revenue	207	1,221
Total current liabilities	3,062	3,173
Deferred revenues - non-current	1,081	671
Deferred rent	116	60
Warrant liability	2,564	1,282
Total liabilities	6,823	5,186
Stockholders' equity:		

Preferred stock, $0.01 par value; 5,000 shares authorized; none outstanding at September 30, 2013 and December 31, 2012	—	—
Common stock, $0.01 par value; 65,000 shares authorized at September 30, 2013 and December 31, 2012; 38,651 and 36,915 issued and outstanding at September 30, 2013 and December 31, 2012, respectively	387	369
Additional paid-in capital	57,264	54,004
Accumulated other comprehensive loss	(13)	(13)
Accumulated deficit during development stage	(52,216)	(40,311)
Total stockholders' equity	5,422	14,049
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 12,245	$ 19,235

The accompanying notes are an integral part of these consolidated financial statements.

NOVABAY PHARMACEUTICALS, INC.

(a development stage company)

CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS

(unaudited)

(in thousands, except per share data)	Three Months Ended September 30, 2013	Three Months Ended September 30, 2012	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2012	Cumulative Period from July 1, 2002 (inception) to September 30, 2013
Sales:					
Sales revenue	$(1)	$—	$78	$—	$ 78
Cost of goods sold	43	—	82	—	82
Gross profit	(44)	—	(4)	—	(4)
Other revenue:					
License, collaboration and distribution revenue	1,035	3,617	2,739	5,794	60,193
Other revenues	65	25	150	40	268
Total other revenue	1,100	3,642	2,889	5,834	60,461
Operating expenses:					
Research and development	2,513	2,514	8,424	7,156	68,570
General and administrative	1,525	1,234	5,081	4,145	44,716
Total operating expenses	4,038	3,748	13,505	11,301	113,286
Operating loss	(2,982)	(106)	(10,620)	(5,467)	(52,829)
Non-cash gain (loss) on changes in fair value of warrants	(866)	209	(1,282)	802	(575)
Other income (expense), net	3	(17)	8	5	1,274
Income (loss) before provision for income taxes	(3,845)	86	(11,894)	(4,660)	(52,130)
Provision for income taxes	(3)	(6)	(11)	(17)	(86)
Net income (loss)	(3,848)	80	(11,905)	(4,677)	(52,216)
Change in unrealized gains (losses) on available-for-sale securities	6	33	(13)	15	(26)
Comprehensive income (loss)	$(3,842)	$113	$(11,918)	$(4,662)	$ (52,242)
Net loss per share:					
Basic	$(0.10)	$0.00	$(0.32)	$(0.16)	

Diluted	$(0.10)	$0.00	$(0.32)	$(0.16)
Shares used in per share calculations:				
Basic	37,467	28,861	37,166	28,702
Diluted	37,467	29,284	37,166	28,702

The accompanying notes are an integral part of these consolidated financial statements.

NOVABAY PHARMACEUTICALS, INC.

(a development stage company)

CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

(in thousands)	Nine Months Ended September 30, 2013	2012	Cumulative Period from July 1, 2002 (inception) to September 30, 2013
Cash flows from operating activities:			
Net loss	$(11,905)	$(4,677)	$(52,216)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	240	256	2,510
Accretion of discount on short-term investments	—	—	(252)
Net realized loss on sales of short-term investments	19	65	135
Loss on disposal of property and equipment	—	30	313
Stock-based compensation expense for options and stock issued to employees and directors	705	1,021	6,746
Compensation expense for warrants issued for services	166	34	366
Stock-based compensation expense for options, warrants and stock issued to non-employees	98	170	1,340
Non-cash loss (gain) on changes in fair value of warrants	1,282	(802)	575
Taxes paid by LLC	—	—	1
Changes in operating assets and liabilities:			
(Increase) decrease in accounts receivable	671	(123)	(272)
Purchase of inventory	(40)	—	(63)
(Increase) decrease in prepaid expenses and other assets	115	(67)	(206)
Increase in accounts payable and accrued liabilities	959	1,294	3,177
Increase (decrease) in deferred revenue	(604)	(633)	1,637
Net cash used in operating activities	(8,294)	(3,432)	(36,209)
Cash flows from investing activities:			
Purchases of property and equipment	(36)	(54)	(3,397)
Proceeds from disposal of property and equipment	—	1	52
Purchases of short-term investments	(4,330)	(3,434)	(117,748)
Proceeds from maturities and sales of short-term investments	4,550	4,424	113,899
Cash acquired in purchase of LLC	—	—	516

Net cash (used in) provided by investing activities	184	937	(6,678)
Cash flows from financing activities:			
Proceeds from preferred stock issuances, net	—	—	11,160
Proceeds from common stock issuances	425	1,300	3,242
Proceeds from exercise of options and warrants	1,884	57	3,990
Proceeds from initial public offering, net of costs	—	—	17,077
Proceeds from shelf offering, net of costs	—	—	13,231
Proceeds from stock subscription receivable	—	—	873
Proceeds from issuance of notes	—	—	405
Principal payments on capital lease	—	—	(157)
Proceeds from short-term borrowing	—	(71)	88
Principal payment on short-term borrowing	—	—	(88)
Proceeds from borrowings under equipment loan	—	—	1,216
Principal payments on equipment loan	—	—	(1,216)
Net cash provided by financing activities	2,309	1,286	49,821
Net increase (decrease) in cash and cash equivalents	(5,801)	(1,209)	6,934
Cash and cash equivalents, beginning of period	12,735	8,428	—
Cash and cash equivalents, end of period	$6,934	$7,219	$6,934

The accompanying notes are an integral part of these consolidated financial statements.

NOVABAY PHARMACEUTICALS, INC.

(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

NOTE 1. ORGANIZATION

NovaBay Pharmaceuticals, Inc. ("NovaBay," the "Company" or "we") is a clinical-stage biopharmaceutical company focused on addressing the large unmet therapeutic needs of the global, topical anti-infective market with its two distinct categories of products: *Aganocides® and NeutroPhase®*

Aganocide® Compounds

NovaBay's first-in-class Aganocide® compounds, led by auriclosene (NVC-422), are patented, synthetic molecules with a broad spectrum of activity against bacteria, viruses and fungi. Mimicking the mechanism of action that human white blood cells use against infections, Aganocides possess a reduced likelihood that bacteria or viruses will be able to develop resistance, which is critical for advanced anti-infectives. Having demonstrated therapeutic proof-of-concept in three Phase 2 clinical studies, these compounds are well suited to treat and prevent a wide range of local, non-systemic infections. Our Aganocide compounds are currently being developed for three large therapeutic markets:

Dermatology - Partnered with Galderma, a leading dermatology company, we are developing a gel formulation of auriclosene (NVC-422) for treating the highly contagious skin infection, impetigo. On November 6, 2013 we announced that the auriclosene Phase 2b clinical study of impetigo has been completed. While the study showed that auriclosene is safe and well tolerated, it did not meet its primary clinical endpoint. We are working with Galderma to examine the results from this study and expect to use the findings to guide the future course of the clinical development of auriclosene for impetigo.

Ophthalmology - NovaBay is developing an eye drop formulation of auriclosene (NVC-422) for treating adenoviral conjunctivitis, for which there is currently no FDA-approved treatment. The Company expects to complete enrollment in a global Phase 2b clinical study (BAYnovation) for this indication by the end of 2013 and have data available in the first half of 2014. NovaBay also initiated a proof-of-concept study (BACTOvation) for bacterial

conjunctivitis in July of 2013 with auriclosene (NVC-422). Results are expected in the first half of 2014.

Urology - Our urinary catheter irrigation solution containing auriclosene (NVC-422) is currently in trials, with the goal of reducing the incidence of urinary catheter blockage and encrustation (UCBE). In November 2011 we reported positive data from randomized placebo controlled two week study. More recently in September 2013, we announced positive results from a four week randomized double-blinded, placebo-controlled crossover design and are continuing to interact with the FDA to move the program forward.

NeutroPhase®

Wound Care –NeutroPhase® is our FDA 510(k)-cleared product for advanced wound care. With a distinct mechanism of action from Aganocides, we believe that NeutroPhase is the only patented pure hypochlorous acid solution available and has the potential to be best suited to treat the six-million-patients in the U.S. who suffer from chronic non-healing wounds, such as pressure, venous stasis and diabetic ulcers.

NovaBay has begun securing commercial partnerships for NeutroPhase. In January 2012, NovaBay announced it had entered into a strategic marketing agreement with Pioneer Pharma Co., Ltd., a Shanghai-based company that markets high-end pharmaceutical products into China, to market NeutroPhase in China. In September 2012, the collaboration with Pioneer Pharma was expanded to include other Asian markets such as Hong Kong, Macau, Taiwan, Singapore, Malaysia, Indonesia, Myanmar, Philippines, Thailand, Vietnam, Brunei, Cambodia and Laos. NovaBay signed a distribution with Shin Poong Pharmaceuticals covering the Korean market during 2013 and expects to announce additional marketing agreements in select geographic markets around the world during 2013 and beyond.

The Company was incorporated under the laws of the State of California on January 19, 2000, as NovaCal Pharmaceuticals, Inc. The Company had no operations until July 1, 2002, on which date it acquired all of the operating assets of NovaCal Pharmaceuticals, LLC, a California limited liability company. In February 2007, the Company changed its name from NovaCal Pharmaceuticals, Inc. to NovaBay Pharmaceuticals, Inc. In August 2007, it formed two subsidiaries—NovaBay Pharmaceuticals Canada, Inc., a wholly-owned subsidiary incorporated under the laws of British Columbia (Canada), which was formed to conduct research and development in Canada but was dissolved in July 2012, and DermaBay, Inc., a wholly-owned U.S. subsidiary, which may explore and pursue dermatological opportunities. In June 2010, the Company changed the state in which it is incorporated (the Reincorporation), and is now incorporated under the laws of the State of Delaware. All references to “we,” “us,” “our,” or “the Company” herein refer to the California corporation prior to the date of the Reincorporation, and to the Delaware corporation on and after the date of the Reincorporation. The Company currently operates in four business segments; see Note 10 for further details.

NOVABAY PHARMACEUTICALS, INC.

(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying unaudited consolidated financial statements of NovaBay Pharmaceuticals, Inc. have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission ("SEC") for interim reporting including the instructions to Form 10-Q and Rule 8-03 of Regulation S-X. These statements do not include all disclosures for annual audited financial statements required by accounting principles generally accepted in the United States of America ("U.S. GAAP") and should be read in conjunction with the Company's audited consolidated financial statements and related notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2012. The consolidated balance sheet at December 31, 2012, has been derived from the audited financial statements at that date, but does not include all of the information and footnotes required by U.S. GAAP for complete financial statements.

The Company believes these consolidated financial statements reflect all adjustments (consisting only of normal, recurring adjustments) that are necessary for a fair presentation of the financial position and results of operations for the periods presented. Results of operations for the interim periods presented are not necessarily indicative of results to be expected for the year.

The financial statements have been prepared under the guidelines for Development Stage Entities. A development stage enterprise is one in which planned principal operations have not commenced, or if its operations have commenced, there have been no significant revenues therefrom. As of September 30, 2013, we continued to conduct clinical trials and had not commenced our planned principal operations.

Certain amounts for prior periods have been reclassified to conform to current period presentation.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, NovaBay Pharmaceuticals Canada, Inc. (prior to its dissolution in July 2012) and DermaBay, Inc. All inter-company accounts and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of financial statements in accordance with U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. These estimates include useful lives for property and equipment and related depreciation calculations, estimated amortization period for payments received from product development and license agreements as they relate to revenue recognition, assumptions for valuing options and warrants, and income taxes. Actual results could differ from those estimates.

Cash, Cash Equivalents and Short-Term Investments

The Company considers all highly liquid instruments with a stated maturity of three months or less at the date of purchase to be cash and cash equivalents. Cash and cash equivalents are stated at cost, which approximates their fair value. As of September 30, 2013, the Company’s cash and cash equivalents were held in financial institutions in the United States and include deposits in money market funds, which were unrestricted as to withdrawal or use.

The Company classifies all highly liquid investments with a stated maturity of greater than three months at the date of purchase as short-term investments. Short-term investments generally consist of municipal and corporate debt securities. The Company has classified its short-term investments as available-for-sale. The Company does not intend to hold securities with stated maturities greater than twelve months until maturity. In response to changes in the availability of and the yield on alternative investments as well as liquidity requirements, the Company occasionally sells these securities prior to their stated maturities. These securities are carried at fair value, with the unrealized gains and losses reported as a component of other comprehensive income (loss) until realized. Realized gains and losses from the sale of available-for-sale securities, if any, are determined on a specific identification basis. A decline in the market value below cost of any available-for-sale security that is determined to be other-than-temporary results in a revaluation of its carrying amount to fair value and an impairment charge to earnings, resulting in a new cost basis for the security. No such impairment charges were recorded for the periods presented. The interest income and realized gains and losses are included in other income (expense), net within the consolidated statements of operations and comprehensive loss. Interest income is recognized when earned.

Concentrations of Credit Risk and Major Partners

Financial instruments which potentially subject us to significant concentrations of credit risk consist primarily of cash and cash equivalents and short-term investments. The Company maintains deposits of cash, cash equivalents and short-term investments with three highly-rated, major financial institutions in the United States.

NOVABAY PHARMACEUTICALS, INC.

(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Deposits in these banks may exceed the amount of federal insurance provided on such deposits. The Company does not believe it is exposed to significant credit risk due to the financial position of the financial institutions in which these deposits are held. Additionally, the Company has established guidelines regarding diversification and investment maturities, which are designed to maintain safety and liquidity.

During the three and nine months ended September 30, 2013, revenues were derived from two collaboration partners, two distribution partners, service revenues and sales of NeutroPhase. During the three and nine months ended September 30, 2012, the majority of the Company's operating revenues were derived from one distribution partner, two collaboration partners and service revenues.

As of September 30, 2013, 76% of accounts receivable was derived from one collaboration partner. As of December 31, 2012, 96% of accounts receivable was derived from one collaboration and two distribution partners.

Comprehensive Income (Loss)

ASC 220, *Comprehensive Income* requires that an entity's change in equity or net assets during a period from transactions and other events from non-owner sources be reported. The Company reports unrealized gains and losses on its available-for-sale securities as other comprehensive income (loss).

Fair Value of Financial Assets and Liabilities

Financial instruments, including cash and cash equivalents and short-term investments, accounts payable and accrued liabilities are carried at cost, which management believes approximates fair value due to the short-term nature of these instruments. The fair value of capital lease obligations and equipment loans approximates their carrying amounts because the obligations bear market rates of interest.

The Company measures the fair value of financial assets and liabilities based on U.S. GAAP guidance which defines fair value, establishes a framework for measuring fair value, and requires disclosures about fair value measurements.

Under U.S. GAAP, fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. A fair value hierarchy is also established, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. There are three levels of inputs that may be used to measure fair value:

Level 1 – quoted prices in active markets for identical assets or liabilities;

Level 2 – quoted prices for similar assets and liabilities in active markets or inputs that are observable;

Level 3 – inputs that are unobservable (for example cash flow modeling inputs based on assumptions).

Property and Equipment

Property and equipment are stated at cost, less accumulated depreciation and amortization. Depreciation is calculated using the straight-line method over the estimated useful lives of the related assets of five to seven years for office and laboratory equipment, three years for software and seven years for furniture and fixtures. Leasehold improvements are depreciated over the shorter of seven years or the lease term. Depreciation of assets recorded under capital leases is included in depreciation expense.

The costs of normal maintenance, repairs, and minor replacements are charged to operations when incurred.

Impairment of Long-Lived Assets

The Company accounts for long-lived assets in accordance with U.S. GAAP, which requires that companies consider whether events or changes in facts and circumstances, both internally and externally, may indicate that an impairment of long-lived assets held for use are present. Management periodically evaluates the carrying value of long-lived assets and has determined that there was no impairment as of all periods presented. Determination of recoverability is based on the estimate of undiscounted future cash flows resulting from the use of the asset and its eventual disposition. In the event that such cash flows are not expected to be sufficient to recover the carrying amount of the asset, the assets are written down to their estimated fair values and the loss is recognized in the statements of operations.

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NOVABAY PHARMACEUTICALS, INC.

(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Revenue Recognition

License and collaboration revenue is primarily generated through agreements with strategic partners for the development and commercialization of the Company's product candidates. The terms of the agreements typically include non-refundable upfront fees, funding of research and development activities, payments based upon achievement of certain milestones and royalties on net product sales. In accordance with revenue recognition criteria under U.S. GAAP, the Company analyzes its multiple element arrangements to determine whether the elements can be separated. The Company performs its analysis at the inception of the arrangement and as each product or service is delivered. If a product or service is not separable, the combined deliverables are

accounted for as a single unit of accounting and revenue is recognized over the performance obligation period. Revenue is recognized when the following criteria have been met: persuasive evidence of an arrangement exists; delivery has occurred and risk of loss has passed; the seller's price to the buyer is fixed or determinable; and collectability is reasonably assured.

Assuming the elements meet the revenue recognition guidelines the revenue recognition methodology prescribed for each unit of accounting is summarized below:

Upfront Fees—The Company defers recognition of non-refundable upfront fees if it has continuing performance obligations without which the technology licensed has no utility to the licensee. If it has performance obligations through research and development services that are required because its know-how and expertise related to the technology is proprietary to it, or can only be performed by it, then such up-front fees are deferred and recognized over the period of the performance obligations. The Company bases the estimate of the period of performance on factors in the contract. Actual time frames could vary and could result in material changes to its results of operations.

Funded Research and Development— Revenue from research and development services is recognized during the period in which the services are performed and is based upon the number of full-time-equivalent personnel working on the specific project at the agreed-upon rate. This revenue approximates the cost incurred. Reimbursements from

collaborative partners for agreed-upon direct costs including direct materials and outsourced, or subcontracted, pre-clinical studies are classified as revenue and recognized in the period the reimbursable expenses are incurred. Payments received in advance are recorded as deferred revenue until the research and development services are performed or costs are incurred.

Milestones—Substantive milestone payments are considered to be performance bonuses that are recognized upon achievement of the milestone only if all of the following conditions are met: the milestone payments are non-refundable; achievement of the milestone involves a degree of risk and was not reasonably assured at the inception of the arrangement; substantive effort is involved in achieving the milestone; the amount of the milestone is reasonable in relation to the effort expended or the risk associated with achievement of the milestone; and a reasonable amount of time passes between the up-front license payment and the first milestone payment as well as between each subsequent milestone payment. If any of these conditions are not met, the milestone payments are deferred and recognized as revenue over the term of the arrangement as we complete our performance obligations.

Royalties—The Company recognizes royalty revenues from licensed products upon the sale of the related products.

Research and Development Costs

The Company charges research and development costs to expense as incurred. These costs include salaries and benefits for research and development personnel, costs associated with clinical trials managed by contract research organizations, and other costs associated with research, development and regulatory activities. The Company uses external service providers to conduct clinical trials, to manufacture supplies of product candidates and to provide various other research and development-related products and services. Research and development expenses under the collaborative agreements approximate the revenue recognized, excluding milestone and upfront payments received under such arrangements.

Patent Costs

Patent costs, including legal expenses, are expensed in the period in which they are incurred. Patent expenses are included in general and administrative expenses in the consolidated statements of operations and comprehensive loss.

Stock-Based Compensation

The Company accounts for stock-based compensation under the provisions of ASC 718, *Compensation-Stock Compensation*. Under the fair value recognition provisions, stock-based compensation expense is measured at the

grant date for all stock-based awards to employees and directors and is recognized as expense over the requisite service period, which is generally the vesting period. Non-employee stock-based compensation charges are amortized over the vesting period on a straight-line basis. For stock options granted, the fair value of the stock options is estimated using a Black-Scholes-Merton option pricing model. See Note 8 for further information regarding stock-based compensation expense and the assumptions used in estimating that expense.

NOVABAY PHARMACEUTICALS, INC.

(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Income Taxes

The Company accounts for income taxes under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is recognized if it is more likely than not that some portion or the entire deferred tax asset will not be recognized.

Common Stock Warrant Liabilities

For warrants where there is a deemed possibility that the Company may have to settle the warrants in cash, the Company records the fair value of the issued warrants as a liability at each balance sheet date and records changes in the estimated fair value as a non-cash gain or loss in the consolidated statement of operations and comprehensive loss. The fair values of these warrants have been determined using the Binomial Lattice (“Lattice”) valuation model. The Lattice model provides for assumptions regarding volatility, call and put features and risk-free interest rates within the total period to maturity. These values are subject to a significant degree of judgment on the part of the Company.

Net Income (Loss) per Share

The Company computes net income (loss) per share by presenting both basic and diluted earnings (loss) per share (EPS).

Basic EPS is computed by dividing net income (loss) available to common shareholders by the weighted average number of common shares outstanding during the period. Diluted EPS gives effect to all dilutive potential common shares outstanding during the period including stock options and warrants, using the treasury stock method, using the if-converted method. In computing diluted EPS, the average stock price for the period is used in determining the number of shares assumed to be purchased from the exercise of stock options or warrants. Potentially dilutive common share equivalents are excluded from the diluted EPS computation in net loss periods since their effect would be anti-dilutive. During the three and nine months ended September 30, 2013, and the nine months ended September 30, 2012, there is no difference between basic and diluted net loss per share due to the Company's net losses. The following table sets forth the calculation of basic EPS and diluted EPS:

	Three Months Ended		**Nine Months Ended**	
	September 30,		**September 30,**	
(in thousands, except per share amounts)	**2013**	**2012**	**2013**	**2012**
Net loss	$(3,848)	$80	$(11,905)	$(4,677)
Basic shares	37,467	28,861	37,166	28,702
Add: shares issued upon assumed exercise of stock options and warrants	—	423	—	—
Diluted shares	37,467	29,284	37,166	28,702
Basic and diluted net loss per share	$(0.10)	$0.00	$(0.32)	$(0.16)
Diluted net income (loss) per share	$(0.10)	$0.00	$(0.32)	$(0.16)

The following outstanding stock options and stock warrants were excluded from the diluted net loss per share computation as their effect would have been anti-dilutive:

	Nine Months Ended	
	September 30,	
(In thousands)	**2013**	**2012**
Stock options	7,181	6,205
Stock warrants	10,010	5,573
	17,191	11,778

NOVABAY PHARMACEUTICALS, INC.

(a development stage company)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Recent Accounting Pronouncements

There have been no recent accounting pronouncements or changes in accounting pronouncements during the nine months ended September 30, 2013, as compared to the recent accounting pronouncements described in the Company's Form 10-K for the year ended December 31, 2012, that are of significance or potential significance to the Company.

NOTE 3. INVESTMENTS

Short-term investments at September 30, 2013, and December 31, 2012 consisted of the following:

	September 30, 2013			
(in thousands)	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Market Value**
Corporate bonds	$648	$ —	$ (11)	$ 637
Municipal bonds	—	—	—	—
Certificates of deposit	$3,250	$ —	$ (2)	$ 3,248
	$3,898	$ —	$ (13)	$ 3,885

	December 31, 2012			
(in thousands)	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Market Value**

Corporate bonds	$514	$	—	$	(9	)	$505
Municipal bonds	$305		—		(2	)	303
Certificates of deposit	3,329		—		(2	)	3,327
	$4,148	$	—	$	(13	)	$4,135

All short-term investments at September 30, 2013, and December 31, 2012, mature in less than one year. Unrealized holding gains and losses classified as available-for-sale are recorded in accumulated other comprehensive loss.

The Company recognized realized losses of $5,000 and $46,000, for the three months ended September 30, 2013 and 2012, respectively. The Company recognized realized losses of $19,000 and $65,000, for the nine months ended September 30, 2013 and 2012, respectively.

NOTE 4. FAIR VALUE MEASUREMENTS

The Company’s cash equivalents and investments are classified within Level 1 or Level 2 of the fair value hierarchy because they are valued using quoted market prices in active markets, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency. The types of investments that are generally classified within Level 1 of the fair value hierarchy include money market securities. The types of investments that are generally classified within Level 2 of the fair value hierarchy include corporate and municipal securities and certificates of deposits.

The Company’s warrant liabilities are classified within level 3 of the fair value hierarchy because the value is calculated using significant judgment based on our own assumptions in the valuation of these liabilities.

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The following table presents the Company's assets and liabilities measured at fair value on a recurring basis as of September 30, 2013:

	Fair Value Measurements Using			
(in thousands)	**Balance at September 30, 2013**	**Quoted Prices in Active Markets for Identical Items (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Assets				
Short-term investments:				
Corporate bonds	637	—	637	—
Certificates of deposit	3,248	—	3,248	—
Total short-term investments	3,885	—	3,885	—
Total assets	$3,885	$ —	$ 3,885	$ —
Liabilities				
Warrant liability	$2,564	$ —	$ —	$ 2,564
Total liabilities	$2,564	$ —	$ —	$ 2,564

For the three and nine month period ended September 30, 2013, as a result of the fair value adjustment of the warrant liability, the Company recorded a non-cash loss on an increase in the fair value of $866,000 and $1.3 million, respectively, in its consolidated statement of operations and comprehensive loss. See Note 6 for further discussion on the calculation of the fair value of the warrant liability.

(in thousands)

	Warrant liability
Fair value of warrants at December 31, 2012	$ 1,282
Adjustment to fair value at September 30, 2013	1,282
Total warrant liability at September 30, 2013	$ 2,564

NOTE 5. COMMITMENTS AND CONTINGENCIES

Operating Leases

The Company leases laboratory facilities and office space under an operating lease which will expire on October 31, 2020. Rent expense was approximately $251,000 and $145,000 for the three months ended September 30, 2013 and 2012, respectively. Rent expense was approximately $716,000 and $591,000 for the nine months ended September 30, 2013 and 2012, respectively.

The Company's monthly rent payments fluctuate under the master lease agreement. In accordance with U.S. GAAP, the Company recognizes rent expense on a straight-line basis. The Company records deferred rent for the difference between the amounts paid and recorded as expense.

Directors and Officers Indemnity

As permitted under Delaware law and in accordance with its bylaws, the Company shall indemnify its officers and directors for certain events or occurrences while the officer or director is or was serving at its request in such capacity. The term of the indemnification period is for the officer's or director's lifetime. The maximum amount of potential future indemnification is unlimited; however, the Company has a director or officer insurance policy that limits its exposure and may enable them to recover a portion of any future payments. The Company believes the fair value of these indemnification agreements is minimal. Accordingly, no liability has been recorded for these agreements as of September 30, 2013.

In the normal course of business, the Company provides indemnifications of varying scope under agreements with other companies, typically its clinical research organizations, investigators, clinical sites, suppliers and others. Pursuant to these agreements, the Company generally indemnifies, holds harmless, and agrees to reimburse the indemnified parties for losses suffered or incurred by the indemnified parties in connection with use or testing of its products or product candidates or with any U.S. patent or any copyright or other intellectual property infringement claims by any third party with respect to their products. The term of these indemnification agreements is generally perpetual. The potential future payments the Company could be required to make under these indemnification agreements is unlimited. Historically, costs related to these indemnification provisions have been immaterial. The Company also maintains various liability insurance policies that limit its exposure. As a result, the Company believes

the fair value of these indemnification agreements is minimal. Accordingly, no liabilities have been recorded for these agreements as of September 30, 2013.

NOVABAY PHARMACEUTICALS, INC.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Legal Matters

From time to time, the Company may be involved in various legal proceedings arising in the ordinary course of business. There are no matters at September 30, 2013, that, in the opinion of management, would have a material adverse effect on the Company's financial position, results of operations or cash flows.

NOTE 6. WARRANT LIABILITY

In July 2011, the Company sold common stock and warrants in a registered direct financing. As part of this transaction, 3,488,005 warrants were issued with an exercise price of $1.33 and were exercisable on January 1, 2012, and expire on July 5, 2016. The terms of the warrants require registered shares to be delivered upon each warrant's exercise and also require possible cash payments to the warrant holders (in lieu of the warrant's exercise) upon specified fundamental transactions involving the Company's common stock, such as in an acquisition of the Company. Under ASC 480, "Distinguishing Liabilities from Equity" ("ASC 480"), the Company's ability to deliver registered shares upon an exercise of the warrants and the Company's potential obligation to cash-settle the warrants if specified fundamental transactions occur are deemed to be beyond the Company's control. The warrants contain a provision where the warrant holder would have the option to receive cash, equal to the Black-Scholes fair value of the remaining unexercised portion of the warrant, as cash settlement in the event that there is a fundamental transaction (contractually defined to include various merger, acquisition or stock transfer activities). Due to this provision, ASC 480 requires that these warrants be classified as liabilities. The fair values of these warrants have been determined using the Binomial Lattice ("Lattice") valuation model, and the changes in the fair value are recorded in the consolidated statement of operations and comprehensive loss. The Lattice model provides for assumptions regarding volatility and risk-free interest rates within the total period to maturity. In addition, after January 5, 2012, and if the closing bid price per share of the common stock on the principal market equals or exceeds $2.66 for any ten trading days (which do not need to be consecutive) in a period of fifteen consecutive trading days, the Company has the right to require the exercise of one-third of the warrants then held by the warrant holders, which would result in gross proceeds to the Company of approximately $1.5 million.

The key assumptions used to value the warrants were as follows:

Assumption	September 30, 2013	2012
Expected price volatility	55 %	70 %
Expected term (in years)	2.76	3.76
Risk-free interest rate	0.56%	0.43%
Dividend yield	0.00%	0.00%
Weighted-average fair value of warrants	$0.74	$0.55

NOTE 7. STOCKHOLDERS' EQUITY

On July 5, 2011, the Company closed a registered direct offering for the sale of 4,650,675 units (The "July 2011 Registered Direct Financing"), each unit consisting of (i) one share of common stock and (ii) one warrant to purchase 0.75 of a share of common stock (or a total of 3,488,005 shares), at a purchase price of $1.11 per unit. The warrants will be exercisable 180 days after issuance for $1.33 per share and will expire five years from the date of issuance. All of the shares of common stock and warrants issued in the offering (and the shares of common stock issuable upon exercise of the warrants) were offered pursuant to a shelf registration statement filed with, and declared effective by, the Securities and Exchange Commission. The shares of common stock and the warrants were immediately separable and were issued separately, but were purchased together in the July 2011 Registered Direct Offering. The Company raised a total of $5.2 million from the July 2011 Registered Direct Financing, or approximately $4.6 million in net proceeds after deducting underwriting commissions of $288,000 and other offering costs of $244,000.

On December 6, 2012, the Company closed a public offering for the sale of 5,900,000 units, each unit consisting of (i) one share of common stock and (ii) one warrant to purchase 0.75 of a share of common stock (or a total of 4,425,000 shares), at a purchase price of $1.25 per unit. The warrants were immediately exercisable for $1.50 per share and will expire one year from the date of issuance. All of the shares of common stock and warrants issued in the offering (and the shares of common stock issuable upon exercise of the warrants) were offered pursuant to a shelf registration statement filed with, and declared effective by, the Securities and Exchange Commission. The shares of common stock and the warrants were immediately separable and were issued separately, but were purchased together. The Company raised a total of $7.4 million from this offering, or approximately $6.6 million in net proceeds after deducting underwriting commissions of $479,000 and other offering costs of $240,000.

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Stock Warrants

In July 2011, 3,488,005 warrants were issued in connection with our July 2011 Registered Direct Financing. These warrants were issued with an exercise price of $1.33 and expire on July 5, 2016. These outstanding warrants were fully exercisable at September 30, 2013. During 2012, 22,500 of these warrants were exercised and the Company received $30,000 in cash upon exercise of the warrants.

In January 2012, warrants to purchase 60,000 shares were issued to a vendor. These warrants were issued with an exercise price of $2.50 per share for 30,000 of the shares and $3.75 per share for the remaining 30,000 shares and became exercisable monthly through June 30, 2012, were fully exercisable on June 30, 2012, and expire on January 2, 2016. The warrants were valued at approximately $34,000 using the Black-Scholes-Merton option-pricing model based upon the following assumptions: (1) expected price volatility of 75% and 89%, respectively, (2) a risk-free interest rate of 0.30% and 0.36% respectively and (3) an expected life of 2.36 and 2.98 years, respectively. The Company accounts for the fair value of these warrants as an expense amortized over the vesting period of the warrants. The Company recognized no expense during the three and nine months ended September 30, 2013, related to these warrants. The Company recognized expense of $0 and $34,000 during the three and nine months ended September 30, 2012, respectively, related to these warrants.

In September 2012 and October 2012, warrants to purchase 800,000 and 1,200,000 shares, respectively, were issued to Pioneer Pharma Co., Ltd as part of a unit purchase agreement that was accounted for along with an expanded distribution agreement. These warrants were issued with an exercise price of $1.50 per share, are immediately exercisable, and expire on August 31, 2013. The warrants were valued at approximately $360,000 and $330,000, respectively, using the Black-Scholes-Merton option-pricing model based upon the following assumptions: (1) expected price volatility of 79% and 71%, respectively, (2) a risk-free interest rate of 0.17% and 0.17%, respectively and (3) an expected life of 0.96 and 0.83 years, respectively. Due to the combined accounting of this agreement along with the expanded distribution agreement, the Company accounted for the fair value of the common stock and warrants as equity. In May 2013 the terms of these warrants were modified to extend the expiration date to November 29, 2013 and in exchange for this extension Pioneer has agreed to exercise the warrant. As a result of this change NovaBay booked an additional expense related to these warrants of $163,000 during the nine months ended September 30, 2013.

In October 2012, warrants to purchase 15,000 shares were issued to a vendor. These warrants were issued with an exercise price of $2.50 per share and 5,000 shares became exercisable on each of October 30, 2012, November 30, 2012, and December 30, 2012, and they all expire on September 30, 2014. The warrants were valued at approximately $4,000 using the Black-Scholes-Merton option-pricing model based upon the following assumptions: (1) expected price volatility of 72%, (2) a risk-free interest rate of 0.27% and (3) an expected life of 2.00 years. The Company accounts for the fair value of these warrants as an expense amortized over the vesting period of the warrants. The Company recognized $0 in expense during the three and nine months ended September 30, 2013, and 2012, related to these warrants.

On December 6, 2012, 4,425,000 warrants were issued in connection with our July public offering. These warrants were issued with an exercise price of $1.50 and expire on December 6, 2013. These outstanding warrants were exercisable at September 30, 2013. During the three and nine months ended September 30, 2013, 1,189,500 of these warrants were exercised and the Company received $1.8 million in cash upon exercise of the warrants.

In January 2013, warrants to purchase 20,000 shares were issued to a vendor. These warrants became exercisable immediately and were issued with an exercise price of $1.50 per share for 10,000 of the shares, which expired on August 31, 2013 and $1.75 per share for the remaining 10,000 shares which expire on December 31, 2013. The warrants were valued at approximately $3,000 using the Black-Scholes-Merton option-pricing model based upon the following assumptions: (1) expected price volatility of 69.82% and 69.40%, respectively, (2) a risk-free interest rate of 0.11% and 0.14%, respectively and (3) an expected life of 0.64 and 0.97 years, respectively. The Company accounts for the fair value of these warrants as an expense amortized over the vesting period of the warrants. The Company recognized no expense during the three months ended September 30, 2013, and 2012, related to these warrants. The Company recognized $3,000 and $0 in expense during the nine months ended September 30, 2013, and 2012, respectively, related to these warrants.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The details of all outstanding warrants as of September 30, 2013, are as follows:

(in thousands, except per share data)	Warrants	Weighted-Average Exercise Price
Outstanding at December 31, 2012	11,190	$ 1.59
Warrants issued	20	$ 1.63
Warrants exercised	(1,190)	$ 1.50
Warrants expired	(10)	$ 1.50
Outstanding at September 30, 2013	10,010	$ 1.61

NOTE 8. EQUITY-BASED COMPENSATION

Equity Compensation Plans

Prior to our Initial Public Offering (IPO), the Company had two equity plans in place: the 2002 Stock Option Plan and the 2005 Stock Option Plan. Upon the closing of the IPO in October 2007, the Company adopted the 2007 Omnibus Incentive Plan (the "2007 Plan") to provide for the granting of stock awards, such as stock options, unrestricted and restricted common stock, stock units, dividend equivalent rights, and stock appreciation rights to employees, directors and outside consultants as determined by the board of directors. In conjunction with the adoption of the 2007 Plan, no further option awards may be granted from the 2002 or 2005 Stock Option Plans and any option cancellations or expirations from the 2002 or 2005 Stock Option Plans may not be reissued. As of September 30, 2013, there were 106,024 shares available for future grant under the 2007 Plan.

Under the terms of the 2007 Plan, the exercise price of incentive stock options may not be less than 100% of the fair market value of the common stock on the date of grant and, if granted to an owner of more than 10% of the Company's stock, then not less than 110%. Stock options granted under the 2007 Plan expire no later than ten years from the date of grant. Stock options granted to employees generally vest over four years while options granted to directors and consultants typically vest over a shorter period, subject to continued service. All of the options granted prior to

October 2007 include early exercise provisions that allow for full exercise of the option prior to the option vesting, subject to certain repurchase provisions. The Company issues new shares to satisfy option exercises under the plans.

Stock Option Summary

The following table summarizes information about the Company's stock options outstanding at September 30, 2013, and activity during the nine-month period then ended:

(in thousands, except years and per share data)	Options	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life (years)	Aggregate Intrinsic Value
Outstanding at December 31, 2012	6,222	$ 1.62		
Options granted	1,635	$ 1.43		
Restricted stock granted	38	$ —		
Options exercised	(219)	$ 0.37		
Restricted stock unit vested	(216)	$ —		
Options forfeited/cancelled	(279)	$ 1.67		
Outstanding at September 30, 2013	7,181	$ 1.65	6.73	$ 1,954
Vested and expected to vest at September 30, 2013	6,928	$ 1.67	6.66	$ 1,835
Vested at September 30, 2013	4,927	$ 1.79	5.68	$ 1,101
Exercisable at September 30, 2013	4,927	$ 1.79	5.68	$ 1,101

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Stock Options and Awards to Employees and Directors

The Company grants options to purchase common stock to its employees and directors at prices equal to or greater than the market value of the stock on the dates the options are granted. The Company has estimated the value of stock option awards as of the date of grant by applying the Black-Scholes-Merton option pricing model using the single-option valuation approach. The application of this valuation model involves assumptions that are judgmental and subjective in nature. See Note 2 for a description of the accounting policies that the Company applied to value its stock-based awards.

The weighted-average assumptions used in determining the value of options are as follows:

	Nine Months Ended September 30,	
Assumption	**2013**	**2012**
Expected price volatility	80 %	94 %
Expected term (in years)	5.07	4.56
Risk-free interest rate	1.13%	0.71%
Dividend yield	0.00%	0.00%
Weighted-average fair value of options granted during the period	$0.92	$0.91

For the nine months ended September 30, 2013 and 2012, the Company recognized stock-based compensation expense of $705,000 and $1.0 million, respectively, for option awards to employees and directors. For the three months ended September 30, 2013 and 2012, the Company recognized stock-based compensation expense of $194,000 and $330,000, respectively, for option awards to employees and directors. As of September 30, 2013, total unrecognized compensation cost related to unvested stock options was $1.6 million. This amount is expected to be recognized as stock-based compensation expense in the Company's consolidated statements of operations and comprehensive loss over the remaining weighted average vesting period of 2.97 years.

Stock-Based Awards to Non-Employees

During the nine months ended September 30, 2013 and 2012, the Company granted options to purchase an aggregate of 84,500 and 59,500 shares of common stock, respectively, to non-employees in exchange for advisory and consulting services. Additionally, during the nine months ended September 30, 2013 and 2012, the Company issued 38,335 and 83,816 shares of common stock, respectively, to non-employees in exchange for services. The stock options are recorded at their fair value on the measurement date and recognized over the respective service or vesting period. The fair value of the stock options granted was calculated using the Black-Scholes-Merton option pricing model based upon the following assumptions:

	Nine Months Ended September 30,	
Assumption	**2013**	**2012**
Expected price volatility	76 %	89 %
Expected term (in years)	8.65	8.59
Risk-free interest rate	2.02%	1.46%
Dividend yield	0.00%	0.00%
Weighted-average fair value of options granted during the period	$1.14	$1.08

For the nine months ended September 30, 2013 and 2012, the Company recognized stock-based compensation expense of $98,000 and $170,000, respectively, related to non-employee stock and option grants. For the three months ended September 30, 2013 and 2012, the Company recognized stock-based compensation expense of $29,000 and $12,000, respectively, related to non-employee stock and option grants.

Summary of Stock-Based Compensation Expense

Stock-based compensation expense is classified in the consolidated statements of operations and comprehensive loss in the same expense line items as cash compensation. Since the Company continues to operate at a net loss, it does not expect to realize any current tax benefits related to stock options.

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A summary of the stock-based compensation expense included in the consolidated statement of operations and comprehensive loss for the options and stock discussed above is as follows:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
(in thousands)	**2013**	**2012**	**2013**	**2012**
Research and development	$63	$98	$315	$344
General and administrative	160	244	488	847
Total stock-based compensation expense	$223	$342	$803	$1,191

NOTE 9. LICENSE, COLLABORATION AND DISTRIBUTION AGREEMENTS

Galderma

On March 25, 2009, the Company entered into a collaboration and license agreement with Galderma S.A. to develop and commercialize the Company's Aganocide compounds, which covers acne and impetigo and potentially other major dermatological conditions, excluding onychomycosis (nail fungus), orphan drug indications and most post surgical use and use in wound care. The Company amended this agreement in December 2009 and again in December 2010. Based on the Impetigo Phase 2a clinical trial results, in December 2010, NovaBay and Galderma S.A., agreed to expand their partnership to focus on the development of NovaBay's Aganocide compound auriclosene (NVC-422) for the topical treatment of impetigo. This expansion is intended to provide NovaBay with the additional funding and resources required for the clinical development of its auriclosene (NVC-422) topical gel formulation for impetigo and other topical infections.

This agreement is exclusive and worldwide in scope, with the exception of Asian markets and North America, as described in the next paragraph.

Galderma is responsible for the development costs of product candidate compounds, except for costs incurred in Japan. In Japan, Galderma has the option to request that the Company share such development costs. Under the original agreement, the Company was supporting the ongoing development program for impetigo; however under the second amendment, entered into on December 2, 2010, Galderma has exercised its option and increased its support to cover the cost of development for this indication. Upon the achievement of a specified milestone, Galderma will reimburse NovaBay for specified, previously incurred expenses related to the development of the impetigo program. NovaBay retains the right to co-market products resulting from the agreement in Japan. In addition, NovaBay has retained all rights to co-promote the products developed under the agreement in hospitals and other healthcare institutions in North America.

Galderma will pay to NovaBay certain upfront fees, ongoing fees, reimbursements, and milestone payments related to achieving development and commercialization of its Aganocide compounds. If products are commercialized under the agreement, NovaBay's royalties will escalate as sales increase. The Company received a $1.0 million upfront technology access fee payment in the first quarter of 2009, and a $3.25 million continuation fee and a $500,000 fee to expand the license to include the Asia-Pacific Territory in December 2010. These fees were recorded as deferred revenues and recognized as earned on a straight-line basis over the Company's expected performance period. The initial upfront technology access fee was recognized over the initial 20 month funding term of the agreement through October 2010, and the continuation and license fees are being recognized over the additional three year funding term of the agreement through November 2013.

Revenue has been recognized under the Galderma agreement as follows:

	Three Months Ended		**Nine Months Ended**	
	September 30,		**September 30,**	
(in thousands)	**2013**	**2012**	**2013**	**2012**
Amortization of Upfront Technology Access Fee	$315	$314	$944	$945
On-going Research and Development (FTE)	409	2,953	1,228	3,760
Materials, Equipment, and Contract Study Costs	257	167	268	755
Total	$981	$3,434	$2,440	$5,460

The Company had deferred revenue balances of $2,000 and $957,000 at September 30, 2013 and December 31, 2012, respectively, related to the Galderma agreement, which consisted of the unamortized balances on the upfront technology and access fee and the continuation and license fee and support for ongoing research and development. As of September 30, 2013, the Company has earned $4.25 million in milestone payments. As of September 30, 2013, the Company has not earned or received any royalty payments under the Galderma agreement.

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Virbac Agreement

In April 2012, the Company entered into a feasibility and option agreement with Virbac, an animal health company, for the development and potential commercialization of Aganocides for a number of veterinary uses. Under the terms of the agreement, NovaBay received an upfront payment and is entitled to additional support for research and development. The company will conduct veterinary studies using NovaBay's Aganocide compounds to assess the feasibility for treating several veterinary indications.

In April 2013, the option was exercised and the Company entered into a collaboration and license agreement with Virbac, a global animal health company. Under this new agreement Virbac acquired exclusive worldwide rights to develop the Company's proprietary compound, auriclosene (NVC-422), for global veterinary markets. The Company received an option exercise fee and may receive future development and pre-commercial milestone payments as a result of the collaboration. The Company also expects to receive royalties on the sale of any commercial products in the companion animal field. Virbac's option exercise follows its extensive testing of auriclosene (NVC-422) for veterinary uses during the 12-month option period. The Company is recognizing the option exercise fee over its expected performance period of 10 years.

Revenue has been recognized under the agreement as follows:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
(in thousands)	**2013**	**2012**	**2013**	**2012**
Amortization of Upfront Technology Access Fee	$ —	$ 38	$42	$75
On-going Research and Development (FTE)	—	87	87	175
Materials, Equipment, and Contract Study Costs	—	42	—	42
Total	$ —	$ 167	$129	$292

The Company had deferred revenue balances of $246,000 and $125,000 at September 30, 2013, and December 31, 2012, respectively, related to this agreement, which consisted of the unamortized balances on the upfront technology access fee and option fee and the support for ongoing research and development.

NeutroPhase Distribution Agreements

In January 2012, the Company entered into a distribution agreement with Pioneer Pharma Co., Ltd., a Shanghai-based company that markets high-end pharmaceutical products into China, for the commercialization of NeutroPhase in this territory. Under the terms of the agreement, NovaBay received an upfront payment of $312,500. NovaBay also received $312,500 in January 2013, related to the submission of the first marketing approval for the product to the CFDA (formerly the SFDA, State Food and Drug Administration), which was submitted in December 2012. The distribution agreement provides that Pioneer Pharma Co., Ltd is entitled to receive cumulative purchase discounts of up to $500,000 upon the purchase of NeutroPhase product. The deferred revenue will be recognized as the purchase discounts are earned, with the remaining deferred revenue recognized ratable over the product distribution period. In addition, NovaBay is entitled to receive $625,000 upon receipt of an MAA approval of the product from the CFDA.

In September 2012, we entered into two agreements with Pioneer Pharma Co., Ltd. (“Pioneer”): (1) an international distribution agreement (“Distribution Agreement”) and (2) a unit purchase agreement (“Purchase Agreement”). These agreements were combined and accounted for as one arrangement with one unit of accounting for revenue recognition purposes.

Pursuant to the terms of the Distribution Agreement, Pioneer has the right to distribute NeutroPhase, upon MAA Approval from a Regulatory Authority, in certain territories in Asia (other than China). Upon execution of the Distribution Agreement, we received an upfront payment of $250,000 from Pioneer, which was initially recorded as deferred revenue; an additional $350,000 was due to us as of December 2012. This amount was recorded as deferred revenue at December 31, 2012 and was received in early January 2013. Pioneer is also obligated to make certain additional payments to us upon receipt of the MAA Approval. The Distribution Agreement further provides that Pioneer is entitled to a cumulative purchase discount not to exceed $500,000 upon the purchase of NeutroPhase product, payable in NovaBay unregistered restricted common stock.

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Pursuant to the Purchase Agreement, we also received $2.5 million from Pioneer for the purchase of restricted units (comprising 1 share of common stock and a warrant for the purchase of 1 share of common stock). The unit purchase was completed in two tranches: (1) 800,000 units in September 2012; and (2) 1,200,000 units in October 2012, with both tranches at a purchase price of $1.25 per share. The fair value of the total units sold was $3.5 million, based upon the trading price of our common stock on the dates the units were purchased and fair value of the warrants based on the Black-Scholes Merton option pricing model. Because the aggregate fair value of the units on the dates of purchase exceeded the $2.5 million in proceeds received from the unit purchase by approximately $1 million, we reallocated $600,000 from deferred revenue to stockholders' equity as consideration for the purchase of the units.

In addition to the Pioneer Pharma agreements, the Company has entered into three other smaller agreements and continues to seek additional distribution agreements.

Revenue has been recognized under these agreements as follows:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
(in thousands)	2013	2012	2013	2012
Amortization of Upfront Technology Access Fee	$ 10	$ 16	$ 38	$ 42
On-going Research and Development (FTE)	44	—	132	—
Total	$ 54	$ 16	$ 170	$ 42

The Company had deferred revenue balances of $1.0 million and $810,000 at September 30, 2013, and December 31, 2012, respectively, related to these agreements, which consisted of the unamortized balances on the upfront technology access fee and the support for ongoing research and development.

NOTE 10. SEGMENT INFORMATION

Beginning in 2012, the Company is reporting financial data for four reportable segments, coinciding with its four business units: dermatology, ophthalmology, urology and wound care. The dermatology segment includes all aspects of its business around the dermatology arena including the collaboration with Galderma and their impetigo clinical trial. The ophthalmology segment includes its clinical trial on ophthalmology which it is conducting on its own at this time. This segment also includes its i-case product which is currently in development phases. The urology segment covers its UCBE trials. The wound care segment encompasses the business around its NeutroPhase product, which went on the market in December 2012. Its remaining activities are immaterial and are shown as an aggregate.

The Company discloses information about its reportable segments based on the measures it uses in assessing the performance of each segment. The Company uses “segment net income (loss)” to measure the performance of its business units. Segment net income (loss) includes the allocation of certain corporate expense. These expenses have been allocated based on the FTE allocations to each individual segment or business unit.

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The Company does not segregate specific assets to each business unit as we do not have a reasonable way to allocate the corporate assets to each unit and the Company does not use this as a measure of segment performance.

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
(in thousands)	2013	2012	2013	2012
Revenues:				
DermaBay (dermatology)	$981	$3,434	$2,441	$5,456
EyeBay (ophthalmology)	—	—	—	
UroBay (urology)	—	—	—	
MediBay (wound care)	52	15	248	42
Other	66	193	278	336
	$1,099	$3,642	$2,967	$5,834
Segment net income (loss):				
DermaBay (dermatology)	$514	$2,970	$220	$3,762
EyeBay (ophthalmology)	(1,190)	(955)	(3,789)	(2,478)
UroBay (urology)	(622)	(739)	(2,405)	(2,518)
MediBay (wound care)	(1,317)	(799)	(3,594)	(2,380)
Other	(367)	(583)	(1,052)	(1,853)
	$(2,982)	$(106)	$(10,620)	$(5,467)

A reconciliation of total segment net loss to consolidated net loss is as follows:

	Three Months ended		Nine Months ended	
	September 30,		September 30,	
(in thousands)	2013	2012	2013	2012

Segment net loss	$(2,982)	(106)	$(10,620)	(5,467)
Non-cash (gain) loss on change in fair value of warrants of warrants	(866)	209	(1,282)	802
Other income (expense), net	3	(17)	8	5
Provision for income taxes	(3)	(6)	(11)	(18)
Net loss	$(3,848)	$80	$(11,905)	$(4,677)

NOTE 11. SUBSEQUENT EVENTS

We evaluated subsequent events through the issuance date of the consolidated financial statements. We are not aware of any significant events, that occurred subsequent to the balance sheet date but prior to the filing of this Quarterly Report on Form 10-Q that would have a material impact on our consolidated financial statements.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion of our financial condition and results of operations should be read together with our consolidated financial statements and related notes included in Part I, Item 1 of this report, and with our consolidated financial statements and related notes, and Management's Discussion and Analysis of Financial Condition and Results of Operations, included in our Annual Report on Form 10-K for the year ended December 31, 2012, which was filed with the Securities and Exchange Commission on March 14, 2013. This discussion contains forward-looking statements that involve risks and uncertainties. Words such as "expects," "anticipated," "will," "may," "goals," "plans," "believes," "estimates," variations of these words, and similar expressions are intended to identify these forward-looking statements. As a result of many factors, such as those set forth under the section entitled "Risk Factors" in Part II, Item 1A and elsewhere in this report, our actual results may differ materially from those anticipated in these forward-looking statements Readers are cautioned that these forward-looking statements are only predictions based upon assumptions made that we believed to be reasonable at the time, and are subject to risks and uncertainties. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. Except as required by law, we undertake no obligation to revise or update publicly any forward-looking statements.

Overview

NovaBay Pharmaceuticals, Inc. is a clinical-stage biopharmaceutical company focused on addressing the large unmet therapeutic needs of the global, topical anti-infective market with its two distinct categories of products: *Aganocides® and NeutroPhase®*

Aganocide® Compounds

NovaBay's first-in-class Aganocide® compounds, led by auriclosene (NVC-422), are patented, synthetic molecules with a broad spectrum of activity against bacteria, viruses and fungi. Mimicking the mechanism of action that human white blood cells use against infections, Aganocides possess a reduced likelihood that bacteria or viruses will be able to develop resistance, which is critical for advanced anti-infectives. Having demonstrated therapeutic proof-of-concept in three Phase 2 clinical studies, these compounds are well suited to treat and prevent a wide range of local, non-systemic infections. Our Aganocide compounds are currently being developed for three large therapeutic markets:

Dermatology – Partnered with Galderma, a leading dermatology company, we are developing a gel formulation of auriclosene (NVC-422) for treating the highly contagious skin infection, impetigo. On November 6, 2013 we announced that the auriclosene Phase 2b clinical study of impetigo has been completed. While the study showed that auriclosene is safe and well tolerated, it did not meet its primary clinical endpoint. We are working with Galderma to

examine the results from this study and expect to use the findings to guide the future course of the clinical development of auriclosene for impetigo.

Ophthalmology – NovaBay is developing an eye drop formulation of auriclosene (NVC-422) for treating adenoviral conjunctivitis, for which there is currently no FDA-approved treatment. The company expects to complete enrollment in a global Phase 2b clinical study (BAYnovation) for this indication by the end of 2013 and have data available in the first half of 2014. NovaBay also initiated a proof-of-concept study (BACTOvation) for bacterial conjunctivitis in July of 2013 with auriclosene (NVC-422). Results are expected in the first half of 2014.

Urology – Our urinary catheter irrigation solution containing auriclosene (NVC-422) is currently in trials, with the goal of reducing the incidence of urinary catheter blockage and encrustation (UCBE). In 2011 we reported positive data from randomized placebo controlled two week study. More recently in September 2013, we announced positive results from a four week randomized double-blinded, placebo-controlled crossover design and are continuing to interact with the FDA to move the program forward.

NeutroPhase®

Wound Care – NeutroPhase® our FDA 510(k)-cleared product for advanced wound care. With a distinct mechanism of action from Aganocides, we believe that NeutroPhase is the only patented pure hypochlorous acid solution available having the potential to be best suited to treat the six-million-patients in the U.S. who suffer from chronic non-healing wounds, such as pressure, venous stasis and diabetic ulcers.

NovaBay has begun securing commercial partnerships for NeutroPhase. In January 2012, NovaBay announced it had entered into a strategic marketing agreement with Pioneer Pharma Co., Ltd., a Shanghai-based company that markets high-end pharmaceutical products into China, to market NeutroPhase in China. In September 2012, the collaboration with Pioneer Pharma was expanded to include other Asian markets such as Hong Kong, Macau, Taiwan, Singapore, Malaysia, Indonesia, Myanmar, Philippines, Thailand, Vietnam, Brunei, Cambodia and Laos. NovaBay signed a distribution with Shin Poong Pharmaceuticals covering the Korean market during 2013 and expects to announce additional marketing agreements in select geographic markets around the world during 2013 and beyond.

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To date, we have generated very little revenue from product sales, and we have financed our operations and internal growth primarily through the sale of our capital stock, and the fees received from Galderma and Alcon, prior to the termination of our collaboration with Alcon Manufacturing Ltd. (Alcon), an affiliate of Alcon, Inc., in June 2011. As we are a development stage company, we have incurred significant losses since commencement of our operations in July 2002, since we have devoted substantially all of our resources to research and development. As of September 30, 2013, we had an accumulated deficit of $52.2 million. This deficit resulted from research and development expenses as well as general and administrative expenses. We expect to incur net losses over the next several years as we continue our clinical and research and development activities and as we apply for patents and regulatory approvals.

Recent Events

On November 6, 2013 we announced that the auriclosene Phase 2b clinical study of impetigo has been completed. While the study showed that auriclosene is safe and well tolerated, it did not meet its primary clinical endpoint. We are working with Galderma to examine the results from this study and expect to use the findings to guide the future course of the clinical development of auriclosene for impetigo.

In September, we announced positive top-line results from our recently completed Phase 2 clinical study CL1001 for auriclosene (NVC-422) to prevent urinary catheter blockage and encrustation (UCBE) of indwelling urinary catheters. The top-line results show auriclosene was effective at reducing the degree of catheter encrustation and maintaining the catheter patency over the course of the study. Based on these study results, we plan to continue discussions with the FDA and move toward registration.

In June, we announced our support for legislation proposed by U.S. Rep. Jim Matheson (D-UT) to combat the growing crisis of antibiotic resistance. We believe that there must be a multi-pronged, comprehensive approach to combating antimicrobial resistance and Rep. Matheson’s bill is an important contribution. The Strategies to Address Antimicrobial Resistance (STAAR) Act, H.R. 2285, is aimed at improving the understanding and monitoring of the cause and spread of antimicrobial resistant infections and improving the rate at which new antibiotics are developed.

In May 2013, we announced that we had entered into a collaboration and license agreement with Virbac, a global veterinary product company. Virbac exercised its March 2012 Feasibility and Option Agreement, thereby acquiring exclusive worldwide rights to develop our proprietary compound, auriclosene (NVC-422), for global topical veterinary markets. We received an option exercise fee and we are entitled to receive additional future development and pre-commercial milestone payments as a result of the collaboration. We also expect to receive royalties on the sale of any commercial products in the companion animal field. Virbac's option exercise follows its extensive testing of auriclosene (NVC-422) for veterinary uses during the 12-month option period. This agreement with Virbac is an important part of NovaBay's strategy of exploring the uses of auriclosene (NVC-422) for a variety of indications, including veterinary medicine.

In April 2013, Shin Poong Pharmaceutical Co., Ltd. announced that it signed an exclusive distribution agreement for Shin Poong Pharma to commercialize NeutroPhase®, Skin and Wound Cleanser in South Korea for acute and chronic wounds.

In April 2013, we announced the enrollment of the first patients in Brazil into our global Phase 2b clinical trial, BAYnovation. The trial is investigating Auriclosene (NVC-422) Ophthalmic Solution as a treatment for adenoviral conjunctivitis, a highly contagious form of "pink eye" for which there is no approved treatment anywhere in the world.

In March 2013, we announced that Keith R. Bley, Ph.D., has joined NovaBay as Senior Vice President of Product Development, effective March 4, 2013. Dr. Bley has more than 20 years of experience in the pharmaceutical industry, holding management positions with increasing responsibility in research and product development.

In February 2013, we announced that the World Health Organization (WHO) has approved the international nonproprietary name (INN) "auriclosene" for our lead Aganocide® compound auriclosene (NVC-422). INNs facilitate the identification of active pharmaceutical ingredients, and each INN is a globally recognized unique name.

In February 2013, we announced that our partner Galderma S.A., a global leading pharmaceutical company exclusively focused on dermatology, had initiated the South African arm of its Phase 2b clinical study of a proprietary topical formulation of auriclosene (NVC-422) for the treatment of impetigo.

In January 2013 we announced that the first patients had been enrolled in India in our global Phase 2b BAYnovation clinical study, investigating Auriclosene (NVC-422) Ophthalmic Solution as a treatment of adenoviral conjunctivitis, a highly contagious form of “pink eye” for which there is an unmet ocular medical need.

Critical Accounting Policies and Estimates

Our consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States for interim reporting. The preparation of these consolidated financial statements requires us to make estimates, assumptions and judgments that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements as well as the reported revenues and expenses during the reporting periods. In preparing these consolidated financial statements, management has made its best estimates and judgments of certain amounts included in the financial statements giving due consideration to materiality. On an ongoing basis, we evaluate our estimates and judgments related to revenue recognition, research and development costs, patent costs, stock-based compensation, income taxes and other contingencies. We base our estimates on historical experience and on various other factors that we believe are reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Our significant accounting policies are more fully described in Note 2 of the Notes to Consolidated Financial Statements (unaudited), included in Part I, Item 1 of this report, and are also described in Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2012. We have not materially changed these policies from those reported in our Annual Report on Form 10-K for the year ended December 31, 2012.

Recent Accounting Pronouncements

See Note 2 to the accompanying unaudited consolidated financial statements included in Part I, Item 1 of this quarterly report on Form 10-Q for information on recent accounting pronouncements.

Results of Operations

Comparison of the Three and Nine Months Ended September 30, 2013, and September 30, 2012

License, Collaboration and Distribution Revenue

Total license, collaboration and distribution revenue was $1.0 million for the three months ended September 30, 2013, compared to $3.6 million for the three months ended September 30, 2012.

Total license, collaboration and distribution revenue was $2.7 million for the nine months ended September 30, 2013, compared to $5.8 million for the nine months ended September 30, 2012.

License, collaboration and distribution revenue over the three and nine months ended September 30, 2013, and 2012, is due to five different agreements entered into by NovaBay. Those agreements comprise:

- a license and collaboration agreement entered into with Galderma in 2009,
- a distribution agreement for NeutroPhase covering China entered into with Pioneer Pharma in Jan 2012,
- a private label distribution agreement entered into with a U.S.-based marketer of healthcare products,
- a distribution agreement for NeutroPhase covering the Unites States and;
- a feasibility and option agreement with Virbac. In April 2013 this option was exercised and NovaBay entered into a Collaboration Agreement with Virbac. At the time of exercise an option fee was paid to NovaBay totaling $250,000.

The decrease in license, collaboration and distribution revenue was related to a large reimbursement of $2.6 million received from Galderma in 2012 and a decrease in overall reimbursable support costs from Galderma for support of the Impetigo trial as the trial progresses. We did not recognize any other significant revenues in the three and nine months ended September 30, 2013 and 2012.

Research and Development

Total research and development expenses remained relatively flat for the three months ended September 30, 2013, compared to the three months ended September 30, 2012. Total research and development expenses increased by 18% to $8.4 million for the nine months ended September 30, 2013, from $7.2 million for the nine months ended September 30, 2012. The changes over the nine month period relate to the increase in clinical activities as we continue to conduct our BAYnovation trial for viral conjunctivitis, begin our BACTOvation trial for bacterial conjunctivitis and completed our urology (UCBE) trial, and scales up our production in anticipation of the phase 3 impetigo trial to be conducted by Galderma. Galderma is expected to reimburse NovaBay for a portion of production expenses in the future. The flat results over the three month period reflect the above mentioned increases offset by the completion of the urology trial during the three months ended September 30, 2013.

We expect to incur research and development expenses throughout 2013 and in subsequent years as we continue to develop product candidates, both independently and in collaboration with our commercial partners. In particular, we expect to incur substantially increased clinical expenses and ongoing manufacturing expenses during the last quarter of 2013 in connection with our dermatology, ophthalmology and urology programs.

General and Administrative

General and administrative expenses increased by 24% to $1.5 million for the three months ended September 30, 2013, from $1.2 million for the three months ended September 30, 2012. Total general and administrative expenses increased by 23% to $5.1 million for the nine months ended September 30, 2013, from $4.1 million for the nine months ended September 30, 2012. This increase is primarily due to expanded business development activities related to NeutroPhase® launch activities as well as planned commercialization in the our dermatology and ophthalmology business units. We also incurred a noncash expense related to the modification in the terms of the warrants with Pioneer Pharma in Asia. This increase is consistent with our expectations as we support our distributors' launch of NeutroPhase and prepare for the announcement of additional clinical data.

Non-Cash Gain (Loss) on Changes in Fair Value of Warrants

The non-cash gain (loss) on changes in fair value of warrants relates to the fair value adjustment to the warrants issued with our July 2011 registered direct offering of common stock and warrants. This balance will fluctuate with market condition and the price of our stock.

Other Income, Net

Other income, net changes were primarily attributable to fluctuation in the returns on our investments.

We expect that other income, net will fluctuate based on our cash balances and the fluctuation in interest rates.

Liquidity and Capital Resources

As of September 30, 2013, we had cash, cash equivalents, and short-term investments of $10.8 million, compared to $16.9 million at December 31, 2012. We have incurred cumulative net losses of $52.2 million since inception through September 30, 2013. We do not expect to generate significant revenue from product candidates for several years. Since inception, we have funded our operations primarily through the sales of our stock and warrants and funds received under our collaboration agreements. We raised $50.0 million through sales of our equity through September 30, 2013. Our last public offering was in December 2012, in which we sold our common stock and warrants with gross proceeds of $7.4 million, or approximately $6.6 million in net proceeds after deducting underwriting commissions of $479,000 and other offering costs of $240,000. Additionally, cash received from our collaboration partners have totaled $64.4 million through September 30, 2013. Under the terms of our collaboration and license agreement with Galderma, Galderma will pay to NovaBay reimbursements, and milestone payments related to achieving development and commercialization of its Aganocide compounds. Failure to achieve the stated milestones may affect Galderma’s payments, however we continue to believe the capital generated through these sources is sufficient to fund our planned operations into 2014. Our capital requirements going forward will depend on numerous factors including:

- the number and characteristics of product development programs we pursue and the pace of each program;
- the scope, rate of progress, results and costs of clinical trials;
- the time, cost and outcome involved in seeking regulatory approvals;
- our ability to establish and maintain strategic collaborations or partnerships for clinical trials, manufacturing and marketing of our product candidates; and
- the cost of establishing clinical and commercial supplies of our product candidates and any products that we may develop.

Cash Used in Operating Activities

For the nine months ended September 30, 2013, cash used in operating activities of $8.3 million was primarily attributable to our research and development and general administrative expenses of operating the company.

Cash Used in Investing Activities

For the nine months ended September 30, 2013, cash provided by investing activities of $184,000 was attributable to the net effect of purchases of short-term investments and sales and maturities.

Cash Provided by Financing Activities

Net cash provided by financing activities of $2.3 million for the nine months ended September 30, 2013, was attributable to proceeds from warrant and stock option exercises and issuances of common stock.

Net Operating Losses and Tax Credit Carryforwards

As of December 31, 2012, we had net operating loss carryforwards for federal and state income tax purposes of $33.8 million and $35.5 million, respectively. If not utilized, the federal and state net operating loss carryforwards will begin expiring at various dates between 2015 and 2032. As of December 31, 2012, we also had tax credit carryforwards for federal income tax purposes of $58,000.

Current federal and California tax laws include substantial restrictions on the utilization of net operating loss carryforwards in the event of an ownership change of a corporation. Accordingly, our ability to utilize net operating loss carryforwards may be limited as a result of such ownership changes. Such a limitation could result in the expiration of carryforwards before they are utilized.

Inflation

We do not believe that inflation has had a material impact on our business and operating results during the periods presented, and we do not expect it to have a material impact in the near future. There can be no assurances, however, that our business will not be affected by inflation.

Off-Balance Sheet Arrangements

We have no off-balance sheet arrangements.

Contractual Obligations

Our commitments at September 30, 2013, consist of an operating lease that was modified slightly to add a small area of additional space during the nine months ended September 30, 2013. The operating lease consists of payments relating to the lease for various laboratory and office space in one office building in Emeryville, California. This lease expires on October 31, 2020, and the total commitment as of September 30, 2013 is $4.7 million due over the lease term, compared to $4.5 million as of December 31, 2012.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our market risk consists principally of interest rate risk on our cash, cash equivalents, and short-term investments. Our exposure to market risk is limited primarily to interest income sensitivity, which is affected by changes in interest rates, particularly because the majority of our investments are in short-term debt securities.

Our investment policy restricts our investments to high-quality investments and limits the amounts invested with any one issuer, industry, or geographic area. The goals of our investment policy are as follows: preservation of capital; assurance of liquidity needs; best available return on invested capital; and minimization of capital taxation. Some of the securities in which we invest may be subject to market risk. This means that a change in prevailing interest rates may cause the principal amount of the investment to fluctuate. For example, if we hold a security that was issued with an interest rate fixed at the then-prevailing rate and the prevailing interest rate later rises, the principal amount of our investment will probably decline. To minimize this risk, in accordance with our investment policy, we maintain our cash and cash equivalents in short-term marketable securities, including money market mutual funds, Treasury bills, Treasury notes, commercial paper, and corporate and municipal bonds. The risk associated with fluctuating interest rates is limited to our investment portfolio. Due to the short term nature of our investment portfolio, we believe we have minimal interest rate risk arising from our investments. As of September 30, 2013, and December 31, 2012, a 10% change in interest rates would have had an immaterial effect on the value of our short-term marketable securities. We do not use derivative financial instruments in our investment portfolio. We do not hold any instruments for trading purposes.

To date, we have operated exclusively in the United States and have not had any material exposure to foreign currency rate fluctuations.

ITEM 4. CONTROLS AND PROCEDURES

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures pursuant to Rule 13a-15 and 15d-15 of the Securities Exchange Act of 1934, as amended (the “Exchange Act”). Based upon that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms and were effective in ensuring that information required to be disclosed by us in the reports that we file or submit under the Exchange Act was accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Assessing the costs and benefits of such controls and procedures necessarily involves the exercise of judgment by management. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, have been detected.

Changes in Internal Control Over Financial Reporting

There was no change in our internal control over financial reporting during the quarter ended September 30, 2013, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1A. RISK FACTORS

Our business is subject to a number of risks, the most important of which are discussed below. You should consider carefully the following risks in addition to the other information contained in this report and our other filings with the SEC, before deciding to buy, sell or hold our common stock. The risks and uncertainties described below are not the only ones facing our company. Additional risks and uncertainties not presently known to us or that we currently believe are not important may also impair our business operations. If any of the following risks actually occur, our business, financial condition or results of operations could be materially adversely affected, the value of our common stock could decline and you may lose all or part of your investment. We have marked with an asterisk (*) those risks described below that reflect substantive changes from the risks described under Part I, Item 1A "Risk Factors" included in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 14, 2013.

Risks Relating to Our Business

Current worldwide economic conditions may limit our access to capital, adversely affect our business and financial condition, as well as further decrease our stock price.

General worldwide economic conditions have been depressed, and although the economic conditions are improving, they are not improving quickly and the economy continues to be weak and fragile. Although the impact of the current status of the economy on our business is uncertain at this time, the weak status of the economy may adversely affect our business and operations in a number of ways, including making it more difficult for us to raise capital as well as making it more difficult to enter into collaboration agreements with other parties. Like many other stocks, our stock price has been subject to fluctuations in recent months. Our stock price could decrease due to concerns that our business, operating results and financial condition will be negatively impacted by the continued weakness in the worldwide economy.

We may be unable to raise additional capital on acceptable terms in the future which may in turn limit our ability to develop and commercialize products and technologies.*

We expect our capital outlays and operating expenditures to increase substantially in the fourth quarter of 2013, and over at least the next several years, as we expand our clinical and regulatory activities. Conducting clinical trials is very expensive, and we expect that we will need to raise additional capital, through future private or public equity offerings, strategic alliances or debt financing, before we achieve commercialization of any of our Aganocide compounds. In addition, we may require even more significant capital outlays and operating expenditures if we do not continue to partner with third parties to develop and commercialize our products.

Our future capital requirements will depend on many factors, including:

- the extent to which we receive milestone payments or other funding from Galderma, if any;
- the scope, rate of progress and cost of our pre-clinical studies and clinical trials and other research and development activities;
- future clinical trial results;
- the terms and timing of any collaborative, licensing and other arrangements that we may establish;
- the cost and timing of regulatory approvals;
- the cost of establishing clinical and commercial supplies of our product candidates and any products that we may develop;
- the effect of competing technological and market developments;
- the cost of filing, prosecuting, defending and enforcing any patent claims and other intellectual property rights; and

the extent to which we acquire or invest in businesses, products and technologies, although we currently have no commitments or agreements relating to any of these types of transactions.

Additional financing may not be available on favorable terms, or at all. Our ability to obtain additional financing may be negatively affected by the recent volatility in the financial markets, as well as the general downturn in the economy and decreased consumer confidence. Even if we succeed in selling additional securities to raise funds, our existing stockholders' ownership percentage would be diluted and new investors may demand rights, preferences or privileges senior to those of existing stockholders. If we raise additional capital through strategic alliance and licensing arrangements, we may have to trade our rights to our technology, intellectual property or products to others on terms that may not be favorable to us. If we raise additional capital through debt financing, the financing may involve covenants that restrict our business activities.

In addition, it is often the case that the cost of pharmaceutical development can be significantly greater than initially anticipated. This may be due to any of a large number of possible reasons, some of which could have been anticipated, while others may be caused by unpredictable circumstances. A significant increase in our costs would cause the amount of financing that would be required to enable us to achieve our goals to be likewise increased.

If we determine that we need to raise additional funds and we are not successful in doing so, we may be unable to complete the clinical development of some or all of our product candidates or to seek or obtain FDA approval of our product candidates. Such events could force us to discontinue product development, enter into a relationship with a strategic partner earlier than currently intended, reduce sales and marketing efforts or forego attractive business opportunities.

We are an early stage company with a history of losses and expect that we will incur net losses in the future, and that we may never achieve or maintain sustained profitability.*

We have incurred net losses each year since our inception through December 31, 2012, with the exception of 2009. For the years ended December 31, 2012, 2011 and 2010, we had net losses of approximately $7.0 million, $5.1 million and $4.3 million, respectively, and for the year ended December 31, 2009, we had net income of $2.7 million. We were able to record a profit in 2009 due to our receipt of a $3.75 million milestone payment under our agreement with Galderma; however, there is no assurance that we will receive any additional large milestone payments under this agreement and, as a result, may not be able to achieve or maintain profitability in the future. We had a net loss of $11.9 million in the nine months ended September 30, 2013. Through September 30, 2013, we had an accumulated deficit of approximately $52.2 million. We have been, and expect to remain for the foreseeable future, mostly in a research and development stage as we proceed through clinical trials. We have incurred substantial research and development expenses, which were approximately $8.4 million, $9.3 million, $9.9 million and $8.6 million for the nine months ended September 30, 2013, and the years ended December 31, 2012, 2011 and 2010, respectively. We expect to continue to make, for at least the next several years, significant expenditures for the development of products that incorporate our Aganocide compounds, as well as continued research into the biological activities of our Aganocide compounds, which expenditures are accounted for as research and development expenses. We expect to incur substantial losses for the foreseeable future, and we may never achieve or maintain sustained profitability. We anticipate that our expenses related to our clinical trials and regulatory activities will increase substantially in the foreseeable future as we:

- conduct pre-clinical studies and clinical trials for our product candidates in different indications;
- develop, formulate, manufacture and commercialize our product candidates either independently or with partners;
- pursue, acquire or in-license additional compounds, products or technologies, or expand the use of our technology;
- maintain, defend and expand the scope of our intellectual property; and
- hire additional qualified personnel.

We will need to generate significant revenues to achieve and maintain profitability. If we cannot successfully develop, obtain regulatory approval for and commercialize our drug product candidates, either independently or with partners, we will not be able to generate such revenues or achieve or maintain profitability in the future. Our failure to achieve and subsequently maintain profitability could have a material adverse impact on the market price of our common stock.

We have limited data on the use of some of our products in humans and will need to perform costly and time consuming clinical trials to bring our products to market.

Much of the data that we have on our aganocide product candidates is from in-vitro (laboratory) studies, in-vivo animal studies, Phase 1 human safety studies, or some small-scale Phase 2a or other exploratory clinical studies. We will need to conduct additional Phase 2 and Phase 3 human clinical trials to confirm such results in larger patient populations to obtain approval from the FDA of our aganocide drug product candidates. Often, positive in-vitro, in-vivo animal studies, or early human clinical trials are not followed by positive results in later clinical trials, and we may not be able to demonstrate that our aganocide product candidates are safe and effective for indicated uses in humans or that they are active against antibiotic resistant microbes, do not allow pathogens to develop resistance or are active against bacteria in biofilm. In addition, for each indication, we estimate that it will take between three and five years to conduct the necessary clinical trials.

We currently only have one marketable products, and if we are unable to develop and obtain regulatory approval for products that we develop, we may never generate product revenues.

To date, our revenues have been derived mainly from research and development collaboration and license agreements. We have generated limited revenues from sales of NeutroPhase and we cannot guarantee that we will have substantial marketable drugs or other products. Satisfaction of all regulatory requirements applicable to our product candidates typically takes many years, is dependent upon the type, complexity, novelty and classification of the product candidates, and requires the expenditure of substantial resources for research and development and testing. We must demonstrate that our product candidates satisfy rigorous standards of safety and efficacy before we can submit for and gain approval from the FDA and regulatory authorities in other countries. In addition, to compete effectively, our products will need to be easy to use, cost-effective and economical to manufacture on a commercial scale. We may not achieve any of these objectives. We cannot be certain that the clinical development of any of our current product candidates or any other product that we may develop in the future will be successful, that they will receive the regulatory approvals required to commercialize them, or that any of our other in-licensing efforts or pre-clinical testing will yield a product suitable for entry into clinical trials. Our commercial revenues from sales of Aganocide products will be derived from sales of products that may not be commercially available for at least the next several years.

We have one commercialized product, NeutroPhase, and if NeutroPhase does not gain market acceptance, our business will suffer.

A number of factors may affect the market acceptance of NeutroPhase or any other products we develop or acquire, including, among others:

- the price of our products relative to other products for the same or similar treatments;
- the perception by patients, physicians and other members of the health care community of the effectiveness and safety of our products for their indicated applications and treatments;
- our ability to find the right distributor; and
- the effectiveness of the sales and marketing efforts of our distributor.

If our products do not gain market acceptance, we may not be able to support funding of our future operations, including developing, testing and obtaining regulatory approval for new product candidates, which would cause our business to suffer.

We have limited experience in developing drugs and medical devices, and we may be unable to commercialize some of the products we develop.

Development and commercialization of drugs and medical devices involves a lengthy and complex process. We have limited experience in developing products and have only one commercialized product in the market. In addition, no one has ever developed or commercialized a product based on our Aganocide compounds, and we cannot assure you that it is possible to develop, obtain regulatory approval for or commercialize any products based on these compounds or that we will be successful in doing so.

Before we can develop and commercialize any new products, we will need to expend significant resources to:

- undertake and complete clinical trials to demonstrate the efficacy and safety of our product candidates;
- maintain and expand our intellectual property rights;
- obtain marketing and other approvals from the FDA and other regulatory agencies; and
- select collaborative partners with suitable manufacturing and commercial capabilities.

The process of developing new products takes several years. Our product development efforts may fail for many reasons, including:

- the failure of our product candidates to demonstrate safety and efficacy;
- the high cost of clinical trials and our lack of financial and other resources; and
- our inability to partner with firms with sufficient resources to assist us in conducting clinical trials.

Success in early clinical trials often is not replicated in later studies, and few research and development projects result in commercial products. At any point, we may abandon development of a product candidate or we may be required to expend considerable resources repeating clinical trials, which would eliminate or adversely impact the timing for revenues from those product candidates. If a clinical study fails to demonstrate the safety and effectiveness of our product candidates, we may abandon the development of the product or product feature that was the subject of the clinical trial, which could harm our business.

Even if we develop products for commercial use, these products may not be accepted by the medical and pharmaceutical marketplaces or be capable of being offered at prices that will enable us to become profitable. We cannot assure you that our products will be approved by regulatory authorities or ultimately prove to be useful for commercial markets, meet applicable regulatory standards, or be successfully marketed.

***Our current research collaboration with Galderma may fail, resulting in a decrease in funding and inhibition of our ability to continue developing products.**

We have entered into an agreement with Galderma S.A. to develop and commercialize our Aganocide compounds, which covers acne and impetigo and potentially other major dermatological conditions, excluding onychomycosis (nail fungus) and orphan drug indications. With the termination of our collaboration with Alcon, our collaboration with Galderma is our only collaboration, and so unless and until we enter into additional collaborations or are able to market products on our own, we will be dependent on Galderma for all of our revenues.

We cannot assure you that our collaboration with Galderma will be successful, or that we will receive the full amount of research funding, milestone payments or royalties, or that any commercially valuable intellectual property will be created, from this arrangement. If Galderma were to breach or terminate its agreement with us or otherwise fail to conduct its collaborative activities successfully and in a timely manner, the research contemplated by our collaboration with them could be delayed or terminated and our costs of performing studies may increase.

As demonstrated by the results of our Phase 2b impetigo clinical trial, there is no guarantee of success with this program. Disappointing clinical results may endanger our ability to collect milestone payments and may put the future of the collaboration agreement in question.

Our research collaboration with Alcon ended, which resulted in a decrease in funding and may impede our ability to develop our Aganocide compounds for application in connection with the eye, ear and sinus and for use in contact lens solutions unless we are able to enter into a new collaboration with another collaboration partner.

In June 2011, we and Alcon terminated our collaboration and license agreement. Under the terms of the collaboration and license agreement prior to termination, we received semi-annual payments to support on-going research and development activities over the term of the agreement, which payments were reduced beginning in 2011. During 2010 we received $6.0 million in funding payments from Alcon, and in the first five months of 2011 we received $2.1 million in funding payments from Alcon. We received a payment of approximately $3.0 million in connection with the termination, but will not receive any additional payments from Alcon. As a result, our revenues have been significantly less than we have recognized in previous years. Further, as we continue the development of auriclosene

(NVC-422) for application in connection with the eye, ear and sinus and for use in contact lens solutions, we have to fund such development unless we are able to enter into a new collaboration with another collaboration partner, which we may not be able to do. If we are not able to enter into a new collaboration with another collaboration partner and we continue the development of auriclosene (NVC-422) for application in connection with the eye, ear and sinus and for use in contact lens solutions, we will need to rely on our own funds, and any additional funds we may raise. If we are not able to enter into a new collaboration with another collaboration partner or are not able to raise additional funds, we may not be able to develop auriclosene (NVC-422) for these applications.

A key part of our business strategy is to establish collaborative relationships to commercialize and fund development of our product candidates. We may not succeed in establishing and maintaining collaborative relationships, which may significantly limit our ability to develop and commercialize our products successfully, if at all.

A key part of our business strategy is to establish collaborative relationships to commercialize and fund development of our product candidates. We may not be able to negotiate additional collaborations on acceptable terms, if at all, and if we do enter into collaborations, these collaborations may not be successful. Our current and future success depends in part on our ability to enter into successful collaboration arrangements and maintain the collaboration arrangement we currently have with Galderma. The process of establishing and maintaining collaborative relationships is difficult, time-consuming and involves significant uncertainty, including:

- our partners may seek to renegotiate or terminate their relationships with us due to unsatisfactory clinical results, a change in business strategy, a change of control or other reasons;
- our shortage of capital resources may impact a willingness on the part of potential companies to collaborate with us;

- our contracts for collaborative arrangements may be terminable for convenience on written notice and may otherwise expire or terminate, and we may not have alternative funding available;
- our partners may choose to pursue alternative technologies, including those of our competitors;
- we may have disputes with a partner that could lead to litigation or arbitration;
- we do not have day-to-day control over the activities of our partners and have limited control over their decisions;
- our ability to receive milestones and royalties from our partners depends upon the abilities of our partners to establish the safety and efficacy of our drug candidates, obtain regulatory approvals and achieve market acceptance of products developed from our drug candidates;
- we or our partners may fail to properly initiate, maintain or defend our intellectual property rights, where applicable, or a party may utilize our proprietary information in such a way as to invite litigation that could jeopardize or potentially invalidate our proprietary information or expose us to potential liability;
- our partners may not devote sufficient capital or resources towards our product candidates; and
- our partners may not comply with applicable government regulatory requirements.

If we are unable to establish and maintain collaborative relationships on acceptable terms or to successfully transition terminated collaborative agreements, we may have to delay or discontinue further development of one or more of our product candidates, undertake development and commercialization activities at our own expense or find alternative sources of capital. Consequently, if we are unable to enter into, maintain or extend successful collaborations, our business may be harmed.

Our long-term success depends upon the successful development and commercialization of other products from our research and development activities.

Our long-term viability and growth will depend upon the successful development and commercialization of other products from our research and development activities. Product development and commercialization is very expensive and involves a high degree of risk. Only a small number of research and development programs result in the commercialization of a product. Success in early stage clinical trials or preclinical work does not ensure that later stage or larger scale clinical trials will be successful. Even if later stage clinical trials are successful, the risk remains that unexpected concerns may arise from additional data or analysis or that obstacles may arise or issues may be identified in connection with review of clinical data with regulatory authorities or that regulatory authorities may disagree with our view of the data or require additional data or information or additional studies.

Conducting clinical trials is a complex, time-consuming and expensive process. Our ability to complete our clinical trials in a timely fashion depends in large part on a number of key factors including protocol design, regulatory and institutional review board approval, the rate of patient enrollment in clinical trials, and compliance with extensive current good clinical practice requirements. We are in many cases using the services of third-party contract clinical trial providers. If we fail to adequately manage the design, execution and regulatory aspects of our clinical trials, our studies and ultimately our regulatory approvals may be delayed or we may fail to gain approval for our product candidates altogether.

If we do not successfully execute our growth initiatives through the acquisition, partnering and in-licensing of products, technologies or companies, our future performance could be adversely affected.

In addition to our internal development projects, we anticipate growing through external growth opportunities, which include the acquisition, partnering and in-licensing of products, technologies and companies or the entry into strategic alliances and collaborations. If we are unable to complete or manage these external growth opportunities successfully, we may not be able to grow our business in the way that we currently expect. The availability of high quality opportunities is limited and we are not certain that we will be able to identify suitable candidates or complete transactions on terms that are acceptable to us. To pursue such opportunities, we may require significant additional financing, which may not be available to us on favorable terms, if at all. The availability of such financing is limited by the recent tightening of the global credit markets.

We may acquire other businesses or form joint ventures or in-license compounds that could disrupt our business, harm our operating results, dilute your ownership interest in us, or cause us to incur debt or significant expense.

As part of our business strategy, we may pursue acquisitions of complementary businesses and assets, and enter into technology or pharmaceutical compound licensing arrangements. We also may pursue strategic alliances that leverage our core technology and industry experience to enhance our ability to commercialize our product candidates and expand our product offerings or distribution. We have no experience with respect to acquiring other companies and limited experience with respect to the formation of commercial partnering agreements, strategic alliances, joint ventures or in-licensing of compounds. If we make any acquisitions, we may not be able to integrate these acquisitions successfully into our existing business, and we could assume unknown or contingent liabilities. If we in-license any additional compounds, we may fail to develop the product candidates, and spend significant resources before determining whether a compound we have in-licensed will produce revenues. Any future acquisitions or in-licensing by us also could result in significant write-offs or the incurrence of debt and contingent liabilities, any of which could harm our operating results. Integration of an acquired company also may require management resources that otherwise would be available for ongoing development of our existing business. We may not identify or complete these transactions in a timely manner, on a cost-effective basis, or at all, and we may not realize the anticipated benefits of any acquisition, technology license, strategic alliance or joint venture.

To finance any acquisitions, we may choose to issue shares of our common stock as consideration, which would dilute your interest in us. If the price of our common stock is low or volatile, we may not be able to acquire other companies for stock. Alternatively, it may be necessary for us to raise additional funds for acquisitions by incurring indebtedness. Additional funds may not be available on terms that are favorable to us, or at all.

We do not have our own manufacturing capacity, and we plan to rely on partnering arrangements or third-party manufacturers for the manufacture of our potential products.

We do not currently operate manufacturing facilities for clinical or commercial production of our product candidates. We have no experience in drug formulation or manufacturing, and we lack the resources and the capabilities to manufacture any of our product candidates on a clinical or commercial scale. As a result, we have partnered and expect to partner with third parties to manufacture our products or rely on contract manufacturers to supply, store and distribute product supplies for our clinical trials. Any performance failure on the part of our commercial partners or future manufacturers could delay clinical development or regulatory approval of our product candidates or commercialization of our products, producing additional losses and reducing or delaying product revenues.

Our products, if developed and commercialized, will require precise, high quality manufacturing. The failure to achieve and maintain high manufacturing standards, including the incidence of manufacturing errors, could result in patient injury or death, product recalls or withdrawals, delays or failures in product testing or delivery, cost overruns

or other problems that could seriously harm our business. Contract manufacturers and partners often encounter difficulties involving production yields, quality control and quality assurance, as well as shortages of qualified personnel. These manufacturers and partners are subject to ongoing periodic unannounced inspection by the FDA and corresponding state agencies to ensure strict compliance with current Good Manufacturing Practice and other applicable government regulations and corresponding foreign standards; however, we do not have control over third-party compliance with these regulations and standards. If any of our manufacturers or partners fails to maintain compliance, the production of our products could be interrupted, resulting in delays, additional costs and potentially lost revenues.

In addition, if the FDA or other regulatory agencies approve any of our product candidates for commercial sale, we will need to manufacture them in larger quantities. Significant scale-up of manufacturing will require validation studies, which the FDA must review and approve. If we are unable to successfully increase the manufacturing capacity for a product, the regulatory approval or commercial launch of any drugs may be delayed or there may be a shortage in supply and our business may be harmed as a result.

We depend on skilled and experienced personnel to operate our business effectively. If we are unable to recruit, hire and retain these employees, our ability to manage and expand our business will be harmed, which would impair our future revenue and profitability.

Our success largely depends on the skills, experience and efforts of our officers, especially our Chief Executive Officer, Chief Financial Officer, Sr. Vice President for Ophthalmic Drug Development, Sr. Vice President for Advanced Wound Care, Chief Alliance Officer and Vice President of Product Development, Vice President of Medical Affairs, Sr. Vice President of Business and Corporate Development and other key employees. The efforts of each of these persons is critical to us as we continue to develop our technologies and as we attempt to transition into a company with commercial products. Any of our officers and other key employees may terminate their employment at any time. The loss of any of our senior management team members could weaken our management expertise and harm our ability to compete effectively, develop our technologies and implement our business strategies.

Our ability to retain our skilled labor force and our success in attracting and hiring new skilled employees will be a critical factor in determining whether we will be successful in the future. Our research and development programs and collaborations depend on our ability to attract and retain highly skilled scientists and technicians. We may not be able to attract or retain qualified scientists and technicians in the future due to the intense competition for qualified personnel among life science businesses, particularly in the San Francisco Bay Area. We also face competition from universities and public and private research institutions in recruiting and retaining highly qualified scientific personnel. We have also encountered difficulties in recruiting qualified personnel from outside the San Francisco Bay Area, due to the high housing costs in the area.

If we grow and fail to manage our growth effectively, we may be unable to execute our business plan.

Our future growth, if any, may cause a significant strain on our management, and our operational, financial and other resources. Our ability to grow and manage our growth effectively will require us to implement and improve our operational, financial and management information systems and to expand, train, manage and motivate our employees. These demands may require the hiring of additional management personnel and the development of additional expertise by management. Any increase in resources devoted to research and product development without a corresponding increase in our operational, financial and management information systems could have a material adverse effect on our business, financial condition, and results of operations.

If our facilities become inoperable, we will be unable to perform our research and development activities, fulfill the requirements under our collaboration agreement and continue developing products and, as a result, our business will be harmed.

We do not have redundant laboratory facilities. We perform substantially all of our research, development and testing in our laboratory located in Emeryville, California. Emeryville is situated on or near active earthquake fault lines. Our facility and the equipment we use to perform our research, development and testing would be costly to replace and could require substantial lead time to repair or replace. The facility may be harmed or rendered inoperable by natural or man-made disasters, including earthquakes, flooding and power outages, which may render it difficult or impossible for us to perform our research, development and testing for some period of time. The inability to perform our research and development activities may result in the loss of partners or harm our reputation, and we may be unable to regain those partnerships in the future. Our insurance coverage for damage to our property and the disruption of our business may not be sufficient to cover all of our potential losses, including the loss of time as well as the costs of lost opportunities, and may not continue to be available to us on acceptable terms, or at all.

Obtaining regulatory approval in the United States does not ensure we will obtain regulatory approval in other countries.

We will aim to obtain regulatory approval in the U.S. as well as in other countries. To obtain regulatory approval to market our proposed products outside of the U.S., we and any collaborator must comply with numerous and varying regulatory requirements in other countries regarding safety and efficacy. Approval procedures vary among countries and can involve additional product testing and additional administrative review periods. The time required to obtain approval in other countries might differ significantly from that required to obtain FDA approval. The regulatory approval process in other countries includes all of the risk associated with FDA approval as well as additional, presently unanticipated risks. Regulatory approval in one country does not ensure regulatory approval in another, but a failure or delay in obtaining regulatory approval in one country may negatively impact the regulatory process in others. Failure to obtain regulatory approval in other countries or any delay or setback in obtaining such approval could have the same adverse effects associated with regulatory approval in the U.S., including the risk that our product candidates may not be approved for all indications requested and that such approval may be subject to limitations on the indicated uses for which the product may be marketed. In addition, failure to comply with applicable regulatory requirements in other countries can result in, among other things, warning letters, fines, injunctions, civil penalties, recall or seizure of products, total or partial suspension of production, refusal of the government to renew marketing applications and criminal prosecution.

If we are unable to design, conduct and complete clinical trials successfully, we will not be able to obtain regulatory approval for our products.

To obtain FDA approval for our drug product candidates, we must submit to the FDA a New Drug Application, or NDA, demonstrating that the product candidate is safe and effective for its intended use. This demonstration requires significant research and animal tests, which are referred to as preclinical studies, as well as human tests, which are referred to as clinical trials.

Any clinical trials we conduct or that are conducted by our partners may not demonstrate the safety or efficacy of our product candidates. Success in pre-clinical testing and early clinical trials does not ensure that later clinical trials will be successful. Results of later clinical trials may not replicate the results of prior clinical trials and pre-clinical testing. Even if the results of one or more of our clinical trials are positive, we may have to commit substantial time and additional resources to conducting further preclinical studies or clinical trials before we can submit NDAs or obtain FDA approvals for our product candidates, and positive results of a clinical trial may not be replicated in subsequent trials.

Clinical trials are very expensive and difficult to design and implement. The clinical trial process is also time-consuming. Furthermore, if participating patients in clinical studies suffer drug-related adverse reactions during the course of such trials, or if we or the FDA believe that participating patients are being exposed to unacceptable health risks, we will have to suspend or terminate our clinical trials. Failure can occur at any stage of the trials, and we could encounter problems that cause us to abandon clinical trials or to repeat clinical studies. Further, because our product candidates are all in the same class of compounds, failure in one clinical trial may cause us or our partners to have to suspend or terminate other clinical trials. For example, if toxicity issues were to arise in one clinical trial, it could indicate that all of our product candidates have toxicity issues.

In addition, the completion of clinical trials can be delayed by numerous factors, including:

- delays in identifying and agreeing on acceptable terms with prospective clinical trial sites;
- slower than expected rates of patient recruitment and enrollment;
- increases in time required to complete monitoring of patients during or after participation in a trial; and
- unexpected need for additional patient-related data.

Any of these delays, if significant, could impact the timing, approval and commercialization of our product candidates and could significantly increase our overall costs of drug development.

Even if our clinical trials are completed as planned, their results may not support our expectations or intended marketing claims. The clinical trials process may fail to demonstrate that our products are safe and effective for indicated uses. Such failure would cause us to abandon a product candidate for some indications and could delay development of other product candidates.

Government agencies may establish usage guidelines that directly apply to our proposed products or change legislation or regulations to which we are subject.

Government usage guidelines typically address matters such as usage and dose, among other factors. Application of these guidelines could limit the use of products that we may develop. In addition there can be no assurance that government regulations applicable to our proposed products or the interpretation thereof will not change and thereby prevent the marketing of some or all of our products for a period of time or permanently. The FDA's policies may change and additional government regulations may be enacted that could prevent or delay regulatory approval of our product candidates. We cannot predict the likelihood, nature or extent of adverse government regulation that may arise from future legislation or administrative action, either in the U.S. or in other countries.

Our product candidates may be classified as a drug or a medical device, depending on the mechanism of action or indication for use and prior precedent, and a change in the classification may have an adverse impact on our revenues or our ability to obtain necessary regulatory approvals.

Several potential indications for our product candidates may be regulated under the medical device regulations of the FDA administered by the Center for Devices and Radiological Health and the same physical product may be regulated by the FDA's Center for Drug Evaluation and Research for another indication. Alternatively the products could be classified as combination products, in which case both the device and drug centers jointly review the submission. The products may be designated by the FDA as a drug or a medical device depending upon the regulatory definition of a drug and a device, their primary mode of action and the indications for use or product claims.

The use of NeutroPhase as a solution for cleansing and debriding wounds was cleared as a Class I medical device. The determination as to whether a particular indication is considered a drug or a device is also based in part upon precedent. A reclassification by the FDA of an indication from a device to a drug indication during our development for that indication could have a significant adverse impact due to the more rigorous and lengthy approval process required for drugs, as compared to medical devices. Such a change in classification can significantly increase development costs and prolong the time for development and approval, thus delaying revenues. A reclassification of an indication after approval from a drug to a device could result in a change in classification for reimbursement. In many cases, reimbursement for devices is significantly lower than for drugs and there could be a significant negative impact on our revenues.

We and our collaborators are and will be subject to ongoing FDA obligations and continued regulatory review, such as continued safety reporting requirements, and we and our collaborators may also be subject to additional FDA post-marketing obligations or new regulations, all of which may result in significant expense and which may limit our ability to commercialize our medical device and drug products and candidates.

Any regulatory approvals that we receive may also be subject to limitations on the indicated uses for which the product may be marketed or contain requirements for potentially costly post-marketing follow-up studies. The FDA may require us to commit to perform lengthy Phase IV post-approval studies, for which we would have to expend additional resources, which could have an adverse effect on our operating results and financial condition. In addition, if the FDA approves any of our drug product candidates, the labeling, packaging, adverse event reporting, storage, advertising, promotion and record keeping for the drug will be subject to extensive regulatory requirements. The subsequent discovery of previously unknown problems with the drugs, including adverse events of unanticipated severity or frequency, may result in restrictions on the marketing of the drugs or the withdrawal of the drugs from the market. If we are not able to maintain regulatory compliance, we may be subject to fines, suspension or withdrawal of regulatory approvals, product recalls, seizure of products, operating restrictions and criminal prosecution. Any of these events could prevent us from marketing any products we may develop and our business could suffer.

Conducting clinical trials of our product candidates may expose us to expensive liability claims, and we may not be able to maintain liability insurance on reasonable terms or at all.

The risk of clinical trial liability is inherent in the testing of pharmaceutical and medical device products. If we cannot successfully defend ourselves against any clinical trial claims, we may incur substantial liabilities or be required to limit or terminate testing of one or more of our product candidates. Our inability to obtain sufficient clinical trial insurance at an acceptable cost to protect us against potential clinical trial claims could prevent or inhibit the commercialization of our product candidates. Our current clinical trial insurance covers individual and aggregate claims up to $5.0 million. This insurance may not cover all claims and we may not be able to obtain additional insurance coverage at a reasonable cost, if at all, in the future. In addition, if our agreements with any future corporate collaborators entitle us to indemnification against product liability losses and clinical trial liability, such indemnification may not be available or adequate should any claim arise.

If we use biological and hazardous materials in a manner that causes injury, we could be liable for damages. Compliance with environmental regulations can be expensive, and noncompliance with these regulations may result in adverse publicity and potentially significant monetary damages and fines.

Our activities currently require the controlled use of potentially harmful biological materials and other hazardous materials and chemicals and may in the future require the use of radioactive compounds. We cannot eliminate the risk of accidental contamination or injury to employees or third parties from the use, storage, handling or disposal of these materials. In the event of contamination or injury, we could be held liable for any resulting damages, and any liability could exceed our resources or any applicable insurance coverage we may have. Additionally, we are subject, on an ongoing basis, to U.S. federal, state and local laws and regulations governing the use, storage, handling and disposal of these materials and specified waste products. The cost of compliance with these laws and regulations might be significant and could negatively affect our operating results. In addition, if more stringent laws and regulations are adopted in the future, the costs of compliance with these new laws and regulations could be substantial or could impose significant changes in our testing and production process.

The pharmaceutical and biopharmaceutical industries are characterized by patent litigation and any litigation or claim against us may cause us to incur substantial costs, and could place a significant strain on our financial resources, divert the attention of management from our business and harm our reputation.

There has been substantial litigation in the pharmaceutical and biopharmaceutical industries with respect to the manufacture, use and sale of new products that are the subject of conflicting patent rights. For the most part, these lawsuits relate to the validity, enforceability and infringement of patents. Generic companies are encouraged to challenge the patents of pharmaceutical products in the United States because a successful challenger can obtain six months of exclusivity as a generic product under the Hatch-Waxman Act. We expect that we will rely upon patents, trade secrets, know-how, continuing technological innovations and licensing opportunities to develop and maintain our competitive position and we may initiate claims to defend our intellectual property rights as a result. Other parties may have issued patents or be issued patents that may prevent the sale of our products or know-how or require us to license such patents and pay significant fees or royalties to produce our products. In addition, future patents may issue to third parties which our technology may infringe. Because patent applications can take many years to issue, there may be applications now pending of which we are unaware that may later result in issued patents that our products may infringe.

Intellectual property litigation, regardless of outcome, is expensive and time-consuming, could divert management's attention from our business and have a material negative effect on our business, operating results or financial condition. If such a dispute were to be resolved against us, we may be required to pay substantial damages, including treble damages and attorney's fees if we were to be found to have willfully infringed a third party's patent, to the party claiming infringement, develop non-infringing technology, stop selling any products we develop, cease using technology that contains the allegedly infringing intellectual property or enter into royalty or license agreements that may not be available on acceptable or commercially practical terms, if at all. Our failure to develop non-infringing technologies or license the proprietary rights on a timely basis could harm our business. Modification of any products we develop or development of new products thereafter could require us to conduct additional clinical trials and to revise our filings with the FDA and other regulatory bodies, which would be time-consuming and expensive. In addition, parties making infringement claims may be able to obtain an injunction that would prevent us from selling any products we develop, which could harm our business.

We may be subject to damages resulting from claims that we or our employees have wrongfully used or disclosed alleged trade secrets of their former employers.

Some of our employees may have been previously employed at universities or other biotechnology or pharmaceutical companies, including our competitors or potential competitors. Although no claims against us are currently pending, we may be subject to claims that these employees or we have inadvertently or otherwise used or disclosed trade secrets or other proprietary information of their former employers. Litigation may be necessary to defend against these claims. Even if we are successful in defending against these claims, litigation could result in substantial costs and be a distraction to management. If we fail in defending such claims, in addition to paying money damages, we may lose valuable intellectual property rights or personnel. A loss of key research personnel or their work product could hamper

or prevent our ability to commercialize product candidates, which could severely harm our business.

If product liability lawsuits are brought against us, they could result in costly litigation and significant liabilities.

The product candidates we are developing or attempting to develop will, in most cases, undergo extensive clinical testing and will require approval from the applicable regulatory authorities prior to sale. However, despite all reasonable efforts to ensure safety, it is possible that we or our collaborators will sell products which are defective, to which patients react in an unexpected manner, or which are alleged to have side effects. The manufacture and sale of such products may expose us to potential liability, and the industries in which our products are likely to be sold have been subject to significant product liability litigation. Any claims, with or without merit, could result in costly litigation, reduced sales, significant liabilities and diversion of our management's time and attention and could have a material adverse effect on our financial condition, business and results of operations.

If a product liability claim is brought against us, we may be required to pay legal and other expenses to defend the claim and, if the claim is successful, damage awards may not be covered, in whole or in part, by our insurance. We may not have sufficient capital resources to pay a judgment, in which case our creditors could levy against our assets. We may also be obligated to indemnify our collaborators and make payments to other parties with respect to product liability damages and claims. Defending any product liability claims, or indemnifying others against those claims, could require us to expend significant financial and managerial resources.

Failure to obtain sufficient quantities of products and substances necessary for research and development, nonclinical studies, human clinical trials and product commercialization that are of acceptable quality at reasonable prices or at all could constrain our product development and have a material adverse effect on our business.

We have relied and will continue to rely on contract manufacturers for the foreseeable future to produce quantities of products and substances necessary for research and development, nonclinical studies, human clinical studies and product commercialization. It will be important to us that such products and substances can be manufactured at a cost and in quantities necessary to make them commercially viable. At this point in time, we have not attempted to identify, and do not know whether there will be, any third party manufacturers which will be able to meet our needs with respect to timing, quantity and quality for commercial production. In addition, if we are unable to contract for a sufficient supply or required products and substances on acceptable terms, or if we should encounter delays or difficulties in our relationships with manufacturers, our research and development, pre-clinical and clinical testing would be delayed, thereby delaying the submission of product candidates for regulatory approval or the market introduction and subsequent sales of products. Any such delay may have a material adverse effect on our business, financial condition and results of operations.

Because our clinical development activities rely heavily on sensitive and personal information, an area which is highly regulated by privacy laws, we may not be able to generate, maintain or access essential patient samples or data to continue our research and development efforts in the future on reasonable terms and conditions, which may adversely affect our business.

As a result of our clinical development, we will have access to very sensitive data regarding the patients enrolled in our clinical trials. This data will contain information that is personal in nature. The maintenance of this data is subject to certain privacy-related laws, which impose upon us administrative and financial burdens, and litigation risks. For instance, the rules promulgated by the Department of Health and Human Services under the Health Insurance Portability and Accountability Act, or HIPAA, create national standards to protect patients' medical records and other personal information in the U.S. These rules require that healthcare providers and other covered entities obtain written authorizations from patients prior to disclosing protected health care information of the patient to companies like NovaBay. If the patient fails to execute an authorization or the authorization fails to contain all required provisions, then we will not be allowed access to the patient's information and our research efforts can be substantially delayed. Furthermore, use of protected health information that is provided to us pursuant to a valid patient authorization is subject to the limits set forth in the authorization (i.e., for use in research and in submissions to regulatory authorities for product approvals). As such, we are required to implement policies, procedures and reasonable and appropriate security measures to protect individually identifiable health information we receive from covered entities, and to ensure such information is used only as authorized by the patient. Any violations of these rules by us could subject us to civil and criminal penalties and adverse publicity, and could harm our ability to initiate and complete clinical studies required to support regulatory applications for our proposed products. In addition, HIPAA does not replace federal, state, or other laws that may grant individuals even greater privacy protections. We can provide no assurance that future legislation will not prevent us from generating or maintaining personal data or that patients will consent to the use of their personal information, either of which may prevent us from undertaking or publishing essential research. These burdens or risks may prove too great for us to reasonably bear, and may adversely affect our ability to

function profitably in the future.

We may be subject to fines, penalties, injunctions and other sanctions if we are deemed to be promoting the use of our products for non-FDA-approved, or off-label, uses.

Our business and future growth depend on the development, use and ultimate sale of products that are subject to FDA regulation, clearance and approval. Under the U.S. Federal Food, Drug, and Cosmetic Act and other laws, we are prohibited from promoting our products for off-label uses. This means that we may not make claims about the safety or effectiveness of our products and may not proactively discuss or provide information on the use of our products, except as allowed by the FDA.

There is a risk that the FDA or other federal or state law enforcement authorities could determine that the nature and scope of our sales and marketing activities may constitute the promotion of our products for a non-FDA-approved use in violation of applicable law. We also face the risk that the FDA or other regulatory authorities might pursue enforcement based on past activities that we have discontinued or changed, including sales activities, arrangements with institutions and doctors, educational and training programs and other activities.

Government investigations concerning the promotion of off-label uses and related issues are typically expensive, disruptive and burdensome and generate negative publicity. If our promotional activities are found to be in violation of applicable law or if we agree to a settlement in connection with an enforcement action, we would likely face significant fines and penalties and would likely be required to substantially change our sales, promotion, grant and educational activities. In addition, were any enforcement actions against us or our senior officers to arise, we could be excluded from participation in U.S. government healthcare programs such as Medicare and Medicaid.

If we are unable to protect our intellectual property, our competitors could develop and market products similar to ours that may reduce demand for our products.

Our success, competitive position and potential future revenues will depend in significant part on our ability to protect our intellectual property. We rely on the patent, trademark, copyright and trade secret laws of the U.S. and other countries, as well as confidentiality and nondisclosure agreements, to protect our intellectual property rights. We apply for patents covering our technologies as we deem appropriate.

NovaBay aggressively protects and enforces its patent rights worldwide. However, certain risks remain. There is no assurance that patents will issue from any of our applications or, for those patents we have or that do issue, that the claims will be sufficiently broad to protect our proprietary rights, or that it will be economically possible to pursue sufficient numbers of patents to afford significant protection. For example, we do not have any composition of matter patent directed to the NeutroPhase composition. If a potential competitor introduces a similar method of using NeutroPhase with a similar composition that does not fall within the scope of the method of treatment claims, then we or a potential marketing partner would be unable to rely on the allowed claims to protect its market position for the method of using the NeutroPhase composition, and any revenues arising from such protection would be adversely impacted.

In addition, there is no assurance that any patents issued to us or licensed or assigned to us by third parties will not be challenged, invalidated, found unenforceable or circumvented, or that the rights granted there under will provide competitive advantages to us. If we or our collaborators or licensors fail to file, prosecute or maintain certain patents, our competitors could market products that contain features and clinical benefits similar to those of any products we develop, and demand for our products could decline as a result. Further, although we have taken steps to protect our intellectual property and proprietary technology, third parties may be able to design around our patents or, if they do infringe upon our technology, we may not be successful or have sufficient resources in pursuing a claim of infringement against those third parties. Any pursuit of an infringement claim by us may involve substantial expense and diversion of management attention.

We also rely on trade secrets and proprietary know-how that we seek to protect by confidentiality agreements with our employees, consultants and collaborators. If these agreements are not enforceable, or are breached, we may not have adequate remedies for any breach, and our trade secrets and proprietary know-how may become known or be

independently discovered by competitors.

We operate in the State of California. The laws of the State prevent us from imposing a delay before an employee who may have access to trade secrets and proprietary know-how can commence employment with a competing company. Although we may be able to pursue legal action against competitive companies improperly using our proprietary information, we may not be aware of any use of our trade secrets and proprietary know-how until after significant damage has been done to our company.

Furthermore, the laws of foreign countries may not protect our intellectual property rights to the same extent as the laws of the U.S. If our intellectual property does not provide significant protection against foreign or domestic competition, our competitors, including generic manufacturers, could compete more directly with us, which could result in a decrease in our market share. All of these factors may harm our competitive position.

If our competitors develop products similar to NeutroPhase, we may need to modify or alter our business strategy, which may delay the achievement of our goals.

Competitors may develop products with similar characteristics to NeutroPhase. Such similar products marketed by larger competitors can hinder our efforts to penetrate the market. As a result, we may be forced to modify or alter our business and regulatory strategy and sales and marketing plans, as a response to changes in the market, competition and technology limitations, among others. Such modifications may pose additional delays in achieving our goals.

If bacteria develop resistance to Aganocide compounds, our revenues could be significantly reduced.

Based on our understanding of the hypothesis of the mechanism of action of our Aganocide compounds, we do not expect bacteria to be able to develop resistance to Aganocide compounds. However, we cannot assure you that one or more strains of bacteria will not develop resistance to our compounds, either because our hypothesis of the mechanism of action is incorrect or because a strain of bacteria undergoes some unforeseen genetic mutation that permits it to survive. Since we expect lack of resistance to be a major factor in the commercialization of our product candidates, the discovery of such resistance would have a major adverse impact on the acceptability and sales of our products.

If physicians and patients do not accept and use our products, we will not achieve sufficient product revenues and our business will suffer.

Even if the FDA approves product candidates that we develop, physicians and patients may not accept and use them. Acceptance and use of our products may depend on a number of factors including:

- perceptions by members of the healthcare community, including physicians, about the safety and effectiveness of our products;
- published studies demonstrating the cost-effectiveness of our products relative to competing products;
- availability of reimbursement for our products from government or healthcare payers; and
- effectiveness of marketing and distribution efforts by us and our licensees and distributors, if any.

The failure of any of our products to find market acceptance would harm our business and could require us to seek additional financing.

If we are unable to develop our own sales, marketing and distribution capabilities, or if we are not successful in contracting with third parties for these services on favorable terms, or at all, revenues from any products we develop could be disappointing.

We currently have no internal sales, marketing or distribution capabilities. To commercialize any product candidates approved by the FDA, we will either have to develop such capabilities internally or collaborate with third parties who can perform these services for us, such as Pioneer Pharma Co. Ltd. If we decide to commercialize any products we develop such as NeutroPhase, we may not be able to hire the necessary experienced personnel and build sales, marketing and distribution operations which are capable of successfully launching new products and generating sufficient product revenues. In addition, establishing such operations will take time and involve significant expense.

If we decide to enter into co-promotion or other licensing arrangements with third parties, we may be unable to identify acceptable partners because the number of potential partners is limited and because of competition from others for similar alliances with potential partners. Even if we are able to identify one or more acceptable partners, we may not be able to enter into any partnering arrangements on favorable terms, or at all. If we enter into any partnering arrangements, our revenues are likely to be lower than if we marketed and sold our products ourselves.

In addition, any revenues we receive would depend upon our partners' efforts which may not be adequate due to lack of attention or resource commitments, management turnover, and change of strategic focus, further business combinations or other factors outside of our control. Depending upon the terms of our agreements, the remedies we have against an under-performing partner may be limited. If we were to terminate the relationship, it may be difficult or impossible to find a replacement partner on acceptable terms, or at all.

If we cannot compete successfully for market share against other companies, we may not achieve sufficient product revenues and our business will suffer.

The market for our product candidates is characterized by intense competition and rapid technological advances. If our product candidates receive FDA approval and are launched they will compete with a number of existing and future drugs, devices and therapies developed, manufactured and marketed by others. Existing or future competing products may provide greater therapeutic convenience or clinical or other benefits for a specific indication than our products, or may offer comparable performance at a lower cost. If our products are unable to capture and maintain market share, we may not achieve sufficient product revenues and our business will suffer.

We will compete for market share against fully integrated pharmaceutical and medical device companies or other companies that develop products independently or collaborate with larger pharmaceutical companies, academic institutions, government agencies and other public and private research organizations. In addition, many of these competitors, either alone or together with their collaborative partners, have substantially greater capital resources, larger research and development staffs and facilities, and greater financial resources than we do, as well as significantly greater experience in:

- developing drugs and devices;
- conducting preclinical testing and human clinical trials;
- obtaining FDA and other regulatory approvals of product candidates;
- formulating and manufacturing products; and
- launching, marketing, distributing and selling products.

Our competitors may:

- develop and patent processes or products earlier than we will;
- develop and commercialize products that are less expensive or more efficient than any products that we may develop;
- obtain regulatory approvals for competing products more rapidly than we will; and
- improve upon existing technological approaches or develop new or different approaches that render any technology or products we develop obsolete or uncompetitive.

We cannot assure you that our competitors will not succeed in developing technologies and products that are more effective than any developed by us or that would render our technologies and any products we develop obsolete. If we are unable to compete successfully against current or future competitors, we may be unable to obtain market acceptance for any product candidates that we create, which could prevent us from generating revenues or achieving profitability and could cause the market price of our common stock to decline.

Our ability to generate revenues from any products we develop will be diminished if we fail to obtain acceptable prices or an adequate level of reimbursement for our products from healthcare payers.

Our ability to commercialize our product candidates will depend, in part, on the extent to which health insurers, government authorities and other third-party payers will reimburse the costs of products which may be developed by us or our partners. We expect that a portion of our economic return from partnering arrangements with pharmaceutical companies and other collaborators will be derived from royalties, fees or other revenues linked to final sales of products that we or our partners develop. Newly-approved pharmaceuticals and other products which are developed by us or our partners will not necessarily be reimbursed by third-party payers or may not be reimbursed at levels sufficient to generate significant sales. Government and other third-party payers are increasingly attempting to contain health care costs by limiting both coverage and the level of reimbursement for new drugs or medical devices. Cost control initiatives such as these could adversely affect our or our collaborators' ability to commercialize products. In addition, real or anticipated cost control initiatives for final products may reduce the willingness of pharmaceutical companies or other potential partners to collaborate with us on the development of new products.

Significant uncertainty exists as to the reimbursement status of newly-approved healthcare products. Healthcare payers, including Medicare, health maintenance organizations and managed care organizations, are challenging the prices charged for medical products or are seeking pharmacoeconomic data to justify formulary acceptance and reimbursement practices. We currently have not generated pharmacoeconomic data on any of our product candidates. Government and other healthcare payers increasingly are attempting to contain healthcare costs by limiting both coverage and the level of reimbursement for drugs and medical devices, and by refusing, in some cases, to provide coverage for uses of approved products for disease indications for which the FDA has or has not granted labeling approval. Adequate third-party insurance coverage may not be available to patients for any products we discover and develop, alone or with collaborators. If government and other healthcare payers do not provide adequate coverage and reimbursement levels for our products, market acceptance of our product candidates could be limited.

Health care reform measures could limit the prices we or our collaborative partners can obtain for our potential products, or impose additional costs on us.

In March 2010, the U.S. Congress adopted and President Obama signed into law comprehensive health care reform legislation through the passage of the Patient Protection and Affordable Health Care Act. While we anticipate that this legislation may, over time, increase the number of patients who have insurance coverage for pharmaceutical products, it also imposes cost containment measures that may adversely affect the amount of reimbursement for pharmaceutical products. In addition, such legislation contains a number of provisions designed to generate the revenues necessary to fund the coverage expansion, including new fees or taxes on certain health-related industries.

Many of the details of the new law will be included in new and revised regulations, which have not yet been promulgated, and require additional guidance and specificity to be provided by the Department of Health and Human Services, Department of Labor and Department of the Treasury. Accordingly, while it is too early to understand and predict the ultimate impact of the new legislation on our business, the legislation could have a material adverse effect on our business.

Risks Relating to Owning Our Common Stock

The price of our common stock may fluctuate substantially, which may result in losses to our stockholders.

The stock prices of many companies in the pharmaceutical and biotechnology industry have generally experienced wide fluctuations, which are often unrelated to the operating performance of those companies. The market price of our common stock is likely to be volatile and could fluctuate in response to, among other things:

- the results of preclinical or clinical trials relating to our product candidates;
- the announcement of new products by us or our competitors;
- announcement of partnering arrangements by us or our competitors;
- quarterly variations in our or our competitors' results of operations;
- announcements by us related to litigation;
- changes in our earnings estimates, investors' perceptions, recommendations by securities analysts or our failure to achieve analysts' earnings estimates;
- developments in our industry; and
- general, economic and market conditions, including the recent volatility in the financial markets and decrease in consumer confidence and other factors unrelated to our operating performance or the operating performance of our competitors.

The volume of trading of our common stock may be low, leaving our common stock open to risk of high volatility.

The number of shares of our common stock being traded may be very low. Any stockholder wishing to sell his/her stock may cause a significant fluctuation in the price of our stock. In addition, low trading volume of a stock increases the possibility that, despite rules against such activity, the price of the stock may be manipulated by persons acting in their own self-interest. We may not have adequate market makers and market making activity to prevent manipulation.

Our directors, executive officers and principal stockholders have significant voting power and may take actions that may not be in the best interests of our other stockholders.*

As of September 30, 2013, our officers and directors collectively controlled approximately 4,462,057 shares of our outstanding common stock (and approximately 7,401,051 shares of our common stock when including options held by them which were exercisable as of or within 60 days from September 30, 2013). Furthermore, as of September 30, 2013, our largest stockholder is Dr. Ramin Najafi, our Chairman and Chief Executive Officer. Dr. Najafi individually, and through his family trust which he jointly controls with his wife Mrs. Farideh Najafi, owns 4,114,133 shares, or 10.64% of our outstanding common stock (including 576,102 options held by Dr. Najafi which are exercisable as of or within 60 days from September 30, 2013). As a result, Dr. Najafi, can significantly influence the management and affairs of our company and most matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions. This concentration of ownership may have the effect of delaying or preventing a change in control and might adversely affect the market price of our common stock. This concentration of ownership may not be in the best interests of our other stockholders.

Our limited operating history may make it difficult for you to evaluate our business and to assess our future viability.

Our operations to date have been limited to organizing and staffing our company, developing our technology, researching and developing our compounds, and conducting preclinical studies and early-stage clinical trials of our compounds. We have not demonstrated the ability to succeed in achieving clinical endpoints, obtain regulatory approvals, formulate and manufacture products on a commercial scale or conduct sales and marketing activities. Consequently, any predictions you make about our future success or viability are unlikely to be as accurate as they could be if we had a longer operating history.

Our amended and restated certificate of incorporation and bylaws and Delaware law, contain provisions that could discourage a third party from making a takeover offer that is beneficial to our stockholders.

Anti-takeover provisions of our amended and restated certificate of incorporation, amended and restated bylaws and Delaware law may have the effect of deterring or delaying attempts by our stockholders to remove or replace management, engage in proxy contests and effect changes in control. The provisions of our charter documents include:

- a classified board so that only one of the three classes of directors on our Board of Directors is elected each year;
- elimination of cumulative voting in the election of directors;
- procedures for advance notification of stockholder nominations and proposals;
- the ability of our Board of Directors to amend our bylaws without stockholder approval; and
- the ability of our Board of Directors to issue up to 5,000,000 shares of preferred stock without stockholder approval upon the terms and conditions and with the rights, privileges and preferences as our Board of Directors may determine.

In addition, as a Delaware corporation, we are subject to the Delaware General Corporation Law, which includes provisions that may have the effect of deterring hostile takeovers or delaying or preventing changes in control or management of our company. Provisions of the Delaware General Corporation Law could make it more difficult for a third party to acquire a majority of our outstanding voting stock by discouraging a hostile bid, or delaying, preventing or deterring a merger, acquisition or tender offer in which our stockholders could receive a premium for their shares, or effect a proxy contest for control of NovaBay or other changes in our management.

We have not paid dividends in the past and do not expect to pay dividends in the future, and any return on investment may be limited to the value of our stock.

We have never paid cash dividends on our common stock and do not anticipate paying cash dividends on our common stock in the foreseeable future. The payment of dividends on our common stock will depend on our earnings, financial condition and other business and economic factors affecting us at such time as our Board of Directors may consider relevant. If we do not pay dividends, you will experience a return on your investment in our shares only if our stock price appreciates. We cannot assure you that you will receive a return on your investment when you do sell your shares or that you will not lose the entire amount of your investment.

ITEM 5. OTHER INFORMATION

On November 13, 2013, we entered into an At-The-Market Offering Agreement, or sales agreement, with Ascendiant Capital Markets, LLC, or Ascendiant, under which we may offer and sell our common stock having aggregate sales proceeds of up to $5,000,000 from time to time through Ascendiant as our sales agent. Sales of our common stock through Ascendiant, if any, will be made by means of ordinary brokers' transactions on the NYSE Mkt or otherwise at market prices prevailing at the time of sale, in block transactions, or as otherwise agreed upon by us and Ascendiant. Ascendiant will use commercially reasonable efforts to sell our common stock from time to time, based upon instructions from us (including any price, time or size limits or other customary parameters or conditions we may impose). We will pay Ascendiant a commission of 3.0% of the gross sales proceeds of any common stock sold through Ascendiant under the sales agreement. We have also provided Ascendiant with customary indemnification rights.

We are not obligated to make any sales of common stock under the sales agreement. The offering of shares of our common stock pursuant to the sales agreement will terminate upon the earlier of (i) the sale of all common stock subject to the sales agreement, or (ii) termination of the sales agreement in accordance with its terms.

The foregoing description of the sales agreement is not complete and is qualified in its entirety by reference to the full text of the sales agreement, a copy of which is filed herewith as Exhibit 1.1 to this Quarterly Report on Form 10-Q. The opinion of Cooley LLP regarding the shares to be sold under the sales agreement is filed herewith as Exhibit 5.1 to this Quarterly Report on Form 10-Q.

On November 6, 2013, we announced the completion of our auriclosene Phase 2b clinical study of impetigo. While the study showed that auriclosene is safe and well tolerated, it did not meet its primary clinical endpoint. With our partner, Galderma, we are examining the results of the study to help us determine the developmental path for auriclosene.

ITEM 6. EXHIBITS

See the Exhibit Index which follows the signature page of this Quarterly Report on Form 10-Q, which is incorporated here by reference.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: November 13, 2013 NOVABAY PHARMACEUTICALS, INC.

/s/ Ramin Najafi
Ramin (“Ron”) Najafi
Chairman and Chief Executive Officer

(duly authorized officer)

Date: November 13, 2013 /s/ Thomas J. Paulson
Thomas J. Paulson
Chief Financial Officer

(principal financial officer)

EXHIBIT INDEX

Exhibit No.	Description
1.1	At-The-Market Offering Agreement, dated November 13, 2013, between NovaBay Pharmaceuticals, Inc. and Ascendiant Capital Markets, LLC
3.1	Certificate of Incorporation of NovaBay Pharmaceuticals, Inc., a Delaware corporation (Incorporated by reference to the exhibit of the same number from the Company's current report on Form 8-K, as filed with the SEC on June 29, 2010 (SEC File No. 001-33678))
3.2	Amended and Restated Bylaws of registrant (Incorporated by reference to the exhibit of the same number from the Company's current report on Form 8-K as filed with the SEC on June 29, 2010 (SEC File No. 001-33678).)
4.1	Form of Warrant issued in the August 2009 offering. (Incorporated by reference to Exhibit 4.3 to the Company's current report on Form 8-K, as filed with the SEC on August 21, 2009 (SEC File No. 001-33678).)
4.2	Form of Warrant issued in the July 2011 offering. (Incorporated by reference to Exhibit 4.1 to the Company's current report on Form 8-K, as filed with the SEC on June 29, 2011 (SEC File No. 001-33678).)
4.3	Form of Form of Common Stock Purchase Warrant issued in December 2012 (Incorporated by reference to Exhibit 4.1 to the Company's Current Report on Form 8-K as filed with the SEC on December 6, 2012 (SEC File No. 001-33678)).
5.1	Opinion of Cooley LLP
23.1	Consent of Cooley LLP (included in Exhibit 5.1)
31.1	Certification of the principal executive officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of the principal financial officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of the chief executive officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of the chief financial officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS*	XBRL Instance Document
101.SCH*	XBRL Taxonomy Extension Schema Document
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase Document

101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB*	XBRL Taxonomy Extension Label Linkbase Document
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase Document

* XBRL information is furnished and not filed for purposes of Sections 11 and 12 of the Securities Act of 1933 and Section 18 of the Securities Exchange Act of 1934, is not part of any registration statement or prospectus to which it relates and is not incorporated or deemed to be incorporated by reference into any registration statement, prospectus or other document.

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IRSA Inversiones y Representaciones Sociedad Anónima

Notes to the Consolidated Financial Statements (continued)

(In thousands of Argentine Pesos, except share data as otherwise indicated)

21. Differences between Argentine GAAP and US GAAP (continued)

(k) Differences in basis relating to purchase accounting

Under Argentine GAAP and US GAAP, the Company applies the purchase method of accounting to its business acquisitions. Accordingly, the fair market value of assets and liabilities acquired is estimated and the excess of the purchase price over the fair value, if any, is considered goodwill. In the event the fair value of the net assets acquired exceeds the consideration paid, the excess is amortized on a straight-line basis over the weighted-average remaining useful lives of the assets acquired. Under Argentine GAAP, such excess is classified as negative goodwill in the consolidated balance sheet. Under US GAAP, such excess would have been allocated to reduce the carrying value of the assets acquired.

The US GAAP adjustment reflects the application of certain US GAAP adjustments when estimating the fair value of such assets and liabilities, and is comprised of adjustments to goodwill and negative goodwill balances recorded under Argentine GAAP.

The differences in the carrying amount of negative goodwill give rise to differences in depreciation expense. The differences in the carrying amount of goodwill between Argentine GAAP and US GAAP gave rise to differences in amortization expense until June 30, 2002. As described in Note 21.II.(j), the Company adopted SFAS No. 142 effective at the beginning of fiscal year 2003. As required by this standard, under US GAAP the Company discontinued amortization of goodwill as from July 1, 2002. As a result, the 2003 US GAAP income adjustment primarily includes the reversion of the amortization charge recorded under Argentine GAAP.

(l) Present-value accounting

As indicated in Note 4.k, under Argentine GAAP, certain other receivables and liabilities have been measured based on the best estimate of the amount receivable and payable, respectively, discounted at the interest rate applicable to freely available saving accounts published by the Argentine Central Bank in effect at the time of incorporation to the balance sheet. Additionally, as mentioned in Note 5 i. (iv), the Company has recorded a gain on early redemption of debt totaling Ps. 10.7 million. Under US GAAP, present valuing or discounting of these assets and liabilities is precluded.

(m) Restoration of previously recognized impairment losses

As discussed in Notes 4.(ii).c), and 4.e, as a result of an increase in fair market values and as required by Argentine GAAP, during fiscal year 2003 the Company partially reversed certain impairment charges that the Company had recognized during fiscal year 2002. Under US GAAP, restoration of a previously recognized impairment loss is prohibited. When an impairment loss is recognized, the adjusted carrying amount of the asset becomes the new cost basis, which is amortized over the remaining useful life of the asset.

(n) Accounting for convertible notes

As discussed in Note 11, in November 2002 the Company issued US$ 100 million of IRSA Convertible Notes with non-detachable warrants to acquire additional shares of common stock. In accordance with the agreement, IRSA Convertible Notes are convertible at any time, at the option of the holder, into a fixed number of common shares. Once converted, the holder has the right to acquire an additional equal number of shares at the exercise price of the warrant. For Argentine GAAP purposes, no proceeds were allocated to the conversion feature and warrants.

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IRSA Inversiones y Representaciones Sociedad Anónima

Notes to the Consolidated Financial Statements (continued)

(In thousands of Argentine Pesos, except share data as otherwise indicated)

21. Differences between Argentine GAAP and US GAAP (continued)

(n) Accounting for convertible notes (continued)

Under US GAAP, the Company applied EITF No. 00-27, Application of Issue No. 98-5 to Certain Convertible Instruments (EITF No. 00-27), which address how a beneficial conversion amount should be measured when an entity issues a convertible instrument that, if converted, will result in the holder receiving common stock and other equity instruments of the issuer, such as warrants to acquire common stock of the issuer. In EITF No. 00-27, the Task Force reached a tentative conclusion that the intrinsic value of the conversion option should be computed based on a comparison of (a) the proceeds of the convertible instrument allocated to the common stock portion of the conversion option and (b) the fair value at the commitment date of the common stock to be received by the holder upon conversion. The excess of (b) over (a) is the intrinsic value of the embedded conversion option that should be recognized by the issuer at the issuance date for the convertible instrument. In EITF No. 00-27 the Task Force also reached a consensus that the Issue 98-5 model should be modified for convertible instruments that have a stated redemption date to require a discount resulting from recording a beneficial conversion option to be accreted from the date of issuance to the stated redemption date of the convertible instrument, regardless of when the earliest conversion date occurs. EITF 00-27 also states that all of the unamortized discount, if any, remaining at the date of conversion should be immediately recognized as interest expense. As a result of applying EITF 00-27, under US GAAP the Company allocated Ps. 36,191 of the proceeds received, representing the intrinsic value of the embedded beneficial conversion feature at the commitment date, to additional paid-in capital (Ps. 23,524 net of income tax). The resulting debt discount is being recognized as expense over the term of the Convertible Notes. Upon conversion, warrants amounting to Ps. 61,268 would be recognized as additional paid-in capital and any unamortized discount would be immediately recognized as interest expense.

(o) Reversal of gain recognized on trouble debt restructuring

As explained in Note 5.i., in November 2002 the Company completed the refinancing of the Loan Agreement and the IRSA Notes. Under Argentine GAAP, the restructuring of these debts was treated as an exchange of debt instruments with substantially different terms. As a result, the Company removed the original loans from the consolidated balance sheet and recognized the new debt instruments at their present value discounted at an 8% market interest rate. Gain on restructuring recorded in fiscal year 2003 amounted to Ps. 36.5 million (Ps. 31.7 million net of related expensed).

For US GAAP purposes, the restructuring of the debt was accounted for in accordance with SFAS No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings (SFAS 15), as the creditors made certain concessions due to the financial difficulties of the Company. SFAS No. 15 requires that a comparison be made between the future cash outflows associated with the new debt instruments (including interest), and the recorded amount of the payables at the time of restructuring. Gain on trouble debt restructuring is only recognized when the carrying amount of the payable at the time of restructuring exceeds the total future cash payments specified by the new debt terms. Since the total future cash outflows associated with the new debt instruments exceeded the carrying value of the old debts, no gain on restructuring was recorded under US GAAP. As a result, a new effective interest rate was determined, which equates the present value of the future cash payments specified by the new debt instruments with the carrying amount of the old debts.

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IRSA Inversiones y Representaciones Sociedad Anónima

Notes to the Consolidated Financial Statements (continued)

(In thousands of Argentine Pesos, except share data as otherwise indicated)

21. Differences between Argentine GAAP and US GAAP (continued)

(p) Appraisal revaluation of fixed assets

Under Argentine GAAP, APSA recognized a parcel of land acquired prior to June 30, 1986 at its appraised value as of such date. This appraisal increased the carrying value of the land by approximately Ps. 4.0 million, which was recorded against an appraisal revaluation reserve account in the shareholders equity. Under Argentine GAAP, this appraisal revaluation reserve will be amortized to income once the land is disposed of or its value becomes impaired. Under US GAAP, this parcel of land was recorded at original cost and therefore, this reserve has been reversed.

(q) Deferred charges

Under Argentine GAAP, APSA has capitalized certain costs, which are being amortized on a straight-line method over 3 years. Under US GAAP, such costs were expensed as incurred.

(r) Amortization of fees related to the APSA Senior Notes

Under Argentine GAAP, fees and expenses relating to the APSA Senior Notes are being amortized on a straight-line method over the term of the agreement. Under US GAAP, such costs are being amortized over the same period using the effective interest method of amortization. As discussed in Note 10(i), APSA redeemed a portion of its Senior Notes during fiscal years 2003. Under both Argentine GAAP and US GAAP, the Company expensed the unamortized portion of fees and expenses related to the redeemed obligations.

(s) Software developed or obtained for internal use

Under Argentine GAAP, the Company capitalizes certain costs incurred in the development of software for internal use. Under US GAAP, the Company applies Statement of Position 98-1 Accounting for the Costs of Computer Software Developed or Obtained for Internal Use , which requires certain costs be expensed as incurred. During the year ended June 30, 2003 the Company reversed amortization expense charges recognized under Argentine GAAP of Ps. 0.1 million, related to costs that were capitalized under Argentine GAAP in prior years.

(t) Accounting for changes in interest in consolidated affiliated companies

During fiscal year 2003 APSA acquired an additional 24% ownership interest in Alto Invest for a total consideration of Ps. 0.2 million. Under both Argentine GAAP and US GAAP, the excess of the fair value of the net assets acquired over the consideration paid, after reducing to zero the amounts that otherwise would have been assigned to the non-current assets, was recognized in earnings. The difference respect the amount recognized under Argentine GAAP, totaling Ps. 20, relates to the effect of US GAAP adjustments at the date of acquisition. See Note 17.II.(b),

for the income statement classification difference of this gain.

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IRSA Inversiones y Representaciones Sociedad Anónima

Notes to the Consolidated Financial Statements (continued)

(In thousands of Argentine Pesos, except share data as otherwise indicated)

21. Differences between Argentine GAAP and US GAAP (continued)

(u) Deferred income tax

As discussed in Note 3.d, the Company adopted new accounting standards effective July 1, 2002. Pursuant to this adoption, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets are also recognized for tax loss carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recorded or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is recognized for that component of net deferred tax assets which is not recoverable. This standard is similar to the principles of US GAAP set forth in Statement of Financial Accounting Standards (SFAS) No. 109, Accounting for Income Taxes .

However, under Argentine GAAP, the Company has treated the differences between the price-level restated amounts of assets and liabilities and their historical basis as permanent differences for deferred income tax calculation purposes in accordance with Resolution MD No.11/2003 issued by the CPCECABA. Under US GAAP, the Company applies EITF 93-9, Application of FASB Statement No.109 in Foreign Financial Statements Restated for General Price-Level Changes , which requires such differences to be treated as temporary differences in calculating deferred income taxes. In addition, the adjustment includes the effect on deferred income taxes of the foregoing reconciling items, as appropriate.

(v) Minority interest

This adjustment represents the effect on minority interest of the foregoing reconciling items.

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IRSA Inversiones y Representaciones Sociedad Anónima

Notes to the Consolidated Financial Statements (continued)

(In thousands of Argentine Pesos, except share data as otherwise indicated)

21. Differences between Argentine GAAP and US GAAP (continued)

II. Additional disclosure requirements

(a) Balance sheet classification differences

Under Argentine GAAP, assets and liabilities are classified as current or non-current depending on their respective settlement dates. Under US GAAP, balance sheets of real estate entities typically are unclassified.

As discussed in Note 21.II.(o), under Argentine GAAP, the Company s investments in LLR and ITNV were not consolidated for any of the periods presented. For US GAAP purposes, the Company possesses controlling financial interests in these companies. Accordingly, consolidation is appropriate under US GAAP.

In addition, under Argentine GAAP the Company has recognized the net deferred tax asset amounting to Ps. 64.5 million and 2.7 million at June 30, 2003 and 2002, respectively, as a non-current other receivable and a non-current liabilities. Under US GAAP, the classification of deferred taxes is determined by the classification of the asset or liability for financial reporting to which the temporary difference is related. A temporary difference is related to an asset or liability if reduction of the asset or liability causes the temporary difference to reverse. For temporary differences not related to an asset or liability for financial reporting (e.g. tax loss carryforwards), the deferred taxes are classified according to the expected reversal date of the temporary differences. As of June 30, 2003 and 2002, Ps. 11.5 million and Ps. 1.6 million, respectively, would have been classified as current assets, and Ps. 53.0 million and Ps. 1.1 million, respectively, would have been classified as non-current assets.

As these differences have no effect on net income (loss) or on shareholders´ equity, no reconciling items are presented for US GAAP purposes.

(b) Statement of operations classification differences

Gross revenue tax

As indicated in Note 3.d., the Company adopted the provisions of RT 19 effective July 1, 2002. RT 19 provides that only returns and other allowances should be deducted from net sales, while direct taxes and other costs directly associated with sales should now be presented as operating costs, i.e. gross revenue taxes.

Under US GAAP, direct taxes and other costs directly associated with sales should be deducted from revenues. Net sales under US GAAP would have been Ps. 206.6 million, Ps. 134.8 million and Ps. 219.6 million for the years ended June 30, 2003, 2002 and 2001, respectively.

Operating income (loss)

As discussed in Note 21.II.(o), under Argentine GAAP, the Company s investments in LLR and ITNV were not consolidated for any of the periods presented. For US GAAP purposes, the Company possesses controlling financial interests in these companies. Accordingly, consolidation is appropriate under US GAAP.

In addition, (i) certain financial results and other income and expense items included in the Argentine GAAP financial statements of the Company, would be included in the determination of operating income (loss) under US GAAP and (ii) certain gains (losses) on the sale of real estate properties and equity investees were included as operating income (expense) under Argentine GAAP while they should be recognized as separate line items and designated as non-operating income (expenses) under US GAAP.

Accordingly, operating income (loss) under US GAAP would have been Ps. 10.8 million, Ps. (35.4) million and Ps. 19.8 million for the years ended June 30, 2003, 2002 and 2001, respectively.

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IRSA Inversiones y Representaciones Sociedad Anónima

Notes to the Consolidated Financial Statements (continued)

(In thousands of Argentine Pesos, except share data as otherwise indicated)

21. Differences between Argentine GAAP and US GAAP (continued)

(b) Statement of operations classification differences (continued)

Extraordinary items

As discussed in Note 21.I.(t), during 2003 APSA acquired an additional 24% ownership interest in Alto Invest. Under US GAAP, the excess of the fair value of the net assets acquired over the consideration paid, after reducing to zero the amounts that otherwise would have been assigned to the non-current assets, totaling Ps. 146 would have been recognized as an extraordinary item.

(c) Statement of changes in shareholders equity classification differences

As discussed in Note 6.b., from time to time the Company repurchases outstanding shares of common stock when it believes that its stock price is undervalued in the marketplace. At June 30, 2000 treasury shares totaled 6,236,762. During fiscal year 2001, the Company repurchased 19,079,995 outstanding shares of common stock for a total consideration of Ps. 90.4 million. During fiscal years 2001 and 2003, the Company distributed 20,729,472 and 4,587,285 treasury shares, respectively, on a pro rata basis to its shareholders. Under Argentine GAAP, the Company recorded the acquisitions of treasury shares as a reduction in retained earnings. Under US GAAP, these acquisitions would have been accounted for under the cost method, resulting in a reduction of capital stock.

(d) Segment information

As described in Note 3.d, the Company adopted new accounting standards in fiscal year 2003. As a result, the Company is required to disclose segment information in accordance with RT 18. The application of this standard did not affect the presentation of segment information since the Company already disclosed this information in prior years. Guidance set forth in RT 18 is similar to the guidelines set forth in SFAS No. 131 Disclosures About Segments of an Enterprise and Related Information . See Note 7 for details.

(e) Maturities of long-term debt

Aggregate annual maturities during the next five years, as of June 30, 2003, are as follows:

2005	Ps. 87,286
2006	17,639

2007	166,133
2008	321,046
	Ps. 592,104

(f) Operating leases

This note discloses operating leases information of the Company and its controlled and jointly controlled subsidiaries:

- Operating lease revenue information:

Leases and services from office and other buildings

The Company enters into cancelable commercial leases with its tenants for terms ranging from three to five years, with most leases having terms of no more than 5 years. Tenants are charged a base rent on a monthly basis. No contingent rentals were recorded for the years ended June 30, 2003, 2002 and 2001.

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IRSA Inversiones y Representaciones Sociedad Anónima

Notes to the Consolidated Financial Statements (continued)

(In thousands of Argentine Pesos, except share data as otherwise indicated)

21. Differences between Argentine GAAP and US GAAP (continued)

(f) Operating leases (continued)

- Operating lease expense information (continued):

Leases and services from shopping center operations

The Company enters into cancelable commercial leases with its tenants for terms ranging from three to ten years, with most leases having terms of no more than five years. Tenants are generally charged a rent, which consists of the higher of (i) the base rent and (ii) the percentage rent (which generally ranges between 4% and 8% of the tenants sales). Furthermore, pursuant to the rent escalation clause in most leases, a tenant s base rent generally increases between 4% and 7% each year during the term of the lease. Included in lease revenues for the year ended June 30, 2003 were contingent rentals of Ps 10.8 million.

The Company leases office space under cancelable operating leases that expire on various dates through January 2004. Rent expense is recognized ratably over the lease term. Rent expense for the years ended June 30, 2003, 2002 and 2001 amounted to Ps. 1.0 million, Ps. 0.6 million and Ps. 1.3 million, respectively.

(g) Disclosure of related party transactions

The following disclosures of transactions with related parties are required under US GAAP:

- Executive Employment Agreement: On October 30, 1997, the Company entered into Master Executive Employment Agreements (the Employment Agreements) with Eduardo S. Elsztain, M. Marcelo Mindlin, Saúl Zang and Oscar P. Bergotto (collectively herein referred to as the Employees), pursuant to which each such person will serve in his current capacity as director or executive officer. The term of the Employment Agreements is seven years; however either the Company or the relevant executive may terminate the Employment Agreements prior to the expiration of their respective terms. If the Company terminates the Employment Agreements without cause it will be liable to the relevant executive for two years of compensation. Under the Employment Agreements, the Employees will each be entitled to receive from the Company annual compensation in the aggregate of approximately Ps.750, subject to an annual 4% increase. The Employment Agreements also restrict the Employees from participating in real estate activities in Argentina that are in the same line of business as IRSA. The Employment Agreements were executed in December 1997 and approved by the Company s shareholders at an extraordinary shareholders meeting on April 7, 1998.

- APSA loan: On July 20, 2001, Company s board of directors approved to grant APSA several loans to finance transactions related to its swap agreement. On February 8, 2002 the Company and Parque Arauco signed subordination agreements subordinating the repayment of our

respective loans to the payment of APSA s senior notes. The interest rate on such loans till February 1, 2002 was the lesser of (I) variable cost of money for the Company in operations of up to 30 days and (ii) the average of the last five BADLAR rates for U.S. dollar transactions, plus 200 annual nominal basis points for operations in foreign and local currency according to market conditions. The interest rate on such loans from February 1, 2002 till August 20, 2002 was 10.23% plus an inflation adjustment. At August 20, 2002, the outstanding principal of these loans was Ps. 43.6 million. In May and July, 2002 the Company advanced APSA a US$ 10.1 million loan that was applied on August 20, 2002 to our subscription for US$27.2 million of APSA s convertible notes. From May, 2002 to August 20, 2002 the interest rate on such loans was 10%.

- Subscription of convertible notes issued by APSA: In August 2002, the Company subscribed for US$ 27.2 million convertible notes issued by APSA. Furthermore, in January 2003, the Company purchased US$ 2.6 million Convertible Notes issued by APSA. At June 30, 2003, the Company owned 54.79% of APSA s common shares. Immediately following APSA s offering (assuming the Company exercise its conversion rights of all of its convertible notes and no exercise of such rights by any of APSA s other bondholders), the Company would own 80.4 % of APSA s common shares. In the case all shareholders exercise their conversion rights and the Company exercise them as well, the Company would own 58.4% of APSA s common stock.

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Notes to the Consolidated Financial Statements (continued)

(In thousands of Argentine Pesos, except share data as otherwise indicated)

21. Differences between Argentine GAAP and US GAAP (continued)

(g) Disclosure of related party transactions (continued)

- Repurchase Agreement with APSA: On February 17, 2003, the Company and Parque Arauco Argentina S.A., entered into a repurchase agreement with APSA, in which the Company and Parque Arauco Argentina S.A. granted to such company loans for Ps. 4.2 million and Ps. 2.1 million, respectively. According to the repurchase agreement, APSA made a collateral deposit of Ps. 5.5 million nominal value of Class A-2 Notes and Ps. 10.0 million nominal value of Class B-2 Notes with us and other of Ps. 2.8 million nominal value of Class A-2 Notes and Ps. 5.0 million nominal value of Class B-2 Notes with Parque Arauco Argentina S.A. The agreement is likely to be renewed upon expiration.

- Purchase of the Company´s shares by Cresud: As of June 30, 2003, Cresud invested in shares of the Company for a total amount of Ps. 133.6 million, resulting in a 22.65 % ownership at June 30, 2003. Eduardo S. Elsztain, and Saúl Zang, are Chairman, First and Vice-Chairman, respectively, of the Board of Directors as well as shareholders of the Company. They are also Chairman and Vice-Chairman, respectively, of the Board of Directors of Cresud. Mr. Eduardo S. Elsztain and Saúl Zang are also shareholder of Cresud.

- Issue of Convertible Notes by Cresud: On October 15, 2002, Cresud initiated a preemptive rights offering to subscribe for 50,000,000 units consisting of US$ 50.0 million of 8% Convertible Notes due 2007 and non-detachable warrants to purchase shares of its common stock. The offering was fully subscribed and the funds have already been received by Cresud. Proceeds of the offering were applied to subscribe US$ 50.0 million of the Company´s Convertible Notes. As of June 30, 2003, 22.65 % of the Company´s common shares are property of Cresud and no conversion was executed by this company. Assuming Cresud exercises its conversion rights of all of its Convertible Notes and no exercise of such rights by any of our other bondholders, Cresud would own 58.5% of its common shares. In the case all shareholders exercise their conversion rights and Cresud exercise them as well, Cresud would own 39.9% of the Company common stock.

- IRSA Management ownership plan: On October 30, 1997 the Company´s shareholders authorized IRSA to enter into a management ownership plan with certain executive officers. See Note 6.e. for further detail.

- Donations: During the years ended June 30, 2003, 2002, and 2001, the Company made donations to two not-for-profit organizations, namely *Fundación IRSA* and *Museo de los Niños*, for a total amount of Ps. 3.3 million, Ps. 0.1 million and Ps. 2.1 million, respectively. Eduardo S. Elsztain is the President of these organizations.

- Lease agreements: IRSA leases a portion of its headquarters office space from DFM for a monthly rent of Ps. 11.9 under two lease contracts expiring on June 30, 2007. DFM leases such offices both from Elsztain e Hijos S.C.A., a company controlled by relatives of Eduardo S. Elsztain, Chairman of the Company, and also from Hamonet S.A., a company controlled by Fernando A. Elsztain, the Company´s Chief Commercial Officer, and certain of his relatives. Rental expense incurred during the years ended June 30, 2003, 2002 and 2001 amounted to Ps. 200, Ps. 274 and Ps. 314, respectively.

The Company leased office space to Cresud until December 2001. Eduardo Elsztain, Marcelo Mindlin and Saul Zang, Chairman, First Vice-Chairman and Second Vice-Chairman, respectively, of the Board of Directors as well as shareholders of the Company are directors of Cresud. Mr. Eduardo Elsztain is also shareholder of Cresud. Rent income is recognized ratably over the lease term. Rental income amounted to Ps. 165 and Ps. 370 for the year ended June 30, 2002 and for the period ended June 30, 2001, respectively.

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IRSA Inversiones y Representaciones Sociedad Anónima

Notes to the Consolidated Financial Statements (continued)

(In thousands of Argentine Pesos, except share data as otherwise indicated)

21. Differences between Argentine GAAP and US GAAP (continued)

(g) Disclosure of related party transactions (continued)

The Company has entered into lease agreements for offices located in the Costero, a building located in Puerto Madero with Altocity.Com, Alternativa Gratis S.A y Dolphin Interventures S.A. The first agreement expires in January 2004 and the second in May 2004. Both of them may be extended by the lessees for up to seven additional consecutive twelve month periods. The leases are for monthly rents of Ps. 9.5 and Ps. 8.3, respectively.

The Company leases to Tarshop the seventh floor of the Company s property located in Suipacha 664. Monthly rent income amounts to Ps. 3.7 and the lease agreement expires on August 10, 2004.

- Mutual investment fund: Since 1996, the Company has investments in Dolphin Fund Plc, an open ended investment fund which is related to the Company s directors. These investments are carried at market value as of year-end. Unrealized gains and losses related to investment funds are included in financial results, net, in the consolidated statements of operations.

The amounts relating to the Company s net gain on holding Dolphin Fund investments for the years ended June 30, 2003, 2002 and 2001 are Ps. 13.1, million, Ps. 28.2 million and Ps. 3.3 million, respectively.

- Investment in Banco Hipotecario S.A.: As of June 30, 2003 the Company owns 6.4% of Banco Hipotecario S.A. Additionally, as of the same date the Company owns 2,697,500 options to purchase Banco Hipotecario S.A.´s American Depositary Shares (ADS). Each option represents the right to purchase 100 ADS´s at an exercise price of Ps. 7 per ADS. These options are exercisable through February 2, 2004. Some of the Company s directors are also directors of Banco Hipotecario S.A.

- Corporate services: In order to reduce administrative expenses and to achieve a more efficient allocation of corporate resources, as of June 30, 2003, the Company and APSA provide corporate services in the areas of institutional relations, finance and human resources to the Company and Cresud.

In the future and in order to continue with the Company´s policy of achieving a more efficient allocation of corporate resources, the Company may extend the areas in which the Company share corporate services with APSA and Cresud. The Company s chairman and vice-chairman are also chairman and vice-chairman of Cresud.

- Legal services: During the years ended June 30, 2003, 2002 and 2001, the Company paid the law firm Zang, Bergel & Viñes an aggregate amount of approximately Ps. 1.4 million, Ps. 0.5 million and Ps. 1.1 million for legal services. Saúl Zang and Ernesto M. Viñes, directors of the Company, and Salvador D.Bergel and Juan C. Quintana Terán, alternate directors of the Company, are partners of the law firm.

(h) Disclosure about fair value of financial instruments

Under Argentine GAAP, there are no specific rules regarding disclosure of fair value of financial instruments.

Under US GAAP, SFAS No. 105 requires reporting entities to disclose certain information about financial instruments with off-balance sheet risk of accounting loss. SFAS No. 107, Disclosures About Fair Value of Financial Instruments , requires disclosure of fair value information about financial instruments whether or not recognized in the balance sheet, for which it is practicable to estimate fair value. Financial instruments include such items as to cash and cash equivalents and accounts receivable and other instruments. SFAS No. 107 excludes from its disclosure requirements lease contracts and various significant assets and liabilities that are not considered to be financial instruments. SFAS No. 119 requires reporting entities to disclose certain information for derivative financial instruments. SFAS No. 133 superseded SFAS No. 105 and SFAS No. 119 and amended SFAS No. 107 to include in SFAS No. 107 the disclosure requirements of credit risk concentrations from SFAS No. 105. See Note 21.II.(i) for details of concentration of credit risk.

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Notes to the Consolidated Financial Statements (continued)

(In thousands of Argentine Pesos, except share data as otherwise indicated)

21. Differences between Argentine GAAP and US GAAP (continued)

(h) Disclosure about fair value of financial instruments (continued)

Fair value estimates are made as of a specific point in time based on the characteristics of the financial instruments and the relevant market information. Where available, quoted market prices are used. In other cases, fair values are based on estimates using other valuation techniques, such as discounting estimated future cash flows using a rate commensurate with the risks involved or other acceptable methods. These techniques involve uncertainties and are significantly affected by the assumptions used and the judgements made regarding risk characteristics of various financial instruments, prepayments, discount rates, estimates of future cash flows, future expected loss experience, and other factors. Changes in assumptions could significantly affect these estimates. Derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in an immediate sale of the instrument. Also, because of differences in methodologies and assumption used to estimate fair value, the Company s fair values should not be compared to those of other companies.

Under this statement, fair value estimates are based on existing financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Accordingly, the aggregate fair value amount presented does not represent the underlying value of the Company. For certain assets and liabilities, the information required under this statement is supplemental with additional information relevant to an understanding of the fair value.

The methods and assumptions used to estimate the fair values of each class of financial instruments as of June 30, 2003 and 2002 are as follows:

Cash and cash equivalents

The Company considers all highly liquid investments with original maturities of three months or less, consisting primarily of time deposits, to be cash and cash equivalents. The carrying amount reported in the balance sheet approximates fair value.

Marketable securities

The fair value of marketable securities is based on quoted market prices for those or similar investments.

Options to purchase marketable securities

The fair value of options to purchase marketable securities is based on the terms and conditions of the underlying contracts, -i.e. strike price, maturities, expected dividends and vesting period-, available market information, -i.e. quoted market price of underlying shares and expected volatility. The Company used the binomial tree valuation method to estimate fair value.

Mortgages and leases receivable, net

The estimated fair value of mortgage notes receivable collateralized by real property is based on discounting the future cash flows at a year-end risk adjusted lending rate that the Company would utilize for loans of similar risk and duration. It is not practicable to estimate the fair value of leases receivable because of the inability to estimate it without incurring excessive costs.

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IRSA Inversiones y Representaciones Sociedad Anónima

Notes to the Consolidated Financial Statements (continued)

(In thousands of Argentine Pesos, except share data as otherwise indicated)

21. Differences between Argentine GAAP and US GAAP (continued)

(h) Disclosure about fair value of financial instruments (continued)

Retained interest in transferred mortgage receivables

Fair value is estimated by discounting anticipated future cash flows using a discount rate based on specific factors. The anticipated future cash flows are projected on a cash out basis to reflect the restriction of cash flows until the investors have been fully paid. As of June 30, 2003 and 2002, the fair value of retained interests in transferred mortgage and credit card receivables totaled Ps. 7.3 million and Ps. 3.6 million, respectively**.**

Accounts payable

The carrying amount of accounts and notes payable reported in the balance sheet approximates its fair value.

Short-term debt

The carrying amount of short-term debt reported in the balance sheet approximates fair value due to its short-term nature.

Long-term debt

As of June 30, 2003 and 2002 the carrying amount of long-term debt reported in the balance sheet approximates its fair value.

Other receivables and other liabilities

The carrying amount of other receivables and other liabilities reported in the balance sheet approximates fair value due to their short-term nature.

Forward foreign currency exchange contracts

The fair value of the forward foreign currency exchange contracts is based on the estimated amount at which they could be settled based on forward market exchange rates.

Interest rate swap agreement

The fair value of the interest rate swap agreement was determined based on the present value of the estimated future net cash flows using implied rates in the applicable yield curve as of the valuation date. At June 30, 2003, the fair market value of the swap agreement was Ps. (131.8) million. The swap agreement is carried at fair market value on the balance sheet.

Seller financing

The fair value of the seller financing is estimated based on quoted market prices for the same or similar issues or on current rates offered to the Company for debt of the same remaining maturities.

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IRSA Inversiones y Representaciones Sociedad Anónima

Notes to the Consolidated Financial Statements (continued)

(In thousands of Argentine Pesos, except share data as otherwise indicated)

21. Differences between Argentine GAAP and US GAAP (continued)

(i) Concentration of credit risk

Financial instruments that potentially subject the Company to a concentration of credit risk consist of cash, cash equivalents, accounts receivable and short-term investments. The Company maintains cash and cash equivalents, investments, and other financial investments with various high credit quality financial institutions, thus mitigating the amount of credit exposure to any one institution. The Company has not experienced any significant losses in such accounts.

The Company s accounts receivable are primarily derived from real estate revenues from customers and credit card receivables. The Company is not dependent on any single customer.

Accounts receivable derived from real estate revenues, are related to mortgages to individuals in connection with its sales of residential properties. These properties are located principally in Buenos Aires, Argentina. The Company is subject to credit risk in the event of non-performance by the counterparties to the mortgages; however, in the opinion of management, the values of the properties that collateralize the mortgages are presently adequate to protect the Company from material losses resulting from such non-performance. The company has not experienced any significant losses resulting from non-performance of any counterpart to the mortgage contracts.

Additionally, credit card receivables arise primarily under open-end revolving credit accounts used to finance purchases of goods and services offered by the Company s shopping centers. These accounts have various billing and payment structures, including varying minimum payment levels and finance charge rates. Credit card receivables are shown net of an allowance for uncollectible accounts.

The Company maintains reserves for potential credit losses based on impaired accounts, historical charge-off patterns and management judgement; historically such losses have not been significant and within management s expectations.

As of June 30, 2003 the Company has sold credit card receivables of Ps. 146.1 million through securitization transactions, for which the Company s credit risk exposure is contractually limited to the subordinated CPs held by the Company representing Ps. 7.3 million (equity value) and a Ps. 0.7 million escrow reserves for losses.

(j) Recently issued accounting pronouncements

In June 2001, SFAS No. 142, Goodwill and Other Intangible Assets, was issued establishing accounting and reporting standards that address how goodwill and intangible assets should be accounted for within the financial statements. The statement requires companies to not amortize goodwill and intangible assets with infinite lives, but to test such assets for impairment on a regular basis (at least annually). An intangible asset that has a finite life should be amortized over its useful life and evaluated for impairment on a regular basis in accordance with SFAS No.144, Accounting for the Impairment or Disposal of Long-Lived Assets . The Company adopted the provisions of SFAS No. 142 effective July 1, 2002. Therefore, the Company discontinued amortization of goodwill as from the beginning of fiscal year 2003 and performed the required impairment tests. As a result of such analysis, no impairment loss has been recognized at June 30, 2003.

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Notes to the Consolidated Financial Statements (continued)

(In thousands of Argentine Pesos, except share data as otherwise indicated)

21. Differences between Argentine GAAP and US GAAP (continued)

(j) Recently issued accounting pronouncements (continued)

In August, 2001, FASB issued Statement of Financial Accounting Standards (SFAS) No. 143, Accounting for Asset Retirement Obligations, which addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. SFAS No. 143 requires an enterprise to record the fair value of an asset retirement obligation as a liability in the period in which it incurs a legal obligation associated with the retirement of tangible long-lived assets. The Company is required to adopt the provisions of SFAS No. 143 for fiscal year beginning on July 1, 2003. The Company does not anticipate that SFAS No. 143 will significantly impact the Company s consolidated financial statements.

On May 1, 2002, the FASB issued SFAS No. 145 Rescission of SFAS Nos. 4, 44 and 64, Amendment of SFAS No. 13, and Technical Corrections as of April 2002 (SFAS No. 145), which, among other things, eliminates the exception of applying APB Opinion No. 30 (APB 30) to all gains and losses related to extinguishments of debt (other than extinguishments of debt to satisfy sinking-fund requirements). As a result, gains and losses from extinguishment of debt should be classified as extraordinary items only if they meet the criteria set forth in APB 30. These provisions are effective for fiscal years beginning after May 15, 2002, with early application encouraged. Any gain or loss on extinguishment of debt that was classified as an extraordinary item in prior periods that does not meet the criteria in APB 30 for classification as an extraordinary item should be reclassified. The Company adopted this standard on April 1, 2002. As such, gains and losses on extinguishment of debt are no longer reported as extraordinary items.

In June 2002, the FASB issued Statement of Financial Accounting Standard No. 146 (SFAS 146), Accounting for Costs Associated with Exit or Disposal Activities . SFAS 146 requires that the liability for a cost associated with an exit or disposal activity be recognized at its fair value when the liability is incurred. Under previous guidance, a liability for certain exit costs was recognized at the date that management committed to an exit plan. SFAS 146 is effective only for exit or disposal activities initiated after December 31, 2002. The adoption of this statement did not have a material effect on the financial statements for the year ended June 30, 2003.

In November 2002, the FASB issued FASB Interpretation No. 45 (FIN 45), Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others . FIN 45 requires that upon issuance of a guarantee, a guarantor must recognize a liability for the fair value of an obligation assumed under a guarantee. FIN 45 also requires additional disclosures by a guarantor in its interim and annual financial statements about the obligations associated with guarantees issued. The recognition provisions of FIN 45 are effective for any guarantees that are issued or modified after December 31, 2002. The Company has adopted the disclosure and measurement requirements of FIN 45. The adoption of the recognition provisions did not have a material impact on the Company s results of operations or financial position.

In December 2002, the FASB issued Statement of Financial Accounting Standard No. 148 (SFAS 148), Accounting for Stock-Based Compensation Transition and Disclosure . SFAS 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. SFAS 148 also requires prominent disclosure in the Summary of Significant Accounting Policies of both annual and interim financial statements about the method of accounting for stock-based employee compensation and

the effect of the method used on reported results. The Company has adopted SFAS 148 for fiscal year 2003. Adoption of this statement has not affected the Company s results of operations or financial position.

In January 2003, the FASB issued FASB Interpretation No. 46 (FIN 46), Consolidation of Variable Interest Entities an interpretation of ARB No. 51 . FIN 46 requires that if any entity has a controlling financial interest in a variable interest entity, the assets, liabilities and results of activities of the variable interest entity should be included in the consolidated financial statements of the entity. FIN 46 provisions are effective for all arrangements entered into after January 31, 2003. For those arrangements entered into prior to January 31, 2003, FIN 46 provisions are required to be adopted at the beginning of the first interim or annual period beginning after June 15, 2003. The adoption of this statement did not have a material effect on the financial statements for the year ended June 30, 2003.

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Notes to the Consolidated Financial Statements (continued)

(In thousands of Argentine Pesos, except share data as otherwise indicated)

21. Differences between Argentine GAAP and US GAAP (continued)

(j) Recently issued accounting pronouncements (continued)

In April 2003, the FASB issued Statement of Financial Accounting Standard No. 149 (SFAS 149), Amendment of Statement 133 on Derivative Instruments and Hedging Activities . SFAS 149 amends and clarifies accounting for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities under SFAS 133. SFAS 149 is generally effective for derivative instruments, including derivative instruments embedded in certain contracts, entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003. Currently, the Company only has an interest rate swap agreement outstanding, which does not qualify for hedging accounting under SFAS No. 133. Therefore, the Company does not anticipate that SFAS No. 149 will significantly impact the Company s consolidated results of operations or financial position.

In May 2003, the FASB issued Statement of Financial Accounting Standard No. 150 (SFAS 150), Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity . SFAS 150 clarifies the accounting for certain financial instruments with characteristics of both liabilities and equity and requires that those instruments be classified as liabilities on the balance sheet. Previously, many of those financial instruments were classified as equity. SFAS 150 is effective for financial instruments entered into or modified after May 31, 2003 and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The Company does not anticipate that SFAS No. 150 will significantly impact the Company s consolidated results of operations or financial position.

(k) Earnings per share

As described in Note 3.d, under Argentine GAAP the Company adopted new accounting standards effective July 1, 2002. Pursuant to this adoption, the Company is required to disclose earnings per share information in accordance with RT 18 for all periods presented. Note 19 to the consolidated financial statements disclose the computation of basic and diluted net income (loss) per common share under Argentine GAAP. Guidance set forth in RT 18 is similar to the basic principles set forth in SFAS No. 128 Earnings per Share (SFAS No.128). See Note 4.y, for details.

Under US GAAP, basic and diluted earnings per share are presented in conformity with SFAS No. 128 and SEC Staff Accounting Bulletin No. 98 (SAB No. 98) for all years presented. Pursuant to the Securities and Exchange Commission Staff Accounting Bulletin No. 98, ordinary shares and convertible preferred shares issued or granted for nominal consideration prior to the anticipated effective date of an initial public offering must be included in the calculation of basic and diluted earnings per share as if they had been outstanding for all periods presented. To date, the Company has not had any issuance or grants for nominal consideration.

As disclosed in Note 19, in calculating diluted net income per common share under Argentine GAAP for the year ended June 30, 2003, the Company has considered the dilutive effects of outstanding warrants, but not using the treasury-stock method as required by US GAAP. Using the treasury-stock method, the weighted-average number of potential common stock would have 128,577 shares. Diluted net income per common share under Argentine GAAP for the year ended June 30, 2003, using the treasury-stock method, would have been Ps. 0.73.

The following tables set forth the computation of basic and diluted net income (loss) per common share under US GAAP for all periods presented:

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Notes to the Consolidated Financial Statements (continued)

(In thousands of Argentine Pesos, except share data as otherwise indicated)

21. Differences between Argentine GAAP and US GAAP (continued)

(k) Earnings per share (continued)

	Year ended June 30,		
	2003	**2002**	**2001**
Numerator:			
Net income (loss) available to common shareholders	Ps. 191,248	Ps. (731,470)	Ps. 22,501
Plus (less): income (loss) impact of assumed conversions:			
Interest expense on convertible debt	17,166		
Foreign currency exchange gain	(65,633)		
Income tax effects	16,963		
Net income (loss) available to common shareholders plus assumed conversions	Ps. 159,744	Ps. (731,470)	Ps. 22,501
Denominator:			
Weighted-average number of shares outstanding	209,840	207,412	204,189
Plus: incremental shares of assumed conversions:			
Warrants (i)	13,973		
Convertible Notes	114,603		
Adjusted weighted-average number of shares	338,416	207,412	204,189
Earnings per share under US GAAP:			
Basic net income (loss) per common share	Ps. 0.91	Ps. (3.53)	Ps. 0.11
Diluted net income (loss) per common share	Ps. 0.47	Ps. (3,53)	Ps. 0.11

(i) Potential common shares related to the warrants have been calculated using the treasury-stock method as required by US GAAP.

As discussed in Note 21.II.(b), under US GAAP the Company recorded an extraordinary gain amounting to Ps. 146 during fiscal year 2003. The effect of the extraordinary gain on the computation of basic and diluted net income per share under US GAAP for the year ended June 30, 2003 is Ps. 0.0007 and Ps. 0.0004, respectively.

As discussed in Note 21.I.(e), under US GAAP the Company recorded a cumulative-effect type adjustment of Ps. 23.0 million gain during fiscal year 2001 related to the adoption of SFAS No. 133. The effect of the accounting change on the computation of basic and diluted net income per share under US GAAP for the year ended June 30, 2001 amounts to Ps. 0.113. Under US GAAP, basic and diluted net income per common

share for the year ended June 30, 2001 considering a retroactive application of a change in accounting principles would have been Ps. (0.003).

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Notes to the Consolidated Financial Statements (continued)

(In thousands of Argentine Pesos, except share data as otherwise indicated)

21. Differences between Argentine GAAP and US GAAP (continued)

(l) Risks and uncertainties

The Company is subject to certain business risks arising in connection with its operations which include, among others:

Risks associated with Argentine operations. A substantial part of the Company s operations and properties are located in Argentina. As a result, the Company financial condition and results of operations depend to a significant extent on macroeconomic and political conditions prevailing in Argentina. The Argentine economy has experienced a persistent recession since 1988, and in recent months the recession has deepened into an unprecedented political and economic crisis which has disrupted Argentina s financial system and effectively paralyzed the economy.

Risks associated with office and other buildings leases: The Company s lease revenues from its real estate operations may be adversely affected by (I) local or national economic conditions in the areas in which the properties are located, (ii) oversupply of office space or a reduction in demand for such space, (iii) increased competition from other real estate operators, (iv) changes in the ability of the Company or the tenants to provide for adequate maintenance and/or insurance, (v) increases in operating expenses, (vi) adverse changes in the regional or national economy, (vii) the bankruptcy or insolvency of, or a downturn in the business of, any of its major tenants, and/or (vii) the possibility that such tenants will not renew their leases as they expire. Unfavorable economic conditions could also result in the inability of tenants in certain sectors to meet their lease obligations and otherwise could adversely affect the Company s ability to attract and retain desirable tenants.

Risks associated with development properties activities: Include (I) the potential abandonment of development opportunities; (ii) construction costs may exceed the Company s original estimates, possibly making a project uneconomical; (iii) occupancy rates and rents at a newly completed project may be insufficient to make the project profitable; (iv) the Company s inability to obtain financing on favorable terms for the development of the project; (v) construction and lease-up may not be completed on schedule, resulting in increased debt service expense and construction costs; and (vi) the Company s inability to obtain, or the delays in obtaining, all necessary zoning, land-use, building, occupancy and other required governmental permits and authorizations.

Risks associated with the hotel industry. The success of the Company s operated hotels will depend, in large part, upon the Company s ability to compete in areas such as access, location, quality of accommodations, room rate structure, quality and scope of food and beverage facilities and other services and amenities. The Company s hotels may face additional competition if other companies decide to build new hotels or improve their existing hotels such that they are more attractive to potential guests. In addition, the profitability of the Company s hotels depends on (I) the Company s ability to form successful relationships with international operators to run the hotels; (ii) changes in travel patterns, including seasonal changes; and (iii) taxes and governmental regulations which influence or determine wages, prices, interest rates, construction procedures and costs.

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Notes to the Consolidated Financial Statements (continued)

(In thousands of Argentine Pesos, except share data as otherwise indicated)

21. Differences between Argentine GAAP and US GAAP (continued)

(l) Risks and uncertainties (continued)

Shopping center operating risks: The development, administration and profitability of shopping centers are impacted by various factors including: the accessibility and the attractiveness of the area where the shopping center is located, the intrinsic attractiveness of the shopping center, the flow of people and the level of sales of each shopping center rental unit within the Company s shopping centers, the amount of rent collected from each shopping center rental unit and the fluctuations in occupancy levels in the shopping centers. In the event that there is an increase in operational costs, caused by inflation or other factors, it could have a material adverse effect on the Company if its tenants are unable to pay their higher rent obligations due to the increase in expenses.

All of the Company s lease agreements with tenants were denominated in U.S. dollars. As a result of the economic measures announced by the government in early 2002, the Company s lease agreements were converted into pesos at a rate of Ps. 1.0 per U.S. dollar, and are subject to an adjusting index (CER) as from February 3, 2002 that will be retroactively collected beginning August 2002. If services prices are higher or lower than amounts paid at due dates, the Company or tenants can request a price readjustment. If the parties do not reach an agreement, lawsuits, or other legal action may be initiated. The increase in the adjusting index may affect the risk of default on the Company s leases with tenants, as any of the Company s tenants may not be able to increase its revenues due to the economic recession.

Since May 28, 1997, Law No. 24,808 provides that tenants may rescind commercial lease agreements after the initial six months upon not less than sixty days written notice, subject to penalties of only one-and-a-half months rent if the tenant rescinds during the first year of the lease, and one-month rent if the tenant rescinds after the first year of the lease. The exercise of such rescission rights could materially and adversely affect the Company.

Credit card operating risks: Credit card operations are subject to federal legislation and regulation. From time to time, such legislation, as well as competitive conditions, may affect, among other things, credit card finance charges. While the Company cannot predict the effect of future competitive conditions and legislation or the measures the Company might take in response thereto, a significant reduction in the finance charges imposed by Tarshop would have an adverse effect on the Company. In addition, changes in general Argentine economic conditions, including, but not limited to, higher interest rates and increases in delinquencies, charge-offs and personal bankruptcies could have an adverse effect on the Company.

E-commerce risks: The Company also offers its services over the Internet, and competes in the market for Internet services and products, which is characterized by intense competition and rapid technological changes. The Company s internet ventures have a limited operating history, have never generated profits, and their prospects are subject to the risks, expenses, and uncertainties frequently encountered by companies in new and rapidly evolving markets for internet products and services. These risks include the failure to develop and extend the Company s online service brands, the rejection of the Company s services by Web consumers, vendors and/or advertisers, the inability of the Company to maintain and increase the levels of traffic on its online services, as well as other risks and uncertainties. In the event that the Company does not successfully implement its business plan, certain assets may not be recoverable.

(m) Summarized financial information of unconsolidated equity investees

Equity investments in unconsolidated affiliated companies, representing between 20% and 50% of the capital stock in such companies, have been accounted for under the equity method, wherein the investment is recorded at the amount of the underlying equity in the net assets of the investments and adjusted to recognize the Company s share of the undistributed earnings or losses. As described in Note 3.d, the Company and its subsidiaries adopted new accounting standards on July 1, 2002. Pursuant to this adoption, the Company has restated its prior year financial statements to give retroactive effect to the newly adopted accounting standards. Information presented below has also been restated to conform to the current year presentation.

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Notes to the Consolidated Financial Statements (continued)

(In thousands of Argentine Pesos, except share data as otherwise indicated)

21. Differences between Argentine GAAP and US GAAP (continued)

(m) Summarized financial information of unconsolidated equity investees (continued)

The Company s share of the income (loss) of these affiliates was Ps. (12.9) million in 2003, Ps. 0.01 million in 2002 and Ps. 0.9 million in 2001, and its investment in these companies totaled Ps. 21.1 million and Ps. 363.0 million at June 30, 2003 and 2002.

Summarized financial information of the Company s significant equity investees (on a 100% basis) is as follows:

	As of and for the year ended June 30,		
	2002	2001	
	APSA (i)	APSA (i)	Brazil Realty (ii)
Current assets	Ps. 56,178	Ps. 180,196	Ps. 111,443
Non-current assets	1,144,861	1,217,687	362,957
Total assets	1,201,039	1,397,883	474,400
Current liabilities	90,936	207,868	96,760
Non-current liabilities	411,398	468,872	93,146
Total liabilities	502,334	676,740	189,906
Minority interest	17,290	22,257	
Shareholders´ equity	681,415	692,767	284,494
Sales	195,966	266,048	149,569
Gross profit	104,896	161,711	77,769
Net (loss) income	Ps. (11,352)	Ps. (7,417)	Ps. 28,440

(i) As discussed in Note 3.b, APSA is included in the Company s financial statements on a consolidated basis in fiscal year 2003.

(ii) The Company sold its equity interest in Brazil Realty in February 2002.

(n) Capitalized interest

No interest costs were capitalized during the years ended June 30, 2003, 2002 and 2001 under both Argentine and US GAAP.

(o) Consolidation under US GAAP

As from June 30, 2000, the Company has a 50% equity interest in LLR. Under Argentine GAAP, the Company did not consolidate LLR for any of the periods presented. For US GAAP purposes, and, in view of the guidance in SFAS No. 94, Consolidation of All Majority-Owned Subsidiaries and Rules 1-02 and 3A-02 of Regulation S-X of the Securities and Exchange Commission, the Company possesses a controlling financial interest in LLR regardless of its 50% ownership interest. Accordingly, consolidation is appropriate under US GAAP.

In addition, the Company s investment in ITNV was not consolidated under Argentine GAAP for any of the periods presented as the Company has a 49% equity interest in such company. Under US GAAP, this investment would be consolidated considering that the issuance of mandatorily redeemable preferred stock did not change the Company s ownership interest (See Note 21.I.(b) (ii) for details).

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Notes to the Consolidated Financial Statements (continued)

(In thousands of Argentine Pesos, except share data as otherwise indicated)

21. Differences between Argentine GAAP and US GAAP (continued)

(o) Consolidation under US GAAP (continued)

As discussed in Note 3.b.(iii), early fiscal year 2003 the Company obtained a controlling interest in APSA through the acquisition of additional shares and convertible notes. As such, the Company changed the method of accounting from the equity method to the consolidation as from July 1, 2002. APSA has ongoing revolving period securitization programs through which it transfers a portion of its customer credit card receivable balances to master trusts that issue certificates to public and private investors. Under Argentine GAAP, to the extent that certificates are sold to third parties, the receivables transferred qualify as sales for financial statement purposes and are removed from the Company s balance sheet. The remaining receivables in the trust, which have not been sold to third parties, are reflected on the Company s balance sheet as a retained interest in transferred credit card receivables. These retained interests are treated in a manner similar to an investment and accounted for under the equity method. Under US GAAP, certain of the special purpose entity structures in securitization programs would have been consolidated in accordance with Emerging Issues Task Force Issue (EITF) No. 96-20, Impact of SFAS No. 125 on Consolidation of Special Purpose Entities considering the criteria established by this standard for precluding consolidation are not met.

Presented below is the consolidated condensed information of the Company at June 30, 2003 and 2002 giving effect to the above-mentioned consolidation:

	2003					
	Company	LLR	ITNV	SPE	Elimination	Consolidated
Current assets	288,603	10,871	5,868	19,714	(5,701)	319,355
Non-current assets	1,764,361	31,706	1,598	37	(15,529)	1,782,173
Total assets	2,052,964	42,577	7,466	19,751	(21,230)	2,101,528
Current liabilities	172,458	16,706	2,211	12,843	(442)	203,776
Non-current liabilities	629,988			1,650		631,638
Total liabilities	802,446	16,706	2,211	14,492	(442)	835,413
Minority interest	441,332				15,597	456,929
Shareholders equity	809,186	25,871	5,255	5,259	(36,385)	809,186

	2002

	Company	LLR	ITNV	Elimination	Consolidated
Current assets	153,170	4,800	6,426	(25)	164,371
Non-current assets	1,139,534	28,685	1,608	(13,468)	1,156,359
Total assets	1,292,704	33,485	8,034	(13,493)	1,320,730
Current liabilities	681,029	12,514	1,992	(25)	695,510
Non-current liabilities	4,061				4,061
Total liabilities	685,090	12,514	1,992	(25)	699,571
Minority interest	84,894			13,545	98,439
Shareholders equity	522,720	20,971	6,042	(27,013)	522,720

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Notes to the Consolidated Financial Statements (continued)

(In thousands of Argentine Pesos, except share data as otherwise indicated)

21. Differences between Argentine GAAP and US GAAP (continued)

(p) Severance indemnities

Under Argentine law and labor agreements, the Company is required to make minimum severance payments to its dismissed employees without cause and employees leaving its employment in certain other circumstances. Under Argentine GAAP, severance payments are expensed as incurred. Under US GAAP, the Company follows the guidelines established by SFAS No. 112, Employers Accounting for Post-employment Benefits , and SFAS No. 43, Accounting for Compensated Absences , which requires the accrual of severance costs if they relate to services already rendered, are related to rights that accumulate or vest, are probable of payment and are reasonably estimable. While the Company expects to make severance payments in the future, it is impossible to estimate the number of employees that will be dismissed without proper cause in the future, if any, and accordingly the Company has not recorded such liability.

(q) Statements of cash flows

As discussed in Note 3.d, the Company adopted new accounting standards effective July 1, 2002. Pursuant to this adoption, the Company is required to present the statements of cash flows in the primary financial statements in accordance with RT 9, as amended. The application of this standard did not affect the presentation of the statements of cash flows since the Company already presented such statements in the primary financial statements following the basic principles of SFAS No. 95 Statement of Cash Flows (SFAS No.95). Guidance set forth in RT 9 (as amended) is similar to the guidelines set forth in SFAS No. 95.

As further described in Note 4.b., the Company considers all highly liquid investments with original maturities of three months or less to be cash equivalents. Under US GAAP, the total amounts of cash and cash equivalents at the end of the years shown in the consolidated statements of cash flows are required to be the same amounts as similarly titled line items shown in the consolidated balance sheets, as of those dates. Note 20 to the consolidated financial statements includes a reconciliation between the balances included as cash and banks in the consolidated balance sheets to the total amounts of cash and cash equivalents at the end of the years shown in the consolidated statements of cash flows.

As discussed in Note 21.II.(o), under Argentine GAAP, the Company s investments in LLR and ITNV were not consolidated for any of the periods presented. Under US GAAP, these investments would have been consolidated. As a result, differences exist between cash flows reported in the primary financial statements and cash flows that would be reported in a statement of cash flows prepared using US GAAP numbers. In addition, under Argentine GAAP, cash flow from purchases, sales and maturities of available-for-sale securities were reported as operating activities. Under US GAAP, these transactions would be classified as cash flows from investing activities. Also, under Argentine GAAP nor the effect of exchange rate changes on cash and cash equivalents, neither the effects of inflation were disclosed by presenting additional cash flow statement categories as required by US GAAP. The following table presents the cash flows from operating, investing and financing activities as well as the effects of inflation accounting and exchange rate changes on cash and cash equivalents that would be reported in the consolidated statement of cash flows under US GAAP.

For the year ended June 30,

	2003	2002	2001
Net cash provided by operating activities	Ps. 55,135	Ps. 11,871	Ps. 98,299
Net cash (used in) provided by investing activities	(52,260)	(21,049)	80,728
Net cash provided by (used in) financing activities	109,439	(41,427)	(173,958)
Effect of exchange rate changes on cash and cash equivalents	51,743	2,043	
Effect of inflation accounting	(1,472)	39,113	
Net increase (decrease) in cash and cash equivalents	Ps. 162,585	Ps. (9,449)	Ps. 5,069

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Notes to the Consolidated Financial Statements (continued)

(In thousands of Argentine Pesos, except share data as otherwise indicated)

21. Differences between Argentine GAAP and US GAAP (continued)

(s) (r) Comprehensive income

On July 1, 1998, the Company adopted SFAS No. 130, Reporting Comprehensive Income . SFAS No. 130 establishes guidelines for the reporting and display of comprehensive income and its components in a full set of general-purpose financial statements. Comprehensive income represents the change in shareholder s equity of the Company during the period from transactions and other events and circumstances from non-owner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners. The adoption of SFAS No. 130 had no impact on total shareholders equity. The following table summarizes the components of comprehensive income for the years ended June 30, 2003, 2002 and 2001.

	Year ended June 30,		
	2003	**2002**	**2001**
Net income (loss) under US GAAP	Ps. 191,248	Ps. (731,470)	Ps. 22,501
Other comprehensive income (loss):			
Foreign currency translation adjustments		112,399	(76,323)
Unrealized loss on available-for-sale-securities	5,669	(8,495)	(38,540)
Unrealized loss on retained interest in transferred mortgage receivables	1,049	(646)	
Unrealized gain on available-for-sale-securities on equity investees	(9)	(1,055)	1,064
Comprehensive income (loss)	Ps. 197,957	(629,267)	Ps. (91,298)

Accumulated nonowner changes in equity (accumulated other comprehensive income) at June 30 were as follows:

	2003	**2002**	**2001**
Foreign currency translation adjustment	Ps.	Ps.	Ps. (112,399)
Unrealized (loss) gain on available-for-sale securities	3,542	(2,127)	6,368
Unrealized loss on retained interest in transferred mortgage receivables	403	(646)	
Unrealized gain on available-for-sale-securities on equity investees		9	1,064
Accumulated other comprehensive income (loss)..	Ps. 3,945	Ps. (2,764)	Ps. (104,967)

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Notes to the Consolidated Financial Statements (continued)

(In thousands of Argentine Pesos, except share data as otherwise indicated)

21. Differences between Argentine GAAP and US GAAP (continued)

(s) Investments in real estate and accumulated depreciation

The following is a summary of the Company s investments in real estate as of June 30, 2003 prepared in accordance with SEC Regulation S-X 12-28.

escription	Land	Buildings and improvements	Improvements	Total buildings and Improvements	Total	Accumulated depreciation	Net carrying value as of June 30	Date of construction	Date acquired	Life on which depreciation in latest income statements is computed
ipacha 652	Ps. 2,533	Ps. 6,369	Ps. 4,347	Ps. 10,716	Ps. 13,249	Ps. 3,304	Ps. 9.945	April-June 1994	November 1991	
v. de Mayo 595	679	987	3,919	4,906	5,585	1,473	4,112	July 1992	March 1992	
sina 934	354	1,421		1,421	1,775	290	1,485		August 1991	
onstitución 1111	584				584	181	403	September 1994 March 1995	June 1994 January 1994	
econquista 823	4,942	15,872		15,872	20,814	3,739	17,075	June 1995	November 1993	
rmiento 517	46	171		171	217	51	166	March 1995	December 1994 July 1994 August 1994	
v. Madero 942	1,303	1,160		1,160	2,463	457	2,006		July 1994 August 1994	
bertador 602	699	2,164	2	2,166	2,865	377	2,488		May 1996	
aipú 1300	10,294	35,665	1,288	36,953	47,247	6,476	40,771		September 1995	
adero 1020	6,222	1,579		1,579	7,801	1,368	6,433		December 1995	
bertador 498	11,731	29,710		29,710	41,441	5,997	35,444		December 1995	
minar	6,595	22,657	696	23,353	29,948	1,927	28,021	N/A	March 1999	
lificios Costeros	5,948	13,102		13,102	19,050	1,113	17,937	September 1998	March 1997	
tercontinental Plaza	8,669	49,112	473	49,585	58,254	(5,474)	63,728	June 1996	November 1997	
to Palermo Plaza	1				1	(1)	2	December 1996 March 1997 September 1997	November 1997	
to Palermo Park	474				474	54	420	June 1996	November 1997	
otel Libertador	3,027	60,399	216	60,615	63,642	29,028	34,614	October 1973 November 1990 December 1997	March 1998	
otel Intercontinental	8,672	29,915	26	29,941	38,613	(2,350)	40,963	December 1994	November 1997	
ock IV	2,726	15,466		15,466	18,192	626	17,566		June 2001	
dvances payment on Hotel Piscis									May 2002	

basto	9,752	240,558	9,279	249,837	259,589	38,275	221,314	November 1998	N/A
to Palermo	8,694	396,455	332	396,787	405,481	158,004	247,477	October 1990	November 1997 and March 1998
to Avellaneda	17,349	145,983	151	146,134	163,483	58,350	105,133	October 1995	November and December 1997
seo Alcorta	8,006	96,144	491	96,635	104,641	31,951	72,690	June 1992	June 1997
to Noa	357	30,787	103	30,890	31,247	7,437	23,810	September 1994	March 1995, September 1996 and January 2000
uenos Aires Desing		42,348	6,543	48,891	48,891	23,051	25,840	November and December 1993	November 1997
tio Bullrich	8,419	150,267	24	150,291	158,710	30,907	127,803	September 1988	October 1998
	Ps. 128,076	Ps. 1.388,291	Ps. 27,890	Ps. 1,416,181	Ps. 1,544,257	Ps. 396,611	Ps. 1,147,646		

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IRSA Inversiones y Representaciones Sociedad Anónima

Notes to the Consolidated Financial Statements (continued)

(In thousands of Argentine Pesos, except share data as otherwise indicated)

21. Differences between Argentine GAAP and US GAAP (continued)

(s) Investments in real estate and accumulated depreciation (continued)

	Year Ended June 30,		
	2003	**2002**	**2001**
Balance, beginning of the year	Ps. 389,327	Ps. 497,400	Ps. 523,074
Additions during the year:			
Acquisitions	1,156,166		
Improvements	31,783	134	3,318
Transfers from real estate inventory	1,212		2,938
Recovery of impairment	18,177		
Transfers from intagible assets	95		
Transfers from leasehold improvements	7,022		
Transfers from work-in-progress leasehold improvements	998		
Advance payments on properties		21,196	
	1,604,780	518,730	529,330
Deductions during the year:			
Transfers to real estate inventory	(16,642)	(46,969)	(29,820)
Impairment loss	(23,711)	(82,434)	
Sales	(5,288)		(2,110)
	(45,641)	(129,403)	(31,930)
Balance, end of the year	Ps. 1,559,139	Ps. 389,327	Ps. 497,400

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Notes to the Consolidated Financial Statements (continued)

(In thousands of Argentine Pesos, except share data as otherwise indicated)

21. Differences between Argentine GAAP and US GAAP (continued)

(t) Mortgage loans on real estate

Prepared in accordance with SEC Regulation S-X 12-29

Col. A.	Col. B.	Col. C.	Col. D.	Col. E.	Col. F.	Col. G.	Col. H.
Description	Interest Rate	Final maturity date	Periodic payment term	Prior liens	Face amount of mortgages	Carrying amount of mortgages	Principal amount of loans subject to delinquent principal or interest
Customer A	12-14%	June 2009	Monthly	None	531	456	None
Customer B	12-14%	December 2007	Monthly	None	249	207	None
Customer C	14%	June 20014	Monthly	None	128	94	None
Customer D	16%	December 2014	Monthly	None	80	78	None
Customer E			Monthly	None		84	None
Customer F	15%	December 2009	Monthly	None	66	86	None
Customer G	14%	June 2014	Monthly		70	91	None
Customer H	14%	June 2010	Monthly		161	103	None
Customer I			Monthly			113	None
Mortgage loans under US$ 30,000	12-16%	July 2003-March 2007-April 2009	Monthly	None	Open	108	None
Mortgage loans US$ 30,000-49,999	12-17%	July 2003-May 2009	Monthly	None	Open	223	None
Mortgage loans US$ 50,000-69,999	9-15%	December 2006-September 2014-January 2015	Monthly	None	Open	465	None
Mortgage loans over US$ 70,000	10-15%	June 2010	Monthly	None	Open	459	None
					Ps. 1,285	Ps. 2,567	

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Notes to the Consolidated Financial Statements (continued)

(In thousands of Argentine Pesos, except share data as otherwise indicated)

21. Differences between Argentine GAAP and US GAAP (continued)

(t) Mortgage loans on real estate (continued)

The summary of activity in mortgage receivables is as follows:

	Year Ended June 30,		
	2003	**2002**	**2001**
Balance, beginning of year	Ps.5,050	Ps.66,681	Ps.78,488
Additions during the year:			
Mortgage loans acquired (Apsa)	1,875		
New mortgage loans		1.642	15.633
Deductions during the year:			
Securitization		(43,121)	
Collections of principal	(4,358)	(20,152)	(27,440)
Balance, end of year	Ps.2,567	Ps.5,050	Ps.66,681

22. Other financial statement information

The following tables present additional financial statement disclosures required under Argentine GAAP:

a. Fixed assets, net

b. Intangible assets, net

c. Allowances and provisions

d. Cost of sales, leases and services

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IRSA Inversiones y Representaciones Sociedad Anónima and Subsidiaries

Notes to the Consolidated Financial Statements (continued)

(In thousands of Argentine Pesos, except share data as otherwise indicated)

22. Other financial statement information

a. Fixed assets, net

	Original value				Depreciation				Net carrying value as of June 30,		
						Current year					
Principal account	Value as of Beginning of year	Additions, transfers and restoration of impairment	Deductions, transfers and impairment loss	Value as of end of year	Accumulated as of beginning of year	Increases / (decreases) and transfers	Amount (i)	Accumulated as of end of year	2003	2002	2001
Facilities	Ps. 46,099	Ps. 12,345	Ps. (8)	Ps. 58,436	Ps. 28,642	Ps. 8,449	Ps. 3,700	Ps. 40,791	Ps. 17,645	Ps. 17,457	Ps. 19,026
Furnitures and fixtures	26,435	11,653	(27)	38,061	20,661	8,768	2,606	32,035	6,026	5,774	7,707
Machinery and equipment	4,119	1		4,120	3,819	22	90	3,931	189	300	517
Computer equipment	8,039	18,421	(34)	26,426	7,349	12,211	2,533	22,093	4,333	690	1,180
Vehicles	197	164		361	197	125	6	328	33		
Leasehold improvements	7,150	13,806	(8,235)	12,721	4,830	3,045	2,632	10,507	2,214	2,320	2,790
Advances to suppliers	357		(343)	14	14			14		343	1,020
Properties											
Alsina 934	1,775			1,775	262		28	290	1,485	1,513	1,542
Alto Palermo Park	844	67	(437)	474	42	(11)	23	54	420	802	3,074
Alto Palermo Plaza	1,011	1,062	(2,072)	1	164	(209)	44	(1)	2	847	4,211
Av. de Mayo 595	5,585			5,585	1,384		89	1,473	4,112	4,201	6,364
Av. de Mayo 701											
Av. Madero 942	5,490		(3,027)	2,463	835	(426)	48	457	2,006	4,655	5,844
Cerviño 3626											
Constitución 1111	584			584	176		5	181	403	408	6,135
Costeros Dique IV	18,192			18,192	351		275	626	17,566	17,841	2,725
Dique II Edificio A y B	19,047	3		19,050	792		321	1,113	17,937	18,255	20,935
Dique II Edificio C y D	5,565	5	(5,570)							5,565	6,152
Dorrego 1916											
Florida 291											
Galeras Pacífico											
Hotel Intercontinental	38,613			38,613	(2,206)	(209)	65	(2,350)	40,963	40,819	48,338
Hotel Libertador	63,640	2		63,642	28,042	(10)	996	29,028	34,614	35,598	36,612
Hotel Llao Llao											
Intercontinental Plaza	58,251	3		58,254	(6,828)	(16)	1,370	(5,474)	63,728	65,079	72,844
Laminar	29,945	3		29,948	1,466	3	458	1,927	28,021	28,479	32,737
Libertador 498	43,625		(2,184)	41,441	5,707	(307)	597	5,997	35,444	37,918	54,121
Libertador 602	2,865			2,865	337		40	377	2,488	2,528	3,207

Madero 1020	11,733		(3,932)	7,801	1,594	(386)	160	1,368	6,433	10,139	20,745
Maipu 1300	47,244	3		47,247	5,749		727	6,476	40,771	41,495	47,875
Montevideo 1975 (Rosario)											
Otros inmuebles para alquiler											
Palacio Alcorta											
Palacio de la Reconquista											
Puerto Madero Dock 5											2,414
Puerto Madero Dock 6											
Reconquista 823	21,194		(380)	20,814	3,428		311	3,739	17,075	17,766	21,678
Rivadavia 2243											8,249
Rivadavia 2768											338
Santa Fe 1588											8,381
Sarmiento 517	303	175	(261)	217	44	(1)	8	51	166	259	583
Serrano 250											
Suipacha 652	13,249			13,249	3,110		194	3,304	9,945	10,139	14,637
Hotel Piscis	583	4,705	(5,288)			(41)	41			583	

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IRSA Inversiones y Representaciones Sociedad Anónima and Subsidiaries

Notes to the Consolidated Financial Statements (Continued)

(In thousands of Argentine Pesos, except share data as otherwise indicated)

22. Other financial statement information (continued)

a. Fixed assets, net (continued)

	Original value				Depreciation				Net carrying value as of June 30,		
						Current year					
Principal account	Value as of Beginning of year	Additions and transfers and restoration of impairment	Deductions, transfers and impairment loss	Value as of end of year	Accumulated as of beginning of year	Increases / (decreases) and transfers	Amount (i)	Accumulated as of end of year	2003	2002	2001
Shopping Centers:											
Abasto		259,589		259,589		30,460	7,815	38,275	221,314		
Alto Palermo		405,481		405,481		139,448	18,556	158,004	247,477		
Alto Avellaneda		163,483		163,483		51,489	6,861	58,350	105,133		
Paseo Alcorta		104,641		104,641		27,907	4,044	31,951	72,690		
Alto Noa		31,247		31,247		6,412	1,025	7,437	23,810		
Buenos Aires Desing		48,891		48,891		20,731	2,320	23,051	25,840		
Patio Bullrich		158,710		158,710		24,385	6,522	30,907	127,803		
Other	11,852	11,278		23,130	2,922	164	609	3,695	19,435	8,930	9,270
Total as of June 30, 2003	Ps. 493,586	Ps. (ii) 1,245,738	(iii) (31,798)	Ps. 1,707,526	Ps. 112,883	Ps. (iv) 332,003	Ps. 65,119	Ps. 510,005	Ps. 1,197,521		
Total as of June 30, 2002	Ps. 600,310	Ps. 23,663	Ps. (130,387)	Ps. 493,586	Ps. 129,059	Ps. (33,071)	Ps. 16,895	Ps. 112,883		Ps. 380,703	
Total as of June 30, 2001	Ps. 621,958	Ps. 10,663	Ps. (32,311)	Ps. 600,310	Ps. 114,627	Ps. (3,180)	Ps. 17,612	Ps. 129,059			471,251

(i) The allocation of annual depreciation charges in the consolidated statements of income is included in Other expenses (Note 22.f.).
(ii) Includes:

- Ps. 1,203,019 for consolidation of APSA;
- Ps. 1,212 transfers from inventories to fixed assets;
- Ps. 112 transfers from intangible asset to fixed assets;

- Ps. 11,637 transfers from equity investees as a consequence of APSA consolidation

- Ps. 15,532 restoration of previously recognized impairment losses

(iii) Includes
- Ps. (21,245) transfers from fixed assets to inventories .

- Ps. (1,892) impairment .

(iv) Includes
- Ps. 336,419 for consolidation of APSA;

- Ps. (1,394) transfers to inventories from fixed assets;

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Notes to the Consolidated Financial Statements (Continued)

(In thousands of Argentine Pesos, except share data as otherwise indicated)

22. Other financial statement information (continued)

b. Intangible assets, net:

	Original value			Amortization				Net carrying value as of June 30,		
					For the year					
Principal account	Value as of beginning of year	Additions / (deductions)	Value as of end of year	Accumulated as of beginning of year	Increases / (decreases)	Amount (i)	Accumulated as of end of year	2003	2002	2001
Preoperating and organization expenses	Ps. 2,178	Ps. (iii) 13,286	Ps. 15,464	Ps. 2,003	Ps. 11,068	Ps. 784	Ps. 13,855	Ps 1,609	Ps. 175	Ps. 434
Deferred financing costs	19,131	(iv) 5,161	24,292	16,289	(viii) (138)	8,141	24,292		2,842	5,148
Selling and advertising expenses	7,741	(191)	7,550	6,318	(77)	553	6,794	756	1,423	2,192
Trademarks		(v) 521	521		173	81	254	267		
Expenses related to securitization of receivables		6,975	6,975		3,536	3,105	6,641	334		
Advertising expenses		5,706	5,706		5,653	15	5,668	38		
Investment projects		(vi) 4,899	4,899		(vi) 3,678	986	4,664	235		
Total as of June 30, 2003	Ps. 29,050	Ps. (ii) 36,357	Ps. 65,407	Ps. 24,610	Ps. (vii) 23,893	Ps. 13,665	Ps. 62,168	Ps. 3,239	Ps.	Ps.
Total as of June 30, 2002	Ps. 35,814	Ps. (6,764)	Ps. 29,050	Ps. 28,040	Ps. (10,170)	Ps. 6,740	Ps. 24,610	Ps.	Ps. 4,440	Ps.
Total as of June 30, 2001	Ps. 30,411	Ps. 5,403	Ps. 35,814	Ps. 19,688	Ps. 3	Ps. 8,349	Ps. 28,040	Ps.	Ps.	Ps. 7,774

(i) The allocation of annual amortization charges in the consolidated statements of income is included in Note 22.f., except for Ps. 3,105 and Ps. 4,357 for the year ended 2003 allocated in Net (loss) income in credit card trust and Interest on discount by liabilities respectively, Ps. 96 and Ps. 193, for the years ended June 30, 2002 and 2001, respectively, included in Other income (expenses), net.

(ii) Includes Ps. 70,447 for consolidation of APSA and Ps. 72 for consolidation of BATAFCSA.

(iii) Includes Ps. (1,508) for impairment charges .

(iv) Includes Ps. (1,104) for reclassification to short and long term debt.

(v) Includes Ps. (67) for impairment charges .
(vi) Includes Ps. (58) for impairment charges and Ps. (112) for transfers to fixed assets.
(vii) Includes Ps. 62,153 for consolidation of APSA and Ps. 36 for consolidation of BATAFCSA.
(viii) Includes Ps. (138) for reclassification to to short and long term debt.

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Notes to the Consolidated Financial Statements (continued)

(In thousands of Argentine Pesos, except share data as otherwise indicated)

22. Other financial statement information (continued)

c. Allowances and provisions

Item	Balances as of beginning of year	Additions due to consolidation of equity investees	Additions (i)	Deductions	Carrying value of June 30, 2003	Carrying value of June 30, 2002	Carrying value of June 30, 2001
Deducted from current assets:							
Allowance for doubtful accounts	1,372	56,426	9,139	(20,237)	46,700	1,372	2,018
Total as of June 30, 2003	1,372	56,426	9,139	(20,237)	46,700		
Total as of June 30, 2002	2,018		530	(1,176)		1,372	
Total as of June 30, 2001	1,844		464	(290)			2,018
Deducted from non-current assets:							
Allowance for doubtful accounts		75		(21)	54		
Allowance for doubtful mortgage receivable		2,481		(273)	2,208		
Allowance for impairment of fixed assets	55,896	41,100	1,892	(ii)(19,844)	79,044	55,896	
Allowance for impairment of inventories	12,621		844	(11,285)	2,180	12,621	
Allowance for impairment of parcels of undeveloped land	9,328	21,671	(iii)22,878	(iv)(9,851)	44,026	9,328	
Allowance for impairment of intangible assets			1,633		1,633		
Allowance for impairment of non current investments			7,474		7,474		
Total as of June 30, 2003	77,845	65,327	34,721	(41,274)	136,619		
Total as of June 30, 2002			82,634	(4,789)		77,845	
Total as of June 30, 2001							
Included in current liabilities:							
Provision for contingencies	494	3,904	1,203	(4,431)	1,170	494	149
Total as of June 30, 2003	494	3,904	1,203	(4,431)	1,170		
Total as of June 30, 2002	149		575	(230)		494	
Total as of June 30, 2001	98		578	(527)			149

Included in non-current liabilities:							
Provision for contingencies	401	4,938	2,666	(3,323)	4,682	401	232
Total as of June 30, 2003	401	4,938	2,666	(3,323)	4,682		
Total as of June 30, 2002	232		372	(203)		401	
Total as of June 30, 2001	2,374		75	(2,217)			232

(i) The accounting allocation of the charges for the year ended June 30, 2003, 2002 and 2000 is the follows:
- Doubtful accounts are disclosed in Note 22.f..
- Debtors under legal proceedings is disclosed in Other income (expenses), net (Note 10.)
- Impairment of fixed assets, inventories, parcels of undeveloped land and intangible assets are included in Gain (loss) from operations and holdings of real estate assets .
- Impairment of non current investments are included in Equity in (losses) earnings on affiliated companies .

(ii) Includes recovery of impairment of Ps. 15,532.
(iii) Includes impairment of the year of Ps. 9,628 and Ps transfer form inventory of Ps. 13,250.
(iv) Corresponds to the recovery of impairment of Ps. 9.851.

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Notes to the Consolidated Financial Statements (continued)

(In thousands of Argentine Pesos, except share data as otherwise indicated)

22. Other financial statement information (continued)

d. Cost of sales, leases and services

	Year ended June 30,		
	2003	**2002**	**2001**
I. Cost of sales			
Stock as of beginning of year (i)	Ps. 79,159	103,099	145,185
Plus:			
Additions due to consolidation of equity investees.	1,315		
Expenses (Note 22.f.)	3,517	9,892	10,287
Transfers to fixed assets	(1,212)		(2,706)
Transfers to intangible assets			(669)
Transfers to parcels of undeveloped land	(39,529)		
Transfers from fixed assets	19,851	41,420	26,754
Transfers from mortgages receivable	2,757		
Transfers from mortgages payable	2,078		
Less:			
Adjustment to purchase price of inventory	2,297	(14,320)	773
Stock as of end of year (i)	(22,985)	(79,159)	(103,099)
Subtotal	47,248	60,932	76,525
Plus:			
Results from holding of real estate assets	(844)	(17,411)	(4,304)
Cost of properties sold	46,404	43,521	72,221
II. Cost of leases			
Expenses (Note 22.f.)	67,439	12,392	11,276
Cost of properties leased	67,439	12,392	11,276
III. Cost of fees for services			
Expenses (Note 22.f.)	1,232	767	4,246
Cost of fees for services	1,232	767	4,246
IV. Cost of hotel activities			
Stock as of beginning of year (i)	273	485	728
Plus:			
Purchases of the year			242

Expenses (Note 22.f.)	19,629	27,201	36,927
Stock as of end of year (i)	(357)	(273)	(485)
Cost of hotel activities	19,545	27,413	37,412
V. Cost of credit card operations			
Expenses (Note 22.f.)	8,330		
Cost of fees for services	8,330		
TOTAL COSTS	Ps. 142,950	Ps. 84,093	Ps. 125,155

(i) The book value of inventories at June 30, 2003 and 2002 are net of the impairment loss mentioned in Note 4.d.

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Notes to the Consolidated Financial Statements (continued)

(In thousands of Argentine Pesos, except share data as otherwise indicated)

22. Other financial statement information (continued)

e. Foreign currency assets and liabilities

Captions	Currency	Amount of foreign currency	Current Exchange rate (i)	Total as of June 30, 2003	Total as of June 30, 2002
Assets					
Current assets					
Cash and banks:					
Cash	US$	1,472,588	0.0027	Ps. 3,976	Ps. 8,409
Cash	Euros	160	0,0031		
Cash	Travel	2,670	0,0027	7	
Bank accounts	US$	18,959,155	0.0027	51,190	2,150
Bank accounts	Euros	3,031,604	0,0031	9,398	
Saving accounts	US$	5,148,610	0,0027	13,901	
Checks to be deposited	US$		0.0027		2,127
Investments:					
Boden	US$	27,292	0.0027	74	
Mutual funds	US$	44,677,748	0.0027	120,630	8,254
Mutual funds	Euros	30,113	0.0031	93	
Mortgages and leases receivable, net:					
Mortgages and leases receivable	US$	23,622	0.0027	64	
Other receivables and prepaid expenses:					
Interest rate swap receivable	US$	109,595	0,0028	307	
Prepaid expenses	US$	61,102	0.0027	165	17
Total current assets				Ps. 199,805	Ps. 20,957
Non-current assets					
Other receivables and prepaid expenses:					
Related parties	US$		0.0028		41,179
Interest rate swap receivable	US$	2,918,658	0,0028	8,172	
Fixed assets	US$		0.0027		582
Total non-current assets				Ps. 8,172	Ps. 41,761
Total assets as of June 30, 2003				Ps. 207,977	
Total assets as of June 30, 2002					Ps. 62,718

(i) Official exchange rate prevailing as of June 30, 2003, except otherwise indicated.

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Notes to the Consolidated Financial Statements (continued)

(In thousands of Argentine Pesos, except share data as otherwise indicated)

22. Other financial statement information (continued)

e. Foreign Currency Assets and Liabilities (continued)

Captions	Currency	Amount of foreign currency	Current Exchange rate (i)	Total as of June 30, 2003	Total as of June 30, 2002
Liabilities					
Current liabilities					
Trade accounts payable	US$	406,297	0.0028	Ps. 1,138	Ps. 235
Customer advances	US$	50,784	0.0028	142	
Mortgages payable	US$	750,000	0,0028	2,100	
Short term debt	US$	26,634,870	0.0028	74,578	630.623
Taxes payable	US$	27,147	0.0028	76	7,112
Other liabilities:					
Other	US$	131,357	0.0028	368	912
Total current liabilities				Ps. 78,402	Ps. 638,882
Non-current liabilities					
Trade accounts payable	US$	1,289,153	0.0028	3,610	
Long term debt	US$	183,668,987	0.0028	514,273	
Total non-current liabilities				Ps. 517,883	Ps.
Total liabilities as of June 30, 2003				Ps. 596,285	
Total liabilities as of June 30, 2002					Ps. 638,882

(i) Official exchange rate prevailing as of June 30, 2003

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Notes to the Consolidated Financial Statements (continued)

(In thousands of Argentine Pesos, except share data as otherwise indicated)

22. Other financial statement information (continued)

f. Other expenses

	EXPENSES										
Items	**Cost of properties sold**	**Cost of properties leased**	**Cost of fees for services**	**Cost of hotel activities**	**Cost of credit card operations**	**Administrative**	**Selling**	**Financing**	**Total for the year 2003**	**Total for the year 2002**	**Total for the year 2001**
Depreciation and amortization	Ps. 294	Ps. 56,465	Ps.	Ps. 3,725	Ps. 894	Ps. 5,972	Ps. 551	Ps. 3,421	Ps. 71,322	Ps. 23,539	Ps. 25,768
Interest and index adjustment								61,871	61,871	53,404	63,855
Salaries and bonuses	178			4,988	2,503	9,541	1,957		19,167	22,005	31,109
Fees and payments for services	29	2,270		1,485	1,083	6,879	127		11,873	9,942	12,076
Maintenance of building	2,078	3,419		2,882	99	705	23		9,206	9,640	16,887
Allowance for doubtful accounts						518	8,621		9,139	530	457
Director s fees						8,900			8,900	1,165	1,584
Gross sales tax							6,305		6,305	2,870	5,096
Commissions and property sales charges				542	2,026	939	1,831		5,338	9,113	10,483
Condominium expenses		4,744							4,744		
Taxes, rates and contributions	47	187			1,326	3,056	1		4,617	2,158	3,430
Social security contributions	38			1,379	63	1,741	382		3,603	2,879	4,295
Advertising						87	2,559		2,646	2,511	3,761
Travel expenses				1,967		57			2,024	2,814	3,000
Mail and telephone				1,358		134	56		1,548	1,386	1,097
Freight and transportation				114	129	810	250		1,303	850	1,227

Lease expense		88			60	883			1,031	507	1,179
Bank charges	16					327		344	687	791	906
Safe deposits box						275		35	310	203	400
Subscriptions and publications						175			175		
Other	837	266	1,232	1,189	147	726	2,920	39	7,356	11,574	9,964
Total as of June 30, 2003	Ps. 3,517	Ps. 67,439	Ps. 1,232	Ps. 19,629	Ps. 8,330	Ps. 41,725	Ps. 25,583	Ps. 65,710	Ps. 233,165	Ps.	Ps.
Total as of June 30, 2002	Ps. 9,892	Ps. 12,392	Ps. 767	Ps. 27,201	Ps.	Ps. 32,057	Ps. 11,281	Ps. 64,291	Ps.	Ps. 157,881	Ps.
Total as of June 30, 2001	Ps. 10,287	Ps. 11,276	Ps. 4,246	Ps. 36,927	Ps.	Ps. 39,996	Ps. 22,279	Ps. 71,563	Ps.	Ps.	Ps. 196,574