NEOSE TECHNOLOGIES INC
Form 10-Q
November 02, 2005

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2005.

OR

o **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: 0-27718

NEOSE TECHNOLOGIES, INC.

(Exact name of registrant as specified in its charter)

Delaware	13-3549286
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
102 Witmer Road Horsham, Pennsylvania	19044
(Address of principal executive offices)	(Zip Code)

(215) 315-9000

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes þ No o

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes þ No o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No þ

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date: 32,782,372 shares of common stock, $.01 par value, were outstanding as of November 1, 2005.

NEOSE TECHNOLOGIES, INC.
INDEX

	Page
PART I. FINANCIAL INFORMATION:	
Item 1. Financial Statements (unaudited)	
Balance Sheets as of September 30, 2005 and December 31, 2004	3
Statements of Operations for the three and nine months ended September 30, 2005 and 2004	4
Statements of Cash Flows for the nine months ended September 30, 2005 and 2004	5
Notes to Financial Statements	6
Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations	22
Item 4. Controls and Procedures	35
PART II. OTHER INFORMATION:	
Item 6. Exhibits	36
SIGNATURES	37

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

Neose Technologies, Inc.
Balance Sheets
(unaudited)
(in thousands, except per share amounts)

	September 30, 2005	December 31, 2004
Assets		
Current assets:		
Cash and cash equivalents	$ 35,476	$ 45,048
Marketable securities	9,977	
Accounts receivable and other current assets	2,045	2,768
Total current assets	47,498	47,816
Property and equipment, net	25,010	41,133
Intangible and other assets, net	1,103	1,782
Total assets	$ 73,611	$ 90,731
Liabilities and Stockholders Equity		
Current liabilities:		
Note payable	$ 258	$
Current portion of long-term debt and capital lease obligations	4,417	4,586
Accounts payable	613	1,783
Accrued compensation	1,560	1,916
Accrued expenses	2,763	2,052
Deferred revenue	1,275	1,560
Total current liabilities	10,886	11,897
Long-term debt and capital lease obligations	11,284	13,759
Deferred revenue, net of current portion	3,316	3,688
Other liabilities	486	533
Total liabilities	25,972	29,877
Stockholders equity:		
Preferred stock, par value $.01 per share, 5,000 shares authorized, none issued		
Common stock, par value $.01 per share, 50,000 shares authorized; 32,782 and 24,717 shares issued and outstanding	328	247
Additional paid-in capital	278,875	248,027
Deferred compensation	(10)	(39)
Accumulated deficit	(231,554)	(187,381)
Total stockholders equity	47,639	60,854

Total liabilities and stockholders equity	$	73,611	$	90,731

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

Neose Technologies, Inc.
Statements of Operations
(unaudited)
(in thousands, except per share amounts)

	Three months ended September 30,		Nine months ended September 30,	
	2005	2004	2005	2004
Revenue from collaborative agreements	$ 1,503	$ 1,451	$ 4,271	$ 3,592
Operating expenses:				
Research and development	7,521	9,305	26,133	24,971
General and administrative	2,685	2,861	8,469	9,047
Restructuring charges	14,002		14,002	
Total operating expenses	24,208	12,166	48,604	34,018
Operating loss	(22,705)	(10,715)	(44,333)	(30,426)
Other income			22	
Interest income	415	195	1,138	431
Interest expense	(331)	(304)	(1,000)	(658)
Net loss	$ (22,621)	$ (10,824)	$ (44,173)	$ (30,653)
Basic and diluted net loss per share	$ (0.69)	$ (0.44)	$ (1.42)	$ (1.38)
Weighted-average shares outstanding used in computing basic and diluted net loss per share	32,782	24,712	31,188	22,284

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

Neose Technologies, Inc.
Statements of Cash Flows
(unaudited)
(in thousands)

	Nine months ended September 30,	
	2005	2004
Cash flows from operating activities:		
Net loss	$ (44,173)	$ (30,653)
Adjustments to reconcile net loss to net cash used in operating activities:		
Impairment of property and equipment	13,187	
Depreciation and amortization expense	3,831	4,433
Non-cash compensation expense	484	93
Loss (gain) on disposition of property and equipment	(21)	5
Changes in operating assets and liabilities:		
Accounts receivable and other current assets	831	(907)
Intangible and other assets		2
Accounts payable	(1,054)	(551)
Accrued compensation	26	(570)
Accrued expenses	774	575
Deferred revenue	(657)	387
Other liabilities	(47)	129
Net cash used in operating activities	(26,819)	(27,057)
Cash flows from investing activities:		
Purchases of property and equipment	(719)	(8,942)
Proceeds from sale of property and equipment	70	
Proceeds from settlement of property and equipment dispute	25	
Purchases of marketable securities	(9,845)	
Proceeds from maturities of marketable securities		5,000
Net cash used in investing activities	(10,469)	(3,942)
Cash flows from financing activities:		
Proceeds from issuance of debt	1,484	12,696
Repayments of debt	(3,860)	(5,756)
Debt issuance costs		(103)
Restricted cash related to debt		901
Proceeds from issuance of common stock, net	30,092	30,103
Proceeds from exercise of stock options		73
Net cash provided by financing activities	27,716	37,914
Net increase (decrease) in cash and cash equivalents	(9,572)	6,915
Cash and cash equivalents, beginning of period	45,048	48,101
Cash and cash equivalents, end of period	$ 35,476	$ 55,016

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

NEOSE TECHNOLOGIES, INC.
NOTES TO FINANCIAL STATEMENTS
(unaudited)
(in thousands, except per share amounts)

1. Organization and Business Activities

Neose Technologies, Inc. is a biopharmaceutical company using its enzymatic technologies to develop proprietary drugs, focusing primarily on therapeutic proteins.

Our revenue from collaborative agreements increased from $1,435 in the year ended December 31, 2003 to $5,070 in the year ended December 31, 2004. In April 2005, we entered into an agreement with BioGeneriX AG for the use of our GlycoAdvance® and GlycoPEGylation technologies to develop a long-acting version of a currently marketed therapeutic protein (see Note 12). We have partnered five of the six proprietary drug programs that use our technologies and are in various stages of research and preclinical development. We have an additional two proteins available for partnering. Under our collaborative agreements, we have begun to receive significant revenues from our planned principal operation of developing proprietary drugs. As a result of the revenue growth in the year ended December 31, 2004 compared to the year ended December 31, 2003 and because we entered into new collaborative agreements in 2004 and 2005, we are no longer considered a development-stage company as we had been since our inception in January 1989, and all cumulative information reported in prior years is no longer reported.

2. Interim Financial Information

The accompanying unaudited financial statements have been prepared in accordance with U.S. generally accepted accounting principles for presentation of interim financial statements. Accordingly, the unaudited financial statements do not include all the information and footnotes necessary for a comprehensive presentation of the financial position, results of operations, and cash flows for the periods presented. In our opinion, however, the unaudited financial statements include all the normal recurring adjustments that are necessary for a fair presentation of the financial position, results of operations, and cash flows for the periods presented. You should not base your estimate of our results of operations for 2005 solely on our results of operations for the nine months ended September 30, 2005. You should read these unaudited financial statements in combination with the other Notes in this section; Management s Discussion and Analysis of Financial Condition and Results of Operations appearing in Item 2; and the Financial Statements, including the Notes to the Financial Statements, included in our Annual Report on Form 10-K for the year ended December 31, 2004.

3. Summary of Significant Accounting Policies

Use of Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires us to make estimates and assumptions. Those estimates and assumptions affect the reported amounts of assets and liabilities as of the date of the financial statements, the disclosure of contingent assets and liabilities as of the date of the financial

NEOSE TECHNOLOGIES, INC.
NOTES TO FINANCIAL STATEMENTS
(unaudited)
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statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Accounting for Restructuring Costs

In August 2005, we announced that we had implemented a restructuring of operations (see Note 13). Statement of Financial Accounting Standards (SFAS) No. 146, *Accounting for Costs Associated with Exit or Disposal Activities* (SFAS No. 146), addresses financial accounting and reporting for costs associated with exit or disposal activities. SFAS No. 146 requires a liability for a cost associated with an exit or disposal activity be recognized and measured initially at fair value only when the liability is incurred. SFAS No. 146 does not apply to costs associated with a disposal activity covered by SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. The restructuring charges recorded by us during the three months ended September 30, 2005 are comprised primarily of costs to write-off property and equipment and to reduce our workforce.

Under SFAS No. 144, any impairment of property and equipment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. To determine the fair value of assets that are not likely to be used over their remaining useful economic life, we use a probability-weighted approach of estimated cash flows to be received upon a range of possible disposition outcomes. In August 2005, we announced we would evaluate alternatives relative to our current headquarters and pilot manufacturing facility (Witmer Road Facility), which we own subject to a mortgage, including the potential disposition of the facility and further consolidation of our research, development and administrative operations into a currently leased facility also located in Horsham, Pennsylvania. As a result of the announcement, we concluded that identifiable cash flows could be assigned to the Witmer Road Facility and related equipment. We based our estimates of potential cash flows related to possible disposition outcomes on conversations with commercial real estate firms that have both knowledge of recent history of sales and expertise in marketing and selling similar facilities. These estimates may turn out to be incorrect and our actual cash flows may be materially different from our estimates.

Under SFAS No. 146, any employee severance costs are determined based on the estimated severance and fringe benefit charge for identified employees. In calculating the cost to exit facilities, we estimate the future lease and operating costs to be paid until the lease is terminated, the amount, if any, of sublease receipts, and real estate broker fees. This requires us to estimate the timing and costs of the amount of operating costs and the timing and rate at which we might be able to sublease the site. To form our estimates for these costs, we performed an assessment of the affected facility and considered the current market conditions for the site. Our assumptions on operating costs until terminated and offsetting sublease receipts may turn out to be incorrect and our actual costs may be different from our estimates.

NEOSE TECHNOLOGIES, INC.
NOTES TO FINANCIAL STATEMENTS
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Our estimates of future liabilities may change, requiring us to record additional restructuring charges or reduce the amount of liabilities recorded. At the end of each reporting period, we evaluate the remaining accrued restructuring charges to ensure their adequacy, that no excess accruals are retained and the utilization of the provisions are for their intended purposes in accordance with developed exit plans. We periodically evaluate current available information and adjust our accrued restructuring charges as necessary.

Stock-based Compensation

We apply the intrinsic value method of accounting for all stock-based employee compensation in accordance with Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. We record deferred compensation for option grants to employees for the amount, if any, by which the market price per share on the grant date exceeds the exercise price per share. In addition, we apply fair value accounting for option grants to non-employees in accordance with SFAS No. 123, *Accounting for Stock-Based Compensation* (SFAS No. 123), and Emerging Issues Task Force Issue 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*.

We have elected to adopt only the disclosure provisions of SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure, an amendment of FASB Statement No. 123*. The following table illustrates the effect on our net loss and basic and diluted net loss per share if we had recorded compensation expense for the estimated fair value of our stock-based employee compensation, consistent with SFAS No. 123:

	Three months ended September 30,		Nine months ended September 30,	
	2005	2004	2005	2004
Net loss as reported	$ (22,621)	$ (10,824)	$ (44,173)	$ (30,653)
Add: Stock-based employee compensation expense included in reported net loss	(2)	11	820	89
Deduct: Total stock-based employee compensation expense determined under fair value-based method for all awards	(1,193)	(2,634)	(4,139)	(7,732)
Net loss pro forma	$ (23,816)	$ (13,447)	$ (47,492)	$ (38,296)
Basic and diluted net loss per share as reported	$ (0.69)	$ (0.44)	$ (1.42)	$ (1.38)
Basic and diluted net loss per share pro forma	$ (0.73)	$ (0.54)	$ (1.52)	$ (1.72)

NEOSE TECHNOLOGIES, INC.
NOTES TO FINANCIAL STATEMENTS
(unaudited)
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Net Loss Per Share

Basic net loss per share is computed by dividing net loss by the weighted-average number of common shares outstanding for the period. Diluted net loss per share is computed by dividing net loss by the sum of weighted-average number of common shares outstanding for the period and the number of additional shares that would have been outstanding if dilutive potential common shares had been issued. Potential common shares are excluded from the calculation of diluted net loss per share if the effect on net loss per share is antidilutive. Our diluted net loss per share is equal to basic net loss per share for all reporting periods presented because giving effect in the computation of diluted net loss per share to the exercise of outstanding options or granting of restricted stock units would have been antidilutive.

Comprehensive Loss

Comprehensive income (loss) is comprised of net income (loss) and other comprehensive income (loss). Other comprehensive income (loss) includes changes to equity that are not included in net income (loss). Our comprehensive loss for the three and nine months ended September 30, 2005 was comprised only of our net loss, and was $22,621 and $44,173, respectively. Our comprehensive loss for the three and nine months ended September 30, 2004 was comprised only of our net loss, and was $10,824 and $30,653, respectively.

Fair Value of Financial Instruments

The fair value of financial instruments is the amount for which instruments could be exchanged in a current transaction between willing parties. As of September 30, 2005, the carrying values of cash and cash equivalents, marketable securities, accounts receivable and other current assets, accounts payable, accrued expenses, and accrued compensation equaled or approximated their respective fair values because of the short duration of these instruments. The fair value of our debt and capital lease obligations was estimated by discounting the future cash flows of each instrument at rates recently offered to us for similar debt instruments offered by our lenders. As of September 30, 2005, the fair and carrying values of our debt and capital lease obligations were $14,841 and $15,959, respectively.

Recent Accounting Pronouncements

In May 2005, the Financial Accounting Standards Board (FASB) issued SFAS No. 154, *Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3* (SFAS No. 154), which replaces APB Opinion No. 20, *Accounting Changes*, and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements*, and changes the requirements for the accounting for and reporting of a change in accounting principle. SFAS No. 154 applies to all voluntary changes in accounting principle, and also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. SFAS No. 154 will be effective for accounting changes

NEOSE TECHNOLOGIES, INC.
NOTES TO FINANCIAL STATEMENTS
(unaudited)
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and corrections of errors made in fiscal years beginning after December 15, 2005. SFAS No. 154 does not change the transition provisions of any existing accounting pronouncements, including those that are in a transition phase as of the effective date of SFAS No. 154. We do not believe the adoption of SFAS No. 154 will have a material impact on our financial statements.

In March 2005, the FASB issued FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations an interpretation of FASB Statement No. 143* (FIN 47), which will require companies to recognize a liability for the fair value of a legal obligation to perform asset retirement activities that are conditional on a future event if the amount can be reasonably estimated. FIN 47 must be adopted no later than the end of the fiscal year ending after December 15, 2005. We have not completed an assessment of the impact that adoption of FIN 47 will have on our financial statements.

In December 2004, the FASB issued SFAS No. 123R, *Share-Based Payment* (SFAS No. 123R), which requires companies to expense the fair value of stock options and other equity-based compensation to employees. SFAS No. 123R also provides guidance for determining whether an award is a liability-classified award or an equity-classified award, and determining fair value. SFAS No. 123R applies to all unvested stock-based payment awards outstanding as of the adoption date. Pursuant to a rule announced by the Securities and Exchange Commission in April 2005, SFAS No. 123R must be adopted no later than the beginning of the first fiscal year that begins after June 15, 2005. We have not completed an assessment of the impact on our financial statements resulting from potential modifications to our equity-based compensation structure or the use of an alternative fair value model in anticipation of adopting SFAS No. 123R.

In December 2004, the FASB issued SFAS No. 153, *Exchanges of Nonmonetary Assets an amendment of APB Opinion No. 29* (SFAS No. 153). APB Opinion No. 29 requires a nonmonetary exchange of assets be accounted for at fair value, recognizing any gain or loss, if the exchange meets a commercial substance criterion and fair value is determinable. The commercial substance criterion is assessed by comparing the entity s expected cash flows immediately before and after the exchange. SFAS No. 153 eliminates the similar productive assets exception, which accounts for the exchange of assets at book value with no recognition of gain or loss. SFAS No. 153 is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The adoption of SFAS No. 153 did not have an impact on our financial statements.

Reclassification

Certain prior year amounts have been reclassified to conform to current year presentation.

NEOSE TECHNOLOGIES, INC.
NOTES TO FINANCIAL STATEMENTS
(unaudited)
(in thousands, except per share amounts)

4. Supplemental Disclosure of Cash Flow Information

The following table contains additional cash flow information for the periods reported.

	Nine months ended September 30,	
	2005	2004
Supplemental disclosure of cash flow information:		
Gross cash paid for interest	$ 986	$ 533
Less capitalized interest		(130)
Cash paid for interest, net of amounts capitalized	$ 986	$ 403
Non-cash investing activities:		
Decrease in accrued property and equipment	$ (63)	$ (475)
Assets acquired under capital leases	$	$ 184
Decrease in acquisition value of property and equipment related to cancellation of a vendor invoice as partial settlement of dispute (see Note 7)	$ 116	$
Decrease in acquisition value of property and equipment related to receivable from vendor as partial settlement of dispute (see Note 7)	$ 50	$
Decrease in acquisition value of property and equipment due to decrease in amount of remaining minimum lease payments under capital lease	$ 10	$
Non-cash financing activity:		
Conversion of accrued compensation from liability to equity classified award upon grant of restricted stock units (see Note 11)	$ 382	$

5. Marketable Securities

As of September 30, 2005, we held a marketable security that was an obligation of a U.S. government agency. The security, which was classified as held-to-maturity, had an original maturity of approximately six months. As of September 30, 2005, the amortized cost of the security was $9,977, which included $132 of accrued interest, and the fair value was $9,980. We held no marketable securities that matured during the nine months ended September 30, 2005. We received proceeds of $5,000 during the nine months ended September 30, 2004 from the maturity of marketable securities. As of December 31, 2004, we held no marketable securities.

NEOSE TECHNOLOGIES, INC.
NOTES TO FINANCIAL STATEMENTS
(unaudited)
(in thousands, except per share amounts)

6. Accounts Receivable and Other Current Assets

Accounts receivable and other current assets consisted of the following:

	September 30, 2005	December 31, 2004
Accounts receivable	$ 1,069	$ 2,150
Prepaid insurance (see Note 9)	287	102
Other prepaid expenses	531	406
Receivable from related party	30	31
Other current assets	128	79
	$ 2,045	$ 2,768

7. Property and Equipment

Property and equipment consisted of the following:

	September 30, 2005	December 31, 2004
Building and facility improvements	$ 19,129	$ 38,270
Laboratory, manufacturing, and office equipment	9,691	19,364
Land	357	700
Construction-in-progress		157
	29,177	58,491
Less accumulated depreciation and amortization	(4,167)	(17,358)
	$ 25,010	$ 41,133

As part of the restructuring announced in August 2005 (see Note 13), we decided to centralize research activities in Horsham, Pennsylvania by ending operations in our leased facility in San Diego, California. During the three months ended September 30, 2005, we recorded a non-cash impairment charge of approximately $187 related to property and equipment located in the San Diego facility. The aggregate acquisition value of the impaired assets was reduced by $745 and the related accumulated depreciation and amortization was reduced by $558. This impairment charge was included in restructuring charges on our statements of operations.

We also announced we would evaluate alternatives relative to our Witmer Road Facility, which we own subject to a mortgage, including the potential disposition of the facility and further consolidation of our research, development and administrative operations into a currently leased facility that is also located in Horsham, Pennsylvania. As a result of the announcement, we concluded that identifiable cash flows could be assigned to the Witmer Road Facility and

NEOSE TECHNOLOGIES, INC.
NOTES TO FINANCIAL STATEMENTS
(unaudited)
(in thousands, except per share amounts)

related equipment. To determine the appropriate carrying value of these assets, we used a probability- weighted approach of estimated cash flows to be received upon a range of possible disposition outcomes. We based our estimates of potential cash flows related to possible disposition outcomes on conversations with commercial real estate firms that have both knowledge of recent history of sales and expertise in marketing and selling similar facilities. Based on those estimates, we recorded during the third quarter of 2005 a non-cash impairment charge of $13,000, which was included in restructuring charges on our statements of operations, on our Witmer Road Facility and related equipment. The aggregate acquisition value of the impaired assets was reduced by $29,007 and the related accumulated depreciation and amortization was reduced by $16,007.

Laboratory, manufacturing, and office equipment as of September 30, 2005 and December 31, 2004 included $530 and $1,021, respectively, of assets acquired under capital leases. Accumulated depreciation and amortization as of September 30, 2005 and December 31, 2004 included $289 and $429, respectively, related to assets acquired under capital leases. Depreciation expense, which includes amortization of assets acquired under capital leases, was $3,391 and $3,680 for the nine months ended September 30, 2005 and 2004, respectively. Research and development expenses on our statements of operations include a gain of $21 during the three and nine months ended September 30, 2005 from the sale of assets that were held for sale as of December 31, 2004 and a loss of $5 during the nine months ended September 30, 2004 from the disposition of property and equipment. During the nine months ended September 30, 2005 and 2004, we disposed of fully depreciated assets that had an original acquisition value of $17 and $2, respectively.

During the three months ended September 30, 2005, we settled a dispute with a vendor from which we had purchased property and equipment. The vendor agreed to pay us $75, of which $25 was paid upon execution of the settlement agreement and the remaining $50 was due during the ensuing 60 days, and to cancel an outstanding invoice of $116. We reduced the acquisition cost of the property and equipment by $191, reduced accounts payable by $116, and recorded a receivable of $50 as of September 30, 2005.

NEOSE TECHNOLOGIES, INC.
NOTES TO FINANCIAL STATEMENTS
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8. Intangible and Other Assets

Intangible and other assets consisted of the following:

	September 30, 2005	December 31, 2004
Acquired intellectual property, net of accumulated amortization of $3,686 and $3,238 as of September 30, 2005 and December 31, 2004, respectively	$ 864	$ 1,312
Non-competition agreement, net of accumulated amortization of $882 and $772 as of September 30, 2005 and December 31, 2004, respectively		110
Deferred financing costs, net of accumulated amortization of $32 and $18 as of September 30, 2005 and December 31, 2004, respectively	149	163
Receivable from related party	29	57
Deposits	61	140
	$ 1,103	$ 1,782

9. Debt and Capital Lease Obligations

Debt and capital lease obligations consisted of the following:

	September 30, 2005	December 31, 2004
Term loan from bank	$ 7,334	$ 8,000
Industrial development authority bond	1,000	1,000
Term loan from landlord (unsecured), annual interest at 13.00%, due June 2008	1,083	1,327
Notes payable to equipment lender, secured by equipment and facility improvements, interest rates from 8.00% to 9.44%, due 2006 to 2009	5,943	7,463
Note payable, secured by insurance policies, annual interest at 3.91%, due January 2006	258	¾
Subtotal	15,618	17,790
Capital lease obligations	341	555
Total debt	15,959	18,345
Less note payable	(258)	¾
Less current portion of long-term debt	(4,417)	(4,586)
Total debt, net of current portion	$ 11,284	$ 13,759

NEOSE TECHNOLOGIES, INC.
NOTES TO FINANCIAL STATEMENTS
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Term Loan from Bank and Industrial Development Authority Bonds

During the first quarter of 2004, we and a bank entered into agreements under which the bank acquired and reissued the $1,000 outstanding of our tax-exempt Industrial Development Authority bonds. In addition, we borrowed $8,000 from the bank, of which $6,200 funded improvements to our leased facility, which we occupied in April 2004, in Horsham, PA. The remaining $1,800 borrowed from the bank was used to repay other debt.

The interest rate on the bond and bank debt varies quarterly, depending on 90-day LIBOR rates. At September 30, 2005, the 90-day LIBOR was 4.07%. We have the option each quarter to incur interest on the outstanding principal at the LIBOR-based variable interest rate or a fixed rate offered by our bank.

For the $8,000 term loan, interest accrues at an interest rate equal to the 90-day LIBOR plus 3.0%. We made quarterly, interest-only payments prior to March 31, 2005. Commencing on March 31, 2005, we began to make quarterly principal payments of $222 plus interest. We are required to make these payments over the remaining term of the ten-year loan period.

For the $1,000 Industrial Development Authority bond, we are making quarterly, interest-only payments for ten years at an interest rate equal to the 90-day LIBOR plus 1.5%, followed by a single repayment of principal at the end of the ten-year loan period. If the 90-day LIBOR at the beginning of any calendar quarter is between 4.0% and 6.0%, the bond will bear interest at the 90-day LIBOR plus 1.25%. If the 90-day LIBOR at the beginning of any calendar quarter exceeds 6.0%, the bond will bear interest at the 90-day LIBOR plus 1.0%.

To provide security for these borrowings, we granted a first mortgage to our bank on the land and building where our present headquarters are located, as well as a security interest of first priority on certain improvements, certain equipment, and other tangible personal property. Under our agreements with the bank, if the bank determines a material adverse change has occurred in our business, financial condition, results of operations, or business prospects, the bank in its sole discretion may declare at any time an event of default, of which one potential outcome could be the accelerated repayment of the loan balance, which was $8,334 as of September 30, 2005. Under our agreements with the bank, we agreed to limit our total outstanding debt to $22,000. As of September 30, 2005, our total outstanding debt was $15,959. At any time after January 30, 2008, or if we fail to maintain a minimum required cash and short-term investments balance of at least $22,000, our bank has the option to require additional collateral from us in the form of a security interest in certain cash and short-term investments, or in the form of a letter of credit, which may have the effect of requiring us to repay the outstanding loan balance to the bank. The agreements with our bank also contain covenants that, among other things, require us to obtain consent from the bank prior to paying dividends, making certain investments, changing the nature of our business, assuming or guaranteeing the indebtedness of another entity or individual, selling or otherwise disposing of a substantial portion of our assets, and merging or consolidating with another entity.

NEOSE TECHNOLOGIES, INC.
NOTES TO FINANCIAL STATEMENTS
(unaudited)
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2005 Activity

During the three months ended September 30, 2005, we reduced the acquisition value of property and equipment and the carrying value of capital lease obligations by $10 due to a decrease in the amount of remaining minimum lease payments under a capital lease, which decrease resulted from the move of equipment into a state in which the payments were no longer subject to sales tax.

In July 2005, we borrowed $783 secured by laboratory equipment and facility improvements. The terms of the financing require us to pay monthly principal and interest payments over 48 months at an interest rate of 9.44%.

In March 2005, we borrowed $701 to finance insurance policy premiums due on certain insurance policies. The insurance policy premiums, net of amortization, are included in accounts receivable and other current assets on our balance sheet at September 30, 2005 (see Note 6). We are required to pay $65 of principal and interest during each of the 11 months beginning on March 15, 2005 and ending on January 15, 2006. The interest is calculated based on an annual percentage rate of 3.91%. To secure payment of the amounts financed, we granted the lender a security interest in all of our right, title and interest to the insurance policies. Upon a default by us, the lender can demand, and will have the right to receive, immediate payment of the total unpaid balance of the loan. In the event of default and the demand for immediate payment by the lender, interest will accrue on any unpaid amounts at the highest rate allowed by applicable law.

10. Accrued Expenses

Accrued expenses consisted of the following:

	September 30, 2005	December 31, 2004
Professional fees	$ 1,110	$ 610
Sponsored research and contract laboratory services	430	557
Restructuring costs (see Note 13)	273	¾
Employee relocation	179	186
Preclinical studies	102	126
Interest expense	43	43
Property and equipment	¾	63
Other expenses	626	467
	$ 2,763	$ 2,052

NEOSE TECHNOLOGIES, INC.
NOTES TO FINANCIAL STATEMENTS
(unaudited)
(in thousands, except per share amounts)

11. Stockholders Equity

Common Stock

In February 2005, we sold 8,050 shares of our common stock at a public offering price of $4.00 per share, generating net proceeds of $30,006.

In January 2005, participating employees purchased 15 shares of common stock pursuant to our employee stock purchase plan, resulting in net proceeds of $86. Effective January 31, 2005, we terminated the employee stock purchase plan due, in part, to the potential financial statement impact resulting from the expected adoption of SFAS No. 123R in January 2006. During the nine months ended September 30, 2005, there were no exercises of options to purchase shares of common stock.

Restricted Stock Units

In May 2005, we granted restricted stock units (RSUs) to members of our board of directors in lieu of cash payment for services. Because these RSUs vested immediately, we charged the fair value of $107 relating to these RSUs to operating expenses on the date of grant.

In March 2005, in order to align the interests of management and stockholders, and as part of a broader program to conserve cash, we modified our bonus program for 2004 for officers, adjusted salaries for officers to reduce cash payments, and granted RSUs to officers. We also decided to pay 2005 bonuses for officers by the award of RSUs instead of cash. During the nine months ended September 30, 2005, we recorded $688 of expense related to these awards, of which $362 was for equity-classified awards.

Modification of 2004 Bonus Awards for Officers

In March 2005, the Compensation Committee of our Board of Directors (Compensation Committee) decided that the 2004 bonus award to our Chief Executive Officer would be paid solely in RSUs instead of cash, and that 2004 bonus awards to other officers would be payable 50% in cash and 50% in RSUs. The liability associated with the cash portion of the 2004 bonus was $441 and was included in accrued compensation at December 31, 2004 on our balance sheet. The number of RSUs granted was determined by dividing the dollar amount of the 2004 bonus to be paid in the form of RSUs by the fair market value of our common stock on the date of grant. Except for two officers that retired, these RSUs will not vest until the first anniversary of the grant, and will not be distributed until 18 months from grant, subject to the occurrence of certain events. The amount of the RSU portion of the 2004 bonus for the retired officers was $67, which we charged to general and administrative expenses on our statement of operations in 2004 because the RSUs were immediately vested. The amount of the RSU portion of the 2004 bonus for other officers was $588, which we are charging to operating expenses on our statements of operations on a straight-line basis over the 26-month period from January 2004 to the vesting

NEOSE TECHNOLOGIES, INC.
NOTES TO FINANCIAL STATEMENTS
(unaudited)
(in thousands, except per share amounts)

date of the RSUs (March 2006). As a result, at December 31, 2004, our accrued compensation included $339 related to these RSUs. The liability classification of these RSUs continued until the grant date, at which time the liability of $382 for the award became equity-classified.

Modification of 2005 Bonus Awards for Officers

Payment of 2005 bonuses, if any, for officers will be made in full by the award of RSUs instead of cash in amounts determined by our Compensation Committee. For 2005 only, each officer s bonus target has been increased by 25% to compensate for the change from cash to RSUs. The number of RSUs granted to each officer will be determined by dividing his or her 2005 bonus, as determined by our Compensation Committee, by the average of our closing stock price on March 3, 2005 and our closing stock price on the grant date, which we anticipate will occur during the first quarter of 2006. Because the RSUs will vest in equal amounts over the four quarters following the date of grant, each RSU will be segregated into four tranches, and the value of each tranche will be amortized to operating expenses on our statements of operations individually as though each is a separate award.

For each quarter of 2005, we will calculate an estimated award value using the fair value of our stock as of the most recent balance sheet date. The award value will be accrued over the period from January 2005 until one year following the date of grant. The accrued award value as of each balance sheet date will be classified as a liability until the grant date, at which time the award will become equity-classified and the liability balance will be reclassified to additional paid-in-capital. The accrued award value as of September 30, 2005 of $283 is included in accrued compensation on our balance sheet.

Adjustment of Officer Base Salaries

In March 2005, the Compensation Committee reduced the base salary levels of all of the Company s officers for the period from March 1, 2005 through February 28, 2006. The salary for each officer is 10% lower than his or her base salary on February 28, 2005. In connection with these reductions, each officer was granted a one-time award of RSUs. The number of RSUs granted for this purpose was determined with reference to the 10% reduction and forgone merit increases, and the closing price of our common stock on the date of grant. The grant date value of these RSUs, which vest in equal amounts over four quarters following the date of grant, of $363 is being charged to operating expenses on a straight-line basis over the 12-month period from March 2005 through February 2006.

12. Collaborative Agreements and Significant Customer Concentration

BioGeneriX Agreements

On January 28, 2005, we entered into a Supply and Option Agreement (Option Agreement) with BioGeneriX AG (BioGeneriX), a company of the ratiopharm Group, that

NEOSE TECHNOLOGIES, INC.
NOTES TO FINANCIAL STATEMENTS
(unaudited)
(in thousands, except per share amounts)

provided for BioGeneriX to pay us a non-refundable payment and to supply to us an undisclosed protein for research purposes. The Option Agreement also granted BioGeneriX an exclusive option to enter into a pre-negotiated Research, License and Option agreement (License Agreement) for the use of our enzymatic technologies to develop a long-acting version of a currently marketed therapeutic protein.

On April 28, 2005, we and BioGeneriX entered into the License Agreement following the exercise by BioGeneriX of the option we granted to it under the Option Agreement. We received a non-refundable payment in connection with the exercise of the option and execution of the License Agreement.

Under the License Agreement, we are entitled to receive research payments for 12 months, and potentially milestone payments of up to $61,500 as well as royalties on product sales. The License Agreement provides that we will conduct research on behalf of BioGeneriX for approximately 12 months and grants to BioGeneriX the right to obtain an exclusive, worldwide license, upon specified terms, to use our enzymatic technologies to develop and commercialize a long-acting version of the undisclosed therapeutic protein that is the target of the research. If BioGeneriX exercises its right to obtain this license, BioGeneriX will be responsible for the further development and commercialization of the target protein. In addition, if requested by BioGeneriX, we will provide, and be fully reimbursed for, any required technical assistance. We will also be entitled, at our request, to supplies of some process reagents from BioGeneriX.

We also are collaborating with BioGeneriX on the development and commercialization of a long-acting granulocyte colony stimulating factor, under a separate agreement, which was described in the Notes to Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2004.

Amendment to Novo Nordisk Agreement

In February 2005, we entered into an amendment (Amendment) to one of our two Research, Development and License Agreements with Novo Nordisk A/S (Novo Nordisk) dated as of November 17, 2003, as previously amended (Novo Agreement). The Novo Agreement was described in the Notes to Financial Statements, included in our Annual Report on Form 10-K for the year ended December 31, 2004.

Under the Novo Agreement, we are conducting work on next-generation versions of two proteins. The Amendment provided for a change in the timing of one milestone payment, and a restructuring of payment of certain project-related costs for one of the two proteins that is the subject of the Novo Agreement.

NEOSE TECHNOLOGIES, INC.
NOTES TO FINANCIAL STATEMENTS
(unaudited)
(in thousands, except per share amounts)

Significant Customer Concentration

During the three and nine months ended September 30, 2005, one customer accounted for 39% and 43%, respectively, of total revenues. During the three and nine months ended September 30, 2004 that customer accounted for 42% and 76%, respectively, of total revenues. During the three and nine months ended September 30, 2005, a second customer accounted for 61% and 57%, respectively, of total revenues. During the three and nine months ended September 30, 2004, that second customer accounted for 58% and 24%, respectively, of total revenues.

13. Restructuring

In August 2005, we announced that we had implemented a restructuring of operations to enable an enhanced focus on next-generation proteins, to allow for the anticipated transfer of production of proteins and reagents to our collaborative partners and contract manufacturers now that our programs are more mature, and to reduce cash burn. Upon completion of the restructuring, we will have reduced the size of our workforce by approximately 25% since the end of the first quarter of 2005. Our net loss for the three and nine months ended September 30, 2005 included $14,002 of charges related to this restructuring, including $13,187 of non-cash property and equipment impairment charges (see Note 7) and $815 of expected payments for employee severance.

The following table reflects the employee severance charges recorded, payments made, and liability remaining as of September 30, 2005. We expect to pay our remaining obligations by the third quarter of 2006. The estimates below have been made based upon our best estimate of the amounts and timing of certain events included in the restructuring plan that will occur in the future. It is possible that the actual outcome of certain events may differ from the estimates. Changes will be made to the restructuring accrual at the point that the differences become determinable.

	Employee severance costs	Facility closure costs	Total
Initial provision	$ 815	$ ¾	$ 815
Cash payments	(542)	¾	(542)
Balance as of September 30, 2005	$ 273	$ ¾	$ 273

During the three months ending December 31, 2005, we expect to record a non-cash charge of approximately $152 in our statements of operations for the remaining required

NEOSE TECHNOLOGIES, INC.
NOTES TO FINANCIAL STATEMENTS
(unaudited)
(in thousands, except per share amounts)

minimum payments under the operating lease for our facility in San Diego, California. This amount will be included in facility closure costs in the above table. Because the remaining lease term extends for only five months beyond our cease-use date of the facility, we have assumed no sublease income in our calculation. During the three months ending December 31, 2005, we also expect to record a restructuring charge of $52 relating to severance payments that are contingent upon continued employment by certain employees of at least 60 days following notice of their termination.

14. Commitments and Contingencies

In connection with the restructuring announced in August 2005 (see Note 13), we committed to pay future cash retention bonuses to certain employees that were not given notice of termination in August 2005, contingent upon such employees not voluntarily terminating their employment prior to the payment date. The total potential value of these payments is $763, of which $317 was accrued during the three months ended September 30, 2005. We expect to record additional accrued compensation related to these retention bonuses of up to $271, $127, and $48 during the three months ending December 31, 2005, March 31, 2006, and June 30, 2006, respectively. We also committed to these employees, that if they were involuntarily terminated in the future, the termination benefit offered would be no less favorable than offered to employees terminated in the August 2005 restructuring. As a result, accrued compensation on our balance sheet as of September 30, 2005 includes an additional $240 related to these potential payments.

In October 2005, we entered into separation agreements with certain officers. Under these agreements, we agreed to pay an aggregate of $21 per month and provide medical benefits over a 12-month period commencing in November 2005. We also committed to award any bonus earned by the individuals for 2005, as determined using the same criteria as if they were employed as of the time of the award. As described in Note 11, payment of 2005 bonuses, if any, for officers will be made in full by the award of restricted stock units instead of cash in amounts determined by our Compensation Committee. In addition, we extended for twelve months the period during which each officer may exercise stock options that were vested and outstanding as of each individual s separation date, except for one individual that will provide consulting services following such individual s separation date. Stock options will continue to vest while the individual provides consulting services, and the twelve-month period during which the individual may exercise stock options will commence upon the conclusion of the individual s provision of consulting services. Because the stock options had no intrinsic value as of the modification date, there will be no charge associated with the option modifications.

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

CAUTIONARY STATEMENT PURSUANT TO SAFE HARBOR PROVISIONS OF THE PRIVATE SECURITIES LITIGATION ACT OF 1995:

This report and the documents incorporated by reference herein contain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (Exchange Act). When used in this report and the documents incorporated herein by reference, the words anticipate, believe, estimate, may, expect, intend, and similar expressions are generally intended to identify forward-looking statements. These forward-looking statements include, among others, the statements in Management s Discussion and Analysis of Financial Condition and Results of Operations about our:

- *estimate of the length of time that our existing cash and cash equivalents, marketable securities, expected revenue, and interest income will be adequate to finance our operating and capital requirements;*
- *expectations as to the costs and benefits of our August 2005 restructuring of operations;*
- *expected losses;*
- *expectations for future capital requirements;*
- *expectations for increases in operating expenses;*
- *expectations for increases in research and development, and general and administrative expenses in order to develop products, manufacture commercial quantities of reagents and products, and commercialize our technology;*
- *expectations for the development of, the timing of regulatory filings related to, and the ability to commence clinical trials for, our proprietary drug candidates;*
- *expectations for generating revenue;*
- *expectations regarding the timing and structure of new or expanded collaborations; and*
- *expectations regarding the success of existing collaborations for the development and commercialization of products using our technologies.*

Our actual results could differ materially from the results expressed in, or implied by, these forward-looking statements. Potential risks and uncertainties that could affect our actual results include the following:

- *our ability to obtain the funds necessary for our operations;*
- *our ability to meet forecasted project timelines due to internal or external causes;*
- *our ability to satisfy the FDA s request for additional information and obtain clearance from the FDA to commence the Phase I clinical trial for NE-180;*
- *our ability to develop commercial-scale manufacturing processes for our products and reagents, either independently or in collaboration with others;*

the risk that we will incur unexpected charges or will have unexpected expenditures related to the restructuring upon the completion of further analysis with respect to the restructuring generally and our assets specifically;

our ability to enter into and maintain collaborative arrangements;

our ability to obtain adequate sources of proteins and reagents either manufactured internally or externally sourced;

our ability to expand and protect our intellectual property and to operate without infringing the rights of others;

our ability to develop and commercialize therapeutic proteins and to commercialize our technologies;

our ability to attract and retain key personnel;

our ability to compete successfully in an intensely competitive field;

our ability to renovate our facilities as required for our operations; and

general economic conditions.

These and other risks and uncertainties that could affect our actual results are discussed in this report and in our other filings with the Securities and Exchange Commission (SEC), particularly the section entitled Factors Affecting The Company s Prospects of our Annual Report on Form 10-K for the year ended December 31, 2004. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, events, levels of activity, performance, or achievements. We do not assume responsibility for the accuracy and completeness of the forward-looking statements other than as required by applicable law.

We do not undertake any duty to update after the date of this report any of the forward-looking statements in this report to conform them to actual results.

You should read this section in combination with the section entitled Management s Discussion and Analysis of Financial Condition and Results of Operations for the year ended December 31, 2004, included in our Annual Report on Form 10-K for the year ended December 31, 2004 and in our 2004 Annual Report to Stockholders.

Overview

We are a biopharmaceutical company using our enzymatic technologies to develop proprietary drugs, focusing primarily on therapeutic proteins. We believe that our core enzymatic technologies, GlycoAdvance and GlycoPEGylation, improve the drug properties of therapeutic proteins by building out, and attaching polyethylene glycol (PEG) to, carbohydrate structures on the proteins. We are using our technologies to develop proprietary versions of protein drugs with proven safety and efficacy and to improve the therapeutic profiles of proteins being developed by our partners. We expect these modified proteins to offer significant advantages, including less frequent dosing and possibly improved efficacy, over the original versions of the drugs now on the market, as well as to meet or exceed the pharmacokinetic profile of next-generation versions of the drugs now on the market. We believe this strategy of targeting drugs with proven safety and efficacy allows us to lower the risk profile of our proprietary development portfolio as compared to *de novo* protein drug development.

We have incurred operating losses each year since our inception. As of September 30, 2005, we had an accumulated deficit of $231,554,000. We expect additional losses in 2005 and over the next several years as we continue product research and development efforts and expand our intellectual property portfolio. We have financed our operations through private and public offerings of equity securities, proceeds from debt financings, and revenues from our collaborative agreements.

We believe that our existing cash and cash equivalents, marketable securities, expected revenue from collaborations and license arrangements, and interest income should be sufficient to meet our operating and capital requirements at least through the third quarter of 2006, although changes in our collaborative relationships or our business, whether or not initiated by us, may cause us to deplete our cash, cash equivalents, and marketable securities sooner than the above estimate. Under agreements we entered into with a bank during the first quarter of 2004, we have agreed to limit our total outstanding debt to $22,000,000. As of September 30, 2005, our total outstanding debt was $15,959,000. At any time after January 30, 2008, or if we fail to maintain a minimum required cash and short-term investments balance of at least $22,000,000, the bank has the option to require additional collateral from us in the form of a security interest in certain cash and short-term investments, or in the form of a letter of credit, which may have the effect of requiring us to repay the outstanding loan balance to the bank. See Financing Activities Debt Financing Activities Term Loan from Bank and Industrial Development Authority Bonds in the Liquidity and Capital Resources section of this Form 10-Q for a description of the material features of this borrowing.

Liquidity and Capital Resources

Overview

We had $45,453,000 in cash, cash equivalents, and marketable securities as of September 30, 2005, compared to $45,048,000 in cash and cash equivalents as of December 31, 2004. The increase during the nine months ending September 30, 2005 was attributable to the net proceeds from our public offering in February 2005, offset by the use of cash during the nine months ended September 30, 2005 to fund our operating activities, capital expenditures, and debt repayments.

In February 2005, we offered and sold 8,050,000 shares of our common stock at a public offering price of $4.00 per share, generating net proceeds of $30,006,000.

In August 2005, we implemented a restructuring of operations to enable an enhanced focus on next-generation proteins, to allow for the anticipated transfer of production of proteins and reagents to our collaborative partners and contract manufacturers now that our programs are more mature, and to reduce cash burn. The restructuring supplemented measures that we implemented in March 2005 to reduce the rate of our cash utilization. The actions taken in March 2005 included modifying the bonus program for officers, reducing officers base salaries for one year, and reducing planned operating expenses and capital expenditures. The restructuring reduced the size of our workforce by approximately 25%, as compared to the size of our workforce at the end of the first quarter of 2005. After achieving the full benefits of the restructuring during the fourth quarter of 2005, we expect to realize annualized savings of between $6,000,000 and $8,000,000. Net cash utilization for the fourth quarter of 2005 is

expected to be between $7,500,000 and $8,500,000, which includes the cash effect of restructuring costs but does not take into account any new partnering activities. Our average net cash utilization during the first half of 2005 was approximately $10,500,000 per quarter, excluding the effect of proceeds from equity issuances and purchases of marketable securities.

As part of the restructuring, we centralized research activities in Horsham, Pennsylvania by ending operations in our leased facility in San Diego, California. Our future requirements for internally manufactured products will be substantially lower than the capacity of our 24,000 square-foot pilot manufacturing facility. Therefore, we commenced efforts to evaluate the disposition of our current headquarters and pilot manufacturing facility, which we own subject to a mortgage. Our net loss for the three and nine months ended September 30, 2005 included $14,002,000 of charges related to this restructuring, including $13,187,000 of non-cash property and equipment impairment charges and $815,000 of expected payments for employee severance.

The development of next-generation proprietary protein therapeutics, which we are pursuing both independently and in collaboration with selected partners, will require substantial expenditures by us and our collaborators. We plan to continue financing our operations through private and public offerings of equity securities, proceeds from debt financings, and revenues from existing and future collaborative agreements. Because our remaining 2005 revenues could be substantially affected by entering into new collaborations and on the financial terms of any new collaborations, we cannot estimate our remaining 2005 revenues. Other than revenues from our collaborations with Novo Nordisk and BioGeneriX, and any future collaborations with others, we do not expect to generate significant revenues until such time as products using our technologies are commercialized, which is not expected during the next several years. We expect an additional several years to elapse before we can expect to generate sufficient cash flow from operations to fund our operating and investing requirements. We believe that our existing cash and cash equivalents, marketable securities, expected revenue from collaborations and license arrangements, and interest income should be sufficient to meet our operating and capital requirements at least through the third quarter of 2006. Accordingly, we will need to raise substantial additional funds to continue our business activities and fund our operations until we are generating sufficient cash flow from operations.

Operating Activities

Net cash used in operating activities was $26,819,000 and $27,057,000 for the nine months ending September 30, 2005 and 2004, respectively. Although our net loss for the 2005 period was $13,520,000 greater than the net loss for the 2004 period, there was little change to our net cash used in operating activities for the 2005 period compared to the 2004 period, because the increased net loss was primarily due to the non-cash impairment charges of $13,187,000 recognized during the third quarter of 2005 in connection with the restructuring discussed above.

Investing Activities

During the nine months ended September 30, 2005 and 2004, we invested $719,000 and $8,942,000, respectively, in property, equipment, and building improvements. Of the 2004 amount, $5,085,000 was invested in leasehold improvements that are described below.

During the three months ended September 30, 2005, we recorded proceeds of $25,000 from the settlement of a dispute with a vendor from which we had purchased property and equipment. Under the settlement agreement, the vendor agreed to pay us $75,000, of which $25,000 was paid upon execution of the settlement agreement and the remaining $50,000 was due during the ensuing 60 days, and to cancel an outstanding invoice of $116,000. During the nine months ended September 30, 2005, we received proceeds of $70,000 upon the sale of equipment that we included in assets held for sale in accounts receivable and other current assets on our balance sheet as of December 31, 2004. The carrying value of the equipment was $49,000 and, therefore, we recognized a gain on the sale of the equipment of $21,000. During the nine months ended September 30, 2004, we entered into capital lease obligations for equipment with an aggregate book value of $184,000. We did not enter into any capital lease obligations during the nine months ended September 30, 2005. We had accrued property and equipment of $380,000 as of September 30, 2004. We had no accrued property and equipment as of September 30, 2005.

We entered into a lease agreement in 2002 for a 40,000 square foot building. We converted 25,000 square feet into laboratory and office space. In April 2004, we occupied that finished portion of the facility, and began amortizing the cost of those improvements. We expended $10,175,000 for this project, of which $5,085,000 was expended during the nine months ended September 30, 2004. During the first quarter of 2004, we entered into agreements with a bank for the purpose of funding these improvements. See Financing Activities Debt Financing Activities Term Loan from Bank and Industrial Development Authority Bonds in the Liquidity and Capital Resources section of this Form 10-Q for a description of the material features of this borrowing. In addition, pursuant to the lease, we received $250,000 from the landlord in September 2004 as a partial reimbursement for improvements we made to the facility. This landlord incentive, which is included in other liabilities on our balance sheet, is being amortized ratably as a reduction to rental expense over the lease term.

We anticipate additional capital expenditures during the fourth quarter of 2005 of approximately $200,000. We may finance some or all of these capital expenditures through capital leases or the issuance of new debt or equity. We would prefer to finance capital expenditures through the issuance of new debt, to the extent that we are allowed to do so under our existing bank covenants. The terms of new debt could require us to maintain a minimum cash and investments balance, or to transfer cash into an escrow account to collateralize some portion of the debt, or both.

Financing Activities

Equity Financing Activities

In February 2005, we offered and sold 8,050,000 shares of our common stock at a public offering price of $4.00 per share, generating net proceeds of $30,006,000.

During the nine months ended September 30, 2005 and 2004, participating employees purchased 15,201 and 23,564 shares, respectively, of common stock pursuant to our employee stock purchase plan, resulting in net proceeds of $86,000 and $175,000, respectively. Effective January 31, 2005, we terminated the employee stock purchase plan due, in part, to the potential

financial statement impact resulting from the expected adoption of SFAS No. 123R in January 2006. During the nine months ended September 30, 2004, we received proceeds of $73,000 upon the exercise of options to purchase 24,766 shares of common stock. There were no exercises of options during the nine months ended September 30, 2005.

Debt Financing Activities

Our total debt decreased by $2,386,000 to $15,959,000 at September 30, 2005, compared to $18,345,000 at December 31, 2004. This decrease primarily resulted from debt principal repayments of $3,860,000, partially offset by $1,484,000 in proceeds from the issuance of debt.

Note Payable Secured by Insurance Policies

In March 2005, we borrowed $701,000 to finance the insurance policy premiums due on certain insurance policies. As of September 30, 2005, the outstanding principal balance under this agreement was $258,000. We are required to pay $65,000 of principal and interest during each of the 11 months beginning on March 15, 2005 and ending on January 15, 2006. The interest is calculated based on an annual percentage rate of 3.91%. To secure payment of the amounts financed, we granted the lender a security interest in all of our right, title and interest to the insurance policies. Upon a default by us, the lender can demand, and will have the right to receive, immediate payment of the total unpaid balance of the loan. In the event of default and the demand for immediate payment by the lender, interest will accrue on any unpaid amounts at the highest rate allowed by applicable law.

Term Loan from Bank and Industrial Development Authority Bonds

During the first quarter of 2004, we and a bank entered into agreements under which the bank acquired and reissued the $1,000,000 outstanding of our tax-exempt Industrial Development Authority bonds. In addition, we borrowed $8,000,000 from the bank, of which $1,800,000 was combined with $1,100,000 of our restricted cash for the purpose of paying in full the $2,900,000 outstanding of our taxable Industrial Development Authority bonds. The remaining $6,200,000 borrowed funded improvements to our leased facility, which we occupied in April 2004, in Horsham, PA.

During the twelve months ending September 30, 2006, we will be required to make principal payments totaling $889,000 under these agreements. The interest rate on the bond and bank debt varies quarterly, depending on 90-day LIBOR rates. At September 30, 2005, the 90-day LIBOR was 4.07%. We have the option each quarter to incur interest on the outstanding principal at the LIBOR-based variable interest rate or a fixed rate offered by our bank.

For the $8,000,000 term loan, interest accrues at an interest rate equal to the 90-day LIBOR plus 3.0%. We made quarterly, interest-only payments prior to March 31, 2005. Commencing on March 31, 2005, we began to make quarterly principal payments of $222,000 plus interest. We are required to make these payments over the remaining term of the ten-year loan period.

For the $1,000,000 Industrial Development Authority bond, we are making quarterly, interest-only payments for ten years at an interest rate equal to the 90-day LIBOR plus 1.5%,

followed by a single repayment of principal at the end of the ten-year loan period. If the 90-day LIBOR at the beginning of any calendar quarter is between 4.0% and 6.0%, the bond will bear interest at the 90-day LIBOR plus 1.25%. If the 90-day LIBOR at the beginning of any calendar quarter exceeds 6.0%, the bond will bear interest at the 90-day LIBOR plus 1.0%.

To provide security for these borrowings, we granted a first mortgage to our bank on the land and building where our present headquarters are located, as well as a security interest of first priority on certain improvements, certain equipment, and other tangible personal property. Under our agreements with the bank, if the bank determines a material adverse change has occurred in our business, financial condition, results of operations, or business prospects, the bank in its sole discretion may declare at any time an event of default, of which one potential outcome could be the accelerated repayment of the loan balance, which was $8,334,000 as of September 30, 2005. Under our agreements with the bank, we agreed to limit our total outstanding debt to $22,000,000. As of September 30, 2005, our total outstanding debt was $15,959,000. At any time after January 30, 2008, or if we fail to maintain a minimum required cash and short-term investments balance of at least $22,000,000, our bank has the option to require additional collateral from us in the form of a security interest in certain cash and short-term investments, or in the form of a letter of credit, which may have the effect of requiring us to repay the outstanding loan balance to the bank. The agreements with our bank also contain covenants that, among other things, require us to obtain consent from the bank prior to paying dividends, making certain investments, changing the nature of our business, assuming or guaranteeing the indebtedness of another entity or individual, selling or otherwise disposing of a substantial portion of our assets, and merging or consolidating with another entity.

Term Loan from Landlord

In May 2004, we borrowed $1,500,000 from the landlord of our leased facilities in Horsham, Pennsylvania. As of September 30, 2005, the outstanding principal balance under this agreement was $1,083,000. The terms of the financing require us to pay monthly principal and interest payments over 48 months at an interest rate of 13%. During the twelve months ending September 30, 2006, we will be required to make principal and interest payments totaling $443,000 under this agreement.

Equipment Loans

In July 2005, we borrowed $783,000 secured by laboratory equipment and facility improvements. The terms of the financing require us to pay monthly principal and interest payments over 48 months at an interest rate of 9.44%. As of September 30, 2005, we owe $5,943,000 to an equipment lender that financed the purchase of certain equipment and facility improvements, which collateralize the amounts borrowed. The terms of the financings require us to make monthly principal and interest payments through August 2009 at interest rates ranging from 8.00% to 9.44%. During the twelve months ending September 30, 2006, we will make principal and interest payments totaling $3,341,000 under these agreements.

Capital Lease Obligations

The terms of our capital leases require us to make monthly payments through February 2009. Under these agreements, we will be required to make principal and interest payments totaling $241,000 during the twelve months ending September 30, 2006.

Operating Leases

We lease laboratory, office, warehouse facilities, and equipment under operating lease agreements. In April 2001, we entered into a lease agreement for approximately 10,000 square feet of laboratory and office space in San Diego, California. The initial term of the lease ends in March 2006. As part of the restructuring announced in August 2005 and described in the Liquidity and Capital Resources section of this Form 10-Q, we have centralized research activities in Horsham, Pennsylvania by ending operations in our leased facility in San Diego, California.

We lease approximately 5,000 square feet of office and warehouse space in Horsham, Pennsylvania under a lease agreement that expires April 2007. In February 2002, we entered into a lease agreement for approximately 40,000 square feet of laboratory and office space in Horsham, Pennsylvania. The initial term of the lease ends in July 2022, at which time we have an option to extend the lease for an additional five years, followed by another option to extend the lease for an additional four and one-half years. Pursuant to the lease, we received $250,000 from the landlord in September 2004 as a partial reimbursement for improvements we made to the facility. This landlord incentive, which is included in other liabilities on our accompanying balance sheets, is being amortized ratably as a reduction to rental expense over the lease term. Our laboratory, office, and warehouse facility leases contain escalation clauses, under which the base rent increases annually by 2% to 4%.

Summary of Contractual Obligations

A summary of our obligations to make future payments under contracts existing as of December 31, 2004 is included in Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations, of our Annual Report on Form 10-K for the year ended December 31, 2004. The Liquidity and Capital Resources section of this Form 10-Q describes obligations from material contracts entered into during the nine months ended September 30, 2005.

Off-Balance Sheet Arrangements

We are not involved in any off-balance sheet arrangements that have or are reasonably likely to have a current or future effect that is material to investors on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures, or capital resources.

Critical Accounting Policies and Estimates

A discussion of our critical accounting policies and estimates is included in Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations, of our Annual Report on Form 10-K for the year ended December 31, 2004. Other than as described below, there have not been any changes or additions to our critical accounting policies during the nine months ended September 30, 2005.

Accounting for Restructuring Costs

To account for exit or disposal activities, such as the restructuring described in Overview in the Liquidity and Capital Resources section of this Form 10-Q, we apply Statement of Financial Accounting Standards (SFAS) No. 146, *Accounting for Costs Associated with Exit or Disposal Activities* (SFAS No. 146), which requires a liability for a cost associated with an exit or disposal activity be recognized and measured initially at fair value only when the liability is incurred. It does not apply to costs associated with a disposal activity covered by SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS No. 144). The restructuring charges recorded by us during the three months ended September 30, 2005 are comprised primarily of costs to write-off property and equipment and reduce our workforce. Our net loss for the three and nine months ended September 30, 2005 included $14,002,000 of charges related to this restructuring, including $13,187,000 of non-cash property and equipment impairment charges and $815,000 of expected payments for employee severance costs.

Under SFAS No. 144, any impairment of property and equipment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. To determine the fair value of assets that are not likely to be used over their remaining useful economic life, we use a probability-weighted approach of estimated cash flows to be received upon a range of possible disposition outcomes. In August 2005, we announced we would evaluate alternatives relative to our current headquarters and pilot manufacturing facility (Witmer Road Facility), which we own subject to a mortgage, including the potential disposition of the facility and further consolidation of our research, development and administrative operations into a currently leased facility that is also located in Horsham, Pennsylvania. As a result of the announcement, we concluded that identifiable cash flows could be assigned to the Witmer Road Facility and related equipment. We based our estimates of potential cash flows related to possible disposition outcomes on conversations with commercial real estate firms that have both knowledge of recent history of sales and expertise in marketing and selling similar facilities. These estimates may turn out to be incorrect and our actual cash flows may be materially different from our estimates.

Our estimates of future liabilities may change, requiring us to record additional restructuring charges or reduce the amount of liabilities recorded. At the end of each reporting period, we evaluate the remaining accrued balances to ensure their adequacy, that no excess accruals are retained and the utilization of the provisions are for their intended purposes in accordance with developed exit plans. We periodically evaluate current available information and adjust our restructuring reserve as necessary.

Results of Operations

We recorded a net loss of $22,621,000 and $44,173,000 for the three and nine months ended September 30, 2005, respectively. For the three and nine months ended September 30, 2004, we recorded a net loss of $10,824,000 and $30,653,000, respectively. The following section explains the changes between the reporting periods in each component of net loss.

Revenue from Collaborative Agreements

Revenue from collaborative agreements for the three and nine months ended September 30, 2005 was $1,503,000 and $4,271,000, respectively, compared to $1,451,000 and $3,592,000 for the corresponding periods in 2004. Our revenue from collaborative agreements has historically been derived from a few major collaborators. Our collaborative agreements have had some or all of the following elements: upfront fees, research and development funding, milestone revenues, and royalties on product sales.

During the three and nine months ended September 30, 2005, one customer accounted for 39% and 43%, respectively, of total revenues. During the three and nine months ended September 30, 2004 that customer accounted for 42% and 76%, respectively, of total revenues. During the three and nine months ended September 30, 2005, a second customer accounted for 61% and 57%, respectively, of total revenues. During the three and nine months ended September 30, 2004, that second customer accounted for 58% and 24%, respectively, of total revenues.

Because our remaining 2005 revenues could be substantially affected by entering into new collaborations and by the financial terms of any new collaborations, we cannot estimate our remaining 2005 revenues. Material cash inflows from proprietary drug development projects are highly uncertain, and we cannot reasonably estimate the period in which we will begin to receive material net cash inflows from our major research and development projects. Cash inflows from products in development are dependent on several factors, including entering into collaborative agreements, the achievement of certain milestones, and regulatory approvals. We may not receive milestone payments from any existing or future collaborations if a product in development fails to meet technical or performance targets or fails to obtain the required regulatory approvals. Further, our revenues from collaborations will be affected by the levels of effort committed and made by our collaborative partners. Even if we achieve technical success in developing drug candidates, our collaborative partners may discontinue development, may not devote the resources necessary to complete development and commence marketing of these products, or they may not successfully market potential products.

Research and Development Expense

Our proprietary drug development portfolio consists of two therapeutic protein candidates: GlycoPEG-EPO (NE-180) and GlycoPEG-GCSF. Erythropoietin (EPO) is prescribed to stimulate production of red blood cells, and is approved for sale in major markets around the world for the treatment of chemotherapy-induced anemia and anemia associated with chronic renal failure. Based on early preclinical studies, we believe it is feasible to develop a long-acting EPO through GlycoPEGylation. We submitted an investigational new drug application (IND) for NE-180 to the U.S. Food and Drug Administration (FDA) during the second quarter of 2005. In

August 2005, the FDA advised us that it requires additional manufacturing and preclinical information in order to complete its review of the IND and that our proposed Phase I clinical trial of NE-180 has been placed on hold. We have established a target of the fourth quarter of 2005 to submit a complete response to the FDA. In addition, as an alternative to approval in the U.S., we are exploring the possibility of early clinical development of NE-180 in a European regulatory jurisdiction.

Granulocyte colony stimulating factor (G-CSF) is prescribed to stimulate production of neutrophils (a type of white blood cell), and is approved for sale in major markets around the world for treatment of neutropenia associated with myelosuppressive chemotherapy. Based on proof-of-concept data and preclinical development activities conducted during 2004, we believe it is feasible to develop a long-acting G-CSF through GlycoPEGylation. We and BioGeneriX plan to continue preclinical development activities for GlycoPEG-GCSF through the end of 2005. Such activities include requesting scientific advice from regulatory authorities in Europe. We have established a target of the first quarter of 2006 for the submission of an Investigational Medicinal Product Dossier or its equivalent to a European country.

We conduct exploratory research, both independently and with collaborators, on therapeutic candidates, primarily proteins, for development using our enzymatic technologies. Successful candidates may be advanced for development through our own proprietary drug program or through our partnering and licensing program, or a combination of the two. Although our primary focus is the development of long-acting proteins, we are also conducting research to assess opportunities to use our enzymatic technologies in other areas, such as glycopeptides and glycolipids. We expect to continue this research during the remainder of 2005.

Our current research and development projects are divided between two categories: (i) GlycoAdvance and GlycoPEGylation and (ii) Other Glycotechnology Programs, which includes projects investigating other applications of our intellectual property. The following chart sets forth our projects in each of these categories and the stage to which each has been developed:

	Development Stage	*Status*
GlycoAdvance and GlycoPEGylation		
NE-180	Preclinical	Active
GlycoPEG-GCSF	Preclinical	Active
Other protein projects	Research	Active
Other Glycotechnology Programs		
Non-protein therapeutic applications	Research	Active

The process of bringing drugs from the preclinical research and development stage through Phase I, Phase II, and Phase III clinical trials to FDA approval is time consuming and expensive. Because our announced product candidates are currently in the preclinical stage and there are a variety of potential intermediate clinical and non-clinical outcomes that are inherent in drug development, we cannot reasonably estimate either the timing or costs we will incur to complete these research and development projects. In addition, the timing and costs to complete our research and development projects will be affected by the timing and structure of any

collaboration agreements we may enter into with a third party, neither of which we can currently estimate.

For each of our research and development projects, we incur both direct and indirect expenses. Direct expenses include salaries and other costs of personnel, raw materials, and supplies for each project. We may also incur third-party costs related to these projects, such as contract research, consulting and preclinical development costs. Indirect expenses include depreciation expense and the costs of operating and maintaining our facilities, property, and equipment, to the extent used for our research and development projects, as well as the costs of general management of our research and development projects.

Our research and development expenses for the three and nine months ended September 30, 2005 were $7,521,000 and $26,133,000, respectively, compared to $9,305,000 and $24,971,000 for the corresponding periods in 2004. The following table illustrates research and development expenses incurred during the three and nine months ended September 30, 2005 and 2004 for our significant groups of research and development projects (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2005	2004	2005	2004
GlycoAdvance and GlycoPEGylation	$ 3,843	$ 4,386	$ 13,992	$ 11,254
Other Glycotechnology Programs	237	19	766	141
Indirect expenses	3,441	4,900	11,375	13,576
	$ 7,521	$ 9,305	$ 26,133	$ 24,971

GlycoAdvance and GlycoPEGylation

Our GlycoAdvance and GlycoPEGylation expenses result primarily from the development and preclinical activities, including process development and pilot plant activities, associated with our proprietary drug development programs. These expenses decreased during the third quarter of 2005 due primarily to a reduction in the purchase of supplies and raw materials as compared to the third quarter of 2004. During the nine months ended September 30, 2005, these amounts increased compared to the same period in 2004 due to the conduct of preclinical studies on NE-180 and increased external costs associated with the development of reagents for GlycoPEG-GCSF.

Other Glycotechnology Programs

Research and development expenses related to our Other Glycotechnology Programs increased during the 2005 periods, compared to the 2004 period, as we conducted more research on glycolipids during the 2005 periods.

Indirect expenses

Our indirect research and development expenses decreased during the 2005 periods, compared to the 2004 periods, primarily due to a decrease in consulting and outside research expenses as well as a decrease in indirect labor efforts and personnel related costs, as more labor was focused on the GlycoPEGylation and Glycotechnology programs. Further contributing to the 2005 decrease is a reduction in depreciation expense in the third quarter of 2005 due to the impairment of our Witmer Road facility and subsequent cessation of depreciation as of August 2005.

General and Administrative Expense

General and administrative expenses for the three and nine months ended September 30, 2005 were $2,685,000 and $8,469,000, respectively, compared to $2,861,000 and $9,047,000 for the corresponding periods in 2004. The decrease for the 2005 periods was primarily due to lower salaries and consulting expenses, partially offset by an increase in legal costs associated with our intellectual property portfolio.

Restructuring Charges

Restructuring charges for the nine months ended September 30, 2005 were $14,002,000, which included including $13,187,000 of non-cash property and equipment impairment charges and $815,000 of expected payments for employee severance costs. We did not incur any restructuring charges during the three and nine months ended September 30, 2004.

During the three months ending December 31, 2005, we expect to record a non-cash restructuring charge of approximately $152,000 in our statements of operations for the remaining required minimum payments under the operating lease related to our facility in San Diego, California. Because the remaining lease term extends for only five months beyond our cease-use date of the facility, we have assumed no sublease income in our calculation. During the three months ending December 31, 2005, we also expect to record a restructuring charge of $52,000 relating to severance payments that are contingent upon continued employment by certain employees of at least 60 days following notice of their termination.

Other Income and Expense

Other income for the nine months ended September 30, 2005 was $22,000, and related to payments received during the first quarter of 2005 in excess of the carrying value of accounts receivable due to currency fluctuations. We do not expect any such other income during the remainder of 2005. We had no other income during the three months ended September 30, 2005 or the three and nine months ended September 30, 2004.

Interest income for the three and nine months ended September 30, 2005 was $415,000 and $1,138,000, respectively, compared to $195,000 and $431,000 for the corresponding periods in 2004. The increases were primarily due to higher interest rates during the 2005 periods. Our interest income during the remainder of 2005 is difficult to project, and will depend largely on

prevailing interest rates and whether we receive cash from entering into any new collaborative agreements or by completing any additional equity or debt financings during the year.

Interest expense for the three and nine months ended September 30, 2005 was $331,000 and $1,000,000, respectively, compared to $304,000 and $658,000 for the corresponding periods in 2004. The increases were primarily due to higher interest rates on our variable rate debt. The increase during the nine months ended September 30, 2005 period was also due to the capitalization of $130,000 of interest incurred during 2004 associated with leasehold improvements that we placed in service in April 2004. Our interest expense during the remainder of 2005 is difficult to project and will depend largely on prevailing interest rates and whether we enter into any new debt agreements. See Financing Activities Debt Financing Activities in the Liquidity and Capital Resources section of this Form 10-Q for a description of the material features of our debt financings.

Item 4. Controls and Procedures

We carried out an evaluation, under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures as such term is defined under Rule 13a-15(e) promulgated under the Exchange Act, for financial reporting as of September 30, 2005. Based on that evaluation, our principal executive officer and principal financial officer concluded that these controls and procedures are effective to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported as specified in SEC rules and forms.

Our internal controls and procedures for financial reporting are designed to provide reasonable assurance, and management believes that they provide such reasonable assurance, that our transactions are properly authorized, our assets are safeguarded against unauthorized or improper use, and our transactions are properly recorded and reported, in order to permit the preparation of our financial statements in conformity with U.S. generally accepted accounting principles. There were no changes in these controls or procedures identified in connection with the evaluation of such controls or procedures that occurred during our last fiscal quarter, or in other factors that have materially affected, or are reasonably likely to materially affect, these controls or procedures.

Our management group, including our principal executive officer and principal financial officer, does not expect that our disclosure controls and internal controls and related procedures will prevent all error and all fraud. A control system, no matter how well designed and implemented, can provide only reasonable assurance that the objectives of the control system are met. In addition, the design and implementation of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered in relation to their costs. The design of any system of controls is based, in part, upon certain assumptions about the likelihood of future events, which may prove to be incorrect. Due to the limitations of all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within an organization have been detected or prevented.

PART II. OTHER INFORMATION

Item 6. Exhibits

10.1 Promissory Note of Neose Technologies, Inc. to General Electric Capital Corporation, dated July 12, 2005.

31.1 Certification by Chief Executive Officer pursuant to Rule 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification by Chief Financial Officer pursuant to Rule 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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.

NEOSE TECHNOLOGIES, INC.

Date: November 2, 2005

By: /s/ A. Brian Davis
A. Brian Davis
Senior Vice President and Chief
Financial Officer (Principal Financial
Officer and Duly Authorized Signatory)

Exhibit Index

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