

LIGAND PHARMACEUTICALS INC

Form 10-Q

May 08, 2013

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

Mark One

Quarterly Report Pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934

For the quarterly period ended March 31, 2013 or

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the Transition Period From _____ to _____. Commission File Number: 001-33093

LIGAND PHARMACEUTICALS INCORPORATED

(Exact name of registrant as specified in its charter)

Delaware

77-0160744

(State or other jurisdiction of
incorporation or organization)

(I.R.S. Employer
Identification No.)

11119 North Torrey Pines Road, Suite 200

92037

La Jolla, CA

(Zip Code)

(Address of principal executive offices)

Registrant's Telephone Number, Including Area Code: (858) 550-7500

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large Accelerated Filer

Accelerated Filer

Non-Accelerated Filer (Do not check if a smaller reporting company)

Smaller Reporting Company

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

No

As of May 1, 2013, the registrant had 20,234,959 shares of common stock outstanding.

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LIGAND PHARMACEUTICALS INCORPORATED
QUARTERLY REPORT

FORM 10-Q

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

LIGAND PHARMACEUTICALS INCORPORATED
CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(in thousands, except share data)

	March 31, 2013	December 31, 2012
ASSETS		
Current assets:		
Cash and cash equivalents	\$5,037	\$12,381
Accounts receivable	4,622	4,589
Inventory	2,838	1,697
Other current assets	986	829
Current portion of co-promote termination payments receivable	4,257	4,327
Total current assets	17,740	23,823
Restricted cash and investments	3,933	2,767
Property and equipment, net	758	788
Current portion of deferred income taxes	8	8
Intangible assets, net	55,319	55,912
Goodwill	12,238	12,238
Long-term portion of co-promote termination payments receivable	7,916	8,207
Other assets	451	517
Total assets	\$98,363	\$104,260
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$5,522	\$5,854
Accrued liabilities	4,518	4,961
Current portion of contingent liabilities	356	356
Current portion of deferred income taxes	1,581	1,581
Current portion of note payable	13,212	14,835
Current portion of co-promote termination liability	4,257	4,327
Current portion of lease exit obligations	3,015	3,039
Current portion of deferred revenue	556	486
Total current liabilities	33,017	35,439
Long-term portion of note payable	5,494	13,443
Long-term portion of co-promote termination liability	7,916	8,207
Long-term portion of deferred revenue, net	2,125	2,369
Long-term portion of lease exit obligations	5,074	5,963
Deferred income taxes	791	725
Long-term portion of contingent liabilities	12,384	10,543
Other long-term liabilities	966	1,086
Total liabilities	67,767	77,775
Commitments and Contingencies		
Stockholders' equity:		
Common stock, \$0.001 par value; 33,333,333 shares authorized; 21,342,888 and 21,278,606 shares issued and outstanding at March 31, 2013 and December 31, 2012, 21 respectively		21
Additional paid-in capital	752,952	751,503

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Accumulated other comprehensive income	1,166	—	
Accumulated deficit	(681,263) (682,759)
Treasury stock, at cost; 1,118,222 shares at March 31, 2013 and December 31, 2012, respectively	(42,280	) (42,280)
Total stockholders' equity	30,596	26,485	
Total liabilities and stockholders' equity	\$98,363	\$104,260	

See accompanying notes.

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CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

(in thousands, except share data)

	Three Months Ended March 31,	
	2013	2012
Revenues:		
Royalties	\$5,826	\$3,060
Material sales	1,539	667
Collaborative research and development and other revenues	4,286	1,909
Total revenues	11,651	5,636
Operating costs and expenses:		
Cost of sales	663	155
Research and development	2,465	2,817
General and administrative	4,502	3,416
Lease exit and termination costs	89	87
Total operating costs and expenses	7,719	6,475
Income (loss) from operations	3,932	(839)
Other income (expense):		
Interest expense, net	(912)	(701)
(Increase) decrease in contingent liabilities	(1,841)	513
Other, net	191	254
Total other (expense) income, net	(2,562)	66
Income (loss) before income taxes	1,370	(773)
Income tax (expense) benefit	(66)	35
Income (loss) from continuing operations	1,304	(738)
Discontinued operations:		
Gain on sale of Avinza Product Line before income taxes	191	2,048
Income tax expense on discontinued operations	—	(177)
Income from discontinued operations	191	1,871
Net income:	\$1,495	\$1,133
Basic and diluted per share amounts:		
Income (loss) from continuing operations	\$0.06	\$(0.04)
Income from discontinued operations	0.01	0.10
Net income	\$0.07	\$0.06
Weighted average number of common shares-basic	20,189,378	19,709,078
Weighted average number of common shares-diluted	20,280,030	19,738,801

See accompanying notes.

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LIGAND PHARMACEUTICALS INCORPORATED
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)
(in thousands)

	Three Months Ended March 31,	
	2013	2012
Net income	\$1,495	\$1,133
Unrealized net gain on available-for-sale securities	1,166	—
Comprehensive income	\$2,661	\$1,133

See accompanying notes.

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LIGAND PHARMACEUTICAL INCORPORATED
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(in thousands)

	Three Months Ended March 31,	
	2013	2012
Operating activities		
Net income	\$1,495	\$1,133
Less: gain from discontinued operations	191	1,871
Income (loss) from continuing operations	1,304	(738)
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Non-cash change in estimated fair value of contingent liabilities	1,841	(513)
Depreciation and amortization	670	678
Realized gain on investment	—	(17)
Share-based compensation	1,124	709
Deferred income taxes	66	(35)
Accretion of note payable	142	85
Other	(13)	(10)
Changes in operating assets and liabilities,:		
Accounts receivable	(33)	) 4,118
Inventory	102	(44)
Other current assets	(157)	) (462)
Other long-term assets	66	175
Accounts payable and accrued liabilities	(2,098)	) (3,506)
Other liabilities	(120)) —
Deferred revenue	(174)	) (609)
Net cash provided by (used in) operating activities of continuing operations	2,720	(169)
Net cash used in operating activities of discontinued operations	(642)	) (200)
Net cash provided by (used in) operating activities	2,078	(369)
Investing activities		
Payments to CVR holders	—	(4,549)
Purchases of property and equipment	(37)	) (19)
Proceeds from sale of property and equipment	3	13
Proceeds from sale of short-term investments	—	8,500
Net cash (used in) provided by investing activities	(34)	) 3,945
Financing activities		
Proceeds from issuance of debt	—	7,500
Repayment of debt	(9,714)	) (8,500)
Net proceeds from stock option exercises	326	160
Net cash used in financing activities	(9,388)	) (840)
Net (decrease) increase in cash and cash equivalents	(7,344)	) 2,736
Cash and cash equivalents at beginning of period	12,381	7,041
Cash and cash equivalents at end of period	\$5,037	\$9,777
Supplemental Disclosure of cash flow information		
Interest paid	991	631
Taxes paid	—	17

See accompanying notes.

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LIGAND PHARMACEUTICALS INCORPORATED
Notes to Condensed Consolidated Financial Statements
(Unaudited)

1. Basis of Presentation

Ligand Pharmaceuticals Incorporated, a Delaware corporation (the "Company" or "Ligand") is a biopharmaceutical company with a business model that is based upon the concept of developing or acquiring royalty revenue generating assets and coupling them to a lean corporate cost structure. By diversifying the portfolio of assets across numerous technology types, therapeutic areas, drug targets, and industry partners, the Company offers investors an opportunity to invest in the increasingly complicated and unpredictable pharmaceutical industry. In comparison to its peers, the Company believes it has assembled one of the largest and most diversified asset portfolios in the industry with the potential to generate revenue in the future. These therapies address the unmet medical needs of patients for a broad spectrum of diseases including hepatitis, muscle wasting, Alzheimer's disease, dyslipidemia, diabetes, anemia, asthma, FSGS and osteoporosis. Ligand has established multiple alliances with the world's leading pharmaceutical companies including GlaxoSmithKline, Onyx Pharmaceuticals, Merck, Pfizer, Baxter International, Bristol-Myers Squibb, Celgene, Lundbeck Inc., Spectrum Pharmaceuticals, Inc. and The Medicines Company. The Company's principal market is the United States. The Company sold its Oncology Product Line ("Oncology") and Avinza Product Line ("Avinza") on October 25, 2006 and February 26, 2007, respectively. The operating results for Oncology and Avinza have been presented in the accompanying consolidated financial statements as "Discontinued Operations."

The Company has incurred significant losses since its inception. As of March 31, 2013, the Company's accumulated deficit was \$681.3 million and the Company had negative working capital of \$15.3 million. Management believes that cash flows from operations will improve due to Captisol[®] sales, an increase in royalty revenues driven primarily from continued increases in Promacta[®] and Kyprolis[®] sales, and also from anticipated new license and milestone revenues. In the event revenues and operating cash flows are not meeting expectations, management plans to reduce discretionary expenses. However, it is possible that the Company may be required to seek additional financing. There can be no assurance that additional financing will be available on terms acceptable to management, or at all. Management believes its currently available cash, cash equivalents, and short-term investments as well as its current and future royalty, license and milestone revenues will be sufficient to satisfy its anticipated operating and capital requirements through at least the next 12 months. The Company's future operating and capital requirements will depend on many factors, including, but not limited to: the pace of scientific progress in its research and development programs; the potential success of these programs; the scope and results of preclinical testing and clinical trials; the time and costs involved in obtaining regulatory approvals; the costs involved in preparing, filing, prosecuting, maintaining and enforcing patent claims; competing technological and market developments; the amount of royalties on sales of the commercial products of its partners; the efforts of its collaborative partners; obligations under its operating lease agreements; and the capital requirements of any companies the Company acquires, including Pharmacoepia, Inc. ("Pharmacoepia"), Neurogen Corporation ("Neurogen"), Metabasis Therapeutics, Inc. ("Metabasis") and CyDex Pharmaceuticals, Inc. ("CyDex"). The ability of the Company to achieve its operational targets is dependent upon the Company's ability to further implement its business plan and generate sufficient operating cash flow.

Principles of Consolidation

The accompanying consolidated financial statements include Ligand and its wholly owned subsidiaries, Ligand JVR, Allergan Ligand Retinoid Therapeutics, Seragen, Inc. ("Seragen"), Pharmacoepia, Neurogen, CyDex, Metabasis, and Nexus VI LLC ("Nexus"). All significant intercompany accounts and transactions have been eliminated in consolidation.

Basis of Presentation

The Company's accompanying unaudited consolidated condensed financial statements as of March 31, 2013 and for the three months ended March 31, 2013 and 2012 have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for annual financial statements. The Company's consolidated condensed balance sheet at December 31, 2012 has been derived from the audited financial statements at that date, but does not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation of the financial position and results of operations of the Company, and its subsidiaries have been included. Operating results for the three months ended March 31, 2013 are not necessarily indicative of the results that may be expected for the year ending December 31, 2013. These financial statements should be read in conjunction with the consolidated financial statements and notes therein included in the Company's annual report on Form 10-K for the year ended December 31, 2012.

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Use of Estimates

The preparation of consolidated financial statements in conformity with generally accepted accounting principles requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities, including disclosure of contingent assets and liabilities, at the date of the consolidated financial statements, and the reported amounts of revenue and expenses during the reporting period. The Company's critical accounting policies are those that are both most important to the Company's financial condition and results of operations and require the most difficult, subjective or complex judgments on the part of management in their application, often as a result of the need to make estimates about the effect of matters that are inherently uncertain. Because of the uncertainty of factors surrounding the estimates or judgments used in the preparation of the consolidated financial statements, actual results may materially vary from these estimates.

Reclassifications

Certain reclassifications have been made to the previously issued statement of operations for the three months ended March 31, 2012 for comparability purposes. This reclassification had no effect on the reported net income, stockholders' equity, and operating cash flows as previously reported.

Earnings (Loss) Per Share

Basic earnings (loss) per share is calculated by dividing net income or loss by the weighted average number of common shares and vested restricted stock units outstanding. Diluted earnings per share is computed by dividing net income or loss by the weighted average number of common shares and vested restricted stock units outstanding and the weighted average number of dilutive common stock equivalents, including stock options and non-vested restricted stock units. Common stock equivalents are only included in the diluted earnings per share calculation when their effect is dilutive. The total number of potential common shares excluded from the computation of diluted loss per share because their inclusion would have been anti-dilutive was 1.2 million and 1.5 million, at March 31, 2013 and 2012, respectively.

The following table sets forth the computation of basic and diluted net income (loss) per share for the periods indicated (in thousands, except per share amounts):

	Three Months Ended March 31,	
	2013	2012
Net income (loss) from continuing operations	\$1,304	\$(738)
Net income from discontinued operations	191	1,871
Net income	\$1,495	\$1,133
Shares used to compute basic income (loss) per share	20,189,378	19,709,078
Dilutive potential common shares:		
Restricted stock	90,652	29,723
Shares used to compute diluted income (loss) per share	20,280,030	19,738,801
Basic and diluted per share amounts:		
Income (loss) from continuing operations	\$0.06	\$(0.04)
Income from discontinued operations	0.01	0.10
Net income	\$0.07	\$0.06

Cash, Cash Equivalents and Short-term Investments

Cash and cash equivalents consist of cash and highly liquid securities with maturities at the date of acquisition of three months or less. Non-restricted equity and debt securities with a maturity of more than three months are considered short-term investments.

Restricted Cash and Investments

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Restricted cash and investments consist of certificates of deposit held with a financial institution as collateral under a facility lease including third-party service provider arrangements and available-for-sale securities received by the Company as a result of milestone payments from a licensee. The fair value of the Company's available-for-sale securities are determined using quoted market prices in active markets and are discounted based on trading restrictions.

The following table summarizes the various investment categories at March 31, 2013 and December 31, 2012 (in thousands):

	Cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
March 31, 2013				
Available-for-sale securities	\$1,426	\$1,166	\$—	\$2,592
Certificates of deposit - restricted	1,341	—	—	1,341
	\$2,767	\$1,166	\$—	\$3,933
December 31, 2012				
Available-for-sale securities	\$1,426	\$—	\$—	\$1,426
Certificates of deposit-restricted	1,341	—	—	1,341
	\$2,767	\$—	\$—	\$2,767

Concentrations of Credit Risk

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist primarily of cash equivalents and investments and accounts receivable.

The Company invests its excess cash principally in United States government debt securities, investment grade corporate debt securities and certificates of deposit. The Company has established guidelines relative to diversification and maturities that maintain safety and liquidity. These guidelines are periodically reviewed and modified to take advantage of trends in yields and interest rates. The Company has not experienced any significant losses on its cash equivalents, short-term investments or restricted investments for the periods ending March 31, 2013 and December 31, 2012.

As of March 31, 2013 and December 31, 2012, cash deposits held at financial institutions in excess of FDIC insured amounts of \$250,000 were approximately \$4.4 million and \$11.9 million, respectively.

Accounts receivable from two customers was 64% and 28% of total accounts receivable at March 31, 2013. Accounts receivable from two customers was 53% and 35% of total accounts receivable at December 31, 2012.

The Company currently obtains Captisol from a sole-source supplier. If this supplier was not able to supply the requested amounts of Captisol, the Company would be unable to continue to derive revenues from the sale of Captisol until it obtained an alternative source, which might take a considerable length of time.

Inventory

Inventory is stated at the lower of cost or market. The Company determines cost using the first-in, first-out method. The Company analyzes its inventory levels periodically and writes down inventory to its net realizable value if it has become obsolete, has a cost basis in excess of its expected net realizable value or is in excess of expected requirements.

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Property and Equipment

Property and equipment is stated at cost and consists of the following (in thousands):

	March 31, 2013	December 31, 2012
Lab and office equipment	\$4,837	\$4,374
Leasehold improvements	134	145
Computer equipment and software	1,244	1,150
	6,215	5,669
Less accumulated depreciation and amortization	(5,457	) (4,881
	\$758	\$788

Depreciation of equipment is computed using the straight-line method over the estimated useful lives of the assets, which range from three to ten years. Leasehold improvements are amortized using the straight-line method over their estimated useful lives or their related lease term, whichever is shorter. Depreciation expense of \$0.1 million was recognized for the three months ended March 31, 2013 and 2012.

Other Current Assets

Other current assets consist of the following (in thousands):

	March 31, 2013	December 31, 2012
Prepaid expenses	\$941	\$801
Advanced manufacturing payments	—	2
Other receivables	45	26
	\$986	\$829

Goodwill and Other Identifiable Intangible Assets

Goodwill and other identifiable intangible assets consist of the following (in thousands):

	March 31, 2013	December 31, 2012
Indefinite lived intangible assets		
Acquired in-process research and development	\$13,036	\$13,036
Goodwill	12,238	12,238
Definite lived intangible assets		
Complete technology	15,227	15,227
Trade name	2,642	2,642
Customer relationships	29,600	29,600
	47,469	47,469
Accumulated amortization	(5,186	) (4,593
Total goodwill and other identifiable intangible assets, net	\$67,557	\$68,150

The Company accounts for goodwill in accordance with Accounting Standards Codification Topic 350-Intangibles-Goodwill and Other ("ASC 350") which, among other things, establishes standards for goodwill acquired in a business combination, eliminates the amortization of goodwill and requires the carrying value of goodwill and certain non-amortizing

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intangibles to be evaluated for impairment on an annual basis. The Company considers its market capitalization and the carrying value of its assets and liabilities, including goodwill, when performing its goodwill impairment test. If the carrying value of the assets and liabilities, including goodwill, were to exceed the Company's estimation of the fair value, the Company would record an impairment charge in an amount equal to the excess of the carrying value of goodwill over the implied fair value of the goodwill. The Company performs an evaluation of goodwill as of December 31 of each year, absent any indicators of earlier impairment, to ensure that impairment charges, if applicable, are reflected in our financial results before December 31 of each year. When it is determined that impairment has occurred, a charge to operations is recorded. Goodwill and other intangible asset balances are included in the identifiable assets of the business segment to which they have been assigned. Any goodwill impairment, as well as the amortization of other purchased intangible assets, is charged against the respective business segments' operating income. As of March 31, 2013 and December 31, 2012, there have been no impairment of goodwill for continuing operations.

Amortization of definite lived intangible assets is computed using the straight-line method over the estimated useful life of the asset of 20 years. Amortization expense of \$0.6 million was recognized for the three months ended March 31, 2013 and 2012. Estimated amortization expense for the years ending December 31, 2013 through 2017 is \$2.4 million per year.

Acquired In-Process Research and Development

Intangible assets related to IPR&D are considered to be indefinite-lived until the completion or abandonment of the associated research and development efforts. During the period the assets are considered to be indefinite-lived, they will not be amortized but will be tested for impairment on an annual basis and between annual tests if the Company becomes aware of any events occurring or changes in circumstances that would indicate a reduction in the fair value of the IPR&D projects below their respective carrying amounts. If and when development is complete, which generally occurs if and when regulatory approval to market a product is obtained, the associated assets would be deemed finite-lived and would then be amortized based on their respective estimated useful lives at that point in time.

Impairment of Long-Lived Assets

Management reviews long-lived assets for impairment annually or whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future undiscounted net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured as the amount by which the carrying amount of the assets exceeds the fair value of the assets. Fair value for the Company's long-lived assets is determined using the expected cash flows discounted at a rate commensurate with the risk involved. As of March 31, 2013, management does not believe there have been any events or circumstances indicating that the carrying amount of its long-lived assets may not be recoverable.

Accrued Liabilities

Accrued liabilities consist of the following (in thousands):

	March 31, 2013	December 31, 2012
Compensation	\$915	\$1,807
Professional fees	403	199
Other	3,200	2,955
	\$4,518	\$4,961

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Other Long-Term Liabilities

Other long-term liabilities consist of the following (in thousands):

	March 31, 2013	December 31, 2012
Deposits	\$567	\$538
Deferred rent	399	334
Other	—	214
	\$966	\$1,086

Contingent Liabilities

In connection with the Company's acquisition of CyDex in January 2011, the Company recorded a \$17.6 million contingent liability, inclusive of the \$4.3 million payment made in January 2012, for amounts potentially due to holders of the CyDex contingent value rights ("CVRs") and former license holders. The liability is periodically assessed based on events and circumstances related to the underlying milestones, and the change in fair value is recorded in the Company's consolidated statements of operations. The carrying amount of the liability may fluctuate significantly and actual amounts paid under the CVR agreements may be materially different than the carrying amount of the liability. The fair value of the liability at March 31, 2013 and December 31, 2012 was \$12.7 million and \$10.9 million, respectively. The Company recorded a fair value adjustment to increase the liability for CyDex related contingent liabilities of \$1.8 million for the three months ended March 31, 2013. The Company recorded fair value adjustments to increase the liability for CyDex related contingent liabilities of \$0.6 million for the three months ended March 31, 2012. Additionally, the Company recorded cash payments of \$4.3 million for the January 2012 guaranteed payment and \$0.2 million for the 2011 revenue sharing payment for the three months ended March 31, 2012. There was no revenue sharing payment for the three months ended March 31, 2013.

In connection with the Company's acquisition of Metabasis in January 2010, the Company issued Metabasis stockholders four tradable CVRs, one CVR from each of four respective series of CVR, for each Metabasis share. The CVR will entitle Metabasis stockholders to cash payments as frequently as every six months as cash is received by the Company from proceeds from Metabasis' partnership with Roche (which has been terminated) or the sale or partnering of any of the Metabasis drug development programs, among other triggering events. The fair values of the CVRs are remeasured at each reporting date through the term of the related agreement. Changes in the fair values are reported in the statement of operations as income (decreases) or expense (increases). The carrying amount of the liability may fluctuate significantly based upon quoted market prices and actual amounts paid under the agreements may be materially different than the carrying amount of the liability. The fair value of the liability was estimated to be zero as of March 31, 2013 and 2012. The Company did not record any change in the liability for CVRs for the three months ended March 31, 2013. The Company recorded a decrease in the liability for CVRs of \$1.1 million during the three months ended March 31, 2012.

In connection with the Company's acquisition of Neurogen in December 2009, the Company issued to Neurogen stockholders four CVRs; real estate, Aplindore, VR1 and H3, that entitle them to cash and/or shares of third-party stock under certain circumstances. The Company recorded the acquisition-date fair value of the CVRs as part of the purchase price. In February 2010, the Company completed the sale of the real estate and subsequently distributed the proceeds to the holders of the real estate CVR. As a result and after final settlement of all related expenses, the real estate CVR was terminated in August 2010. In 2012, the Company received a notice from a collaboration partner that it was terminating its agreement related to VR1 for convenience and subsequently the Company recorded a decrease in the fair value of the liability for the related CVR of \$0.2 million. Additionally, per the CVR agreement, no payment event date for the H3 program can occur after December 23, 2012 and the Company recorded a decrease in the fair value of the liability for the related CVR of \$0.5 million. There are no remaining CVR obligations under the agreement with the former Neurogen shareholders.

Fair Value of Financial Instruments

Fair value is defined as the exit price that would be received to sell an asset or paid to transfer a liability. Fair value is a market-based measurement that should be determined using assumptions that market participants would use in pricing an asset or liability. The Company establishes a three-level hierarchy to prioritize the inputs used in measuring fair value. The levels are described in the below with Level 1 having the highest priority and Level 3 having the lowest:

Level 1 - Observable inputs such as quoted prices in active markets

Level 2 - Inputs other than the quoted prices in active markets that are observable either directly or indirectly

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Level 3 - Unobservable inputs in which there is little or no market data, which require us to develop our own assumptions

The Company's long-term investments include investments in equity securities which are subject to trading restrictions. The fair value of the investments is determined using quoted market prices in active markets and discounted for the restrictive effect. The Metabasis CVR liability is marked-to-market at each reporting period based upon the quoted market prices of the underlying CVR. The fair value of the CyDex contingent liabilities are determined at each reporting period based upon an income valuation model.

Revenue Recognition

Royalties on sales of products commercialized by the Company's partners are recognized in the quarter reported by the respective partner.

Revenue from material sales is recognized upon transfer of title, which normally passes upon shipment to the customer. The Company's credit and exchange policy includes provisions for the return of product between 30 to 90 days, depending on the specific terms of the individual agreement, when that product (1) does not meet specifications, (2) is damaged in shipment (in limited circumstances where title does not transfer until delivery), or (3) is exchanged for an alternative grade of Captisol.

Nonrefundable, up-front license fees and milestone payments with standalone value that are not dependent on any future performance by us under our collaboration agreements are recognized as revenue upon the earlier of when payments are received or collection is assured, but are deferred if the Company has continuing performance obligations. Amounts received under multiple-element arrangements requiring ongoing services or performance by the Company are recognized over the period of such services or performance. The Company occasionally has sub-license obligations related to arrangements for which it receives license fees, milestones and royalties. The Company evaluates the determination of gross versus net reporting based on each individual agreement.

The Company analyzes its revenue arrangements and other agreements to determine whether there are multiple elements that should be separated and accounted for individually or as a single unit of accounting. For multiple element contracts, arrangement consideration is allocated at the inception of the arrangement to all deliverables on the basis of relative selling price, using a hierarchy to determine selling price. Management first considers vendor-specific objective evidence ("VSOE"), then third-party evidence ("TPE") and if neither VSOE nor TPE exist, the Company uses its best estimate of selling price.

Many of the Company's revenue arrangements involve the bundling of a license with the option to purchase manufactured product. Licenses are granted to pharmaceutical companies for the use of Captisol in the development of pharmaceutical compounds. The licenses may be granted for the use of the Captisol product for all phases of clinical trials and through commercial availability of the host drug or may be limited to certain phases of the clinical trial process. The Company believes that its licenses have stand-alone value at the outset of an arrangement because the customer obtains the right to use Captisol in its formulations without any additional input by the Company, and in a hypothetical stand-alone transaction, the customer would be able to procure inventory from another manufacturer in the absence of contractual provisions for exclusive supply by the Company.

Revenue from milestones is recognized when earned, as evidenced by written acknowledgement from the collaborator, provided that (i) the milestone event is substantive, its achievability was not reasonably assured at the inception of the agreement, and the Company has no further performance obligations relating to that event, and (ii) collectability is reasonably assured. If these criteria are not met, the milestone payment is recognized over the remaining period of the Company's performance obligations under the arrangement.

Allowance for Doubtful Accounts

The Company maintains an allowance for doubtful accounts based on the best estimate of the amount of probable losses in the Company's existing accounts receivable. Accounts receivable that are outstanding longer than their contractual payment terms, ranging from 30 to 90 days, are considered past due. When determining the allowance for

doubtful accounts, several factors are taken into consideration, including historical write-off experience and review of specific customer accounts for collectability. Account balances are charged off against the allowance after collection efforts have been exhausted and the potential for recovery is considered remote. There was no allowance for doubtful accounts included in the balance sheets at March 31, 2013 and December 31, 2012.

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Accounting for Share-Based Compensation

Share-based compensation expense for awards to employees and non-employee directors is recognized on a straight-line basis over the vesting period until the last tranche vests. Compensation cost for consultant awards is recognized over each separate tranche's vesting period. The following table summarizes share-based compensation expense recorded as components of research and development expenses and general and administrative expenses for the periods indicated (in thousands):

	Three Months Ended March 31,	
	2013	2012
Share-based compensation expense as a component of:		
Research and development expenses	\$ 386	\$ 425
General and administrative expenses	738	284
	\$ 1,124	\$ 709

The fair-value for options that were awarded to employees and directors was estimated at the date of grant using the Black-Scholes option valuation model with the following weighted-average assumptions:

	Three Months Ended March 31,	
	2013	2012
Risk-free interest rate	1.1%	1.1%
Dividend yield	—	