LIGAND PHARMACEUTICALS INC
Form 10-Q
May 07, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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x Quarterly Report Pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934
For the quarterly period ended March 31, 2014
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: 001-33093

LIGAND PHARMACEUTICALS INCORPORATED
(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	77-0160744 (I.R.S. Employer Identification No.)
11119 North Torrey Pines Road, Suite 200 La Jolla, CA (Address of principal executive offices)	92037 (Zip Code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o
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 x No o
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 Filero	Accelerated Filer x
Non-Accelerated Filer o (Do not check if a smaller reporting company)	Smaller Reporting Company 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 x
As of May 7, 2014, the registrant had 20,725,391 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, 2014	December 31, 2013
ASSETS		
Current assets:		
Cash and cash equivalents	$12,977	$11,639
Short-term investments	12,275	4,340
Accounts receivable	4,673	2,222
Inventory	1,949	1,392
Other current assets	841	959
Current portion of co-promote termination payments receivable	688	4,329
Total current assets	33,403	24,881
Restricted cash and investments	1,341	1,341
Property and equipment, net	690	867
Intangible assets, net	52,505	53,099
Goodwill	12,238	12,238
Commercial license rights	4,571	4,571
Long-term portion of co-promote termination payments receivable	448	7,417
Other assets	275	299
Total assets	$105,471	$104,713
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$3,675	$3,951
Accrued liabilities	5,451	5,337
Current portion of contingent liabilities	1,094	1,712
Current portion of deferred income taxes	1,574	1,574
Current portion of note payable	5,769	9,109
Current portion of co-promote termination liability	688	4,329
Current portion of lease exit obligations	2,754	2,811
Current portion of deferred revenue	—	116
Total current liabilities	21,005	28,939
Long-term portion of co-promote termination liability	448	7,417
Long-term portion of deferred revenue, net	2,085	2,085
Long-term portion of lease exit obligations	2,339	3,071
Deferred income taxes	1,151	1,098
Long-term portion of contingent liabilities	12,743	11,795
Other long-term liabilities	699	695
Total liabilities	40,470	55,100
Commitments and Contingencies		
Stockholders' equity:		
Common stock, $0.001 par value; 33,333,333 shares authorized; 20,717,058 and 20,468,521 shares issued and outstanding at March 31, 2014 and December 31, 2013, respectively	21	21

Additional paid-in capital	723,279	718,017
Accumulated other comprehensive income	10,943	2,914
Accumulated deficit	(669,242)	(671,339)
Total stockholders' equity	65,001	49,613
Total liabilities and stockholders' equity	$105,471	$104,713

See accompanying notes.

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LIGAND PHARMACEUTICALS INCORPORATED
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)
(in thousands, except share data)

	Three Months Ended March 31,	
	2014	2013
Revenues:		
Royalties	$7,850	$5,826
Material sales	5,715	1,539
Collaborative research and development and other revenues	2,393	4,286
Total revenues	15,958	11,651
Operating costs and expenses:		
Cost of sales	2,451	663
Research and development	3,131	2,465
General and administrative	5,072	4,502
Lease exit and termination costs	204	89
Total operating costs and expenses	10,858	7,719
Income from operations	5,100	3,932
Other (expense) income:		
Interest expense, net	(248)	(912)
Increase in contingent liabilities	(1,948)	(1,841)
Other, net	(754)	191
Total other expense, net	(2,950)	(2,562)
Income before income taxes	2,150	1,370
Income tax expense	(53)	(66)
Income from continuing operations	2,097	1,304
Discontinued operations:		
Gain on sale of Avinza Product Line before income taxes	—	191
Income from discontinued operations	—	191
Net income:	$2,097	$1,495
Basic per share amounts:		
Income from continuing operations	$0.10	$0.06
Income from discontinued operations	—	0.01
Net income	$0.10	$0.07
Diluted per share amounts:		
Income from continuing operations	$0.10	$0.06
Income from discontinued operations	—	0.01
Net income	$0.10	$0.07
Weighted-average number of common shares-basic	20,600,683	20,189,378
Weighted-average number of common shares-diluted	21,208,023	20,280,030

See accompanying notes.

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

	Three Months Ended March 31,	
	2014	2013
Net income	$2,097	$1,495
Unrealized net gain on available-for-sale securities, net of tax of $0	8,222	1,166
Less: Reclassification of net realized gains included in net income	$(193)	$—
Comprehensive income	$10,126	$2,661

See accompanying notes.

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

	Three Months Ended March 31,	
	2014	2013
Operating activities		
Net income	$2,097	$1,495
Less: gain from discontinued operations	—	191
Income from continuing operations	2,097	1,304
Adjustments to reconcile net income to net cash used in operating activities:		
Non-cash change in estimated fair value of contingent liabilities	1,948	1,841
Realized (gain) on investment	(481)	—
Loss on write off of assets	109	—
Depreciation and amortization	668	670
Stock-based compensation	2,067	1,124
Deferred income taxes	53	66
Accretion of note payable	100	142
Other	—	(13)
Changes in operating assets and liabilities:		
Accounts receivable	(2,451)	(33)
Inventory	(557)	102
Other current assets	118	(157)
Other long-term assets	24	66
Accounts payable and accrued liabilities	(1,002)	(2,218)
Deferred revenue	(116)	(174)
Net cash provided by operating activities of continuing operations	2,577	2,720
Net cash used in operating activities of discontinued operations	—	(642)
Net cash provided by operating activities	2,577	2,078
Investing activities		
Payments to CVR holders and former license holders	(1,618)	—
Purchases of property and equipment	(6)	(37)
Proceeds from sale of property and equipment	—	3
Proceeds from sale of short-term investments	626	—
Net cash used in investing activities	(998)	(34)
Financing activities		
Repayment of debt	(3,436)	(9,714)
Net proceeds from stock option exercises	3,195	326
Net cash used in financing activities	(241)	(9,388)
Net increase (decrease) in cash and cash equivalents	1,338	(7,344)
Cash and cash equivalents at beginning of period	11,639	12,381
Cash and cash equivalents at end of period	$12,977	$5,037
Supplemental disclosure of cash flow information		
Interest paid	$110	$991
Supplemental schedule of non-cash activity		
Accrued inventory purchases	$—	$1,243
Unrealized gain on AFS investments	$8,222	$1,166

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 with 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. These therapies address the unmet medical needs of patients for a broad spectrum of diseases including hepatitis, multiple myeloma, muscle wasting, Alzheimer's disease, dyslipidemia, diabetes, anemia, asthma, Focal Segmental Glomerulosclerosis, or (FSGS) and osteoporosis. Ligand has established multiple alliances with the world's leading pharmaceutical companies including GlaxoSmithKline, Onyx Pharmaceuticals (a subsidiary of Amgen, Inc.), Merck, Pfizer, Baxter International, Lundbeck Inc., and Spectrum Pharmaceuticals, Inc. 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 condensed consolidated financial statements as "Discontinued Operations."

The Company has incurred significant losses since its inception. As of March 31, 2014, the Company's accumulated deficit was approximately $669.2 million and the Company had working capital of approximately $12.4 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. and Captisol material sales 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; costs associated with future acquisitions and the capital requirements of any companies the Company may acquire in the future. 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 condensed consolidated financial statements include Ligand and its wholly owned subsidiaries, Ligand JVR, Allergan Ligand Retinoid Therapeutics, Seragen, Inc., Pharmacopeia, Inc. ("Pharmacopeia"), Neurogen Corporation ("Neurogen"), CyDex Pharmaceuticals, Inc. ("CyDex"), Metabasis Therapeutics, Inc. ("Metabasis"), and Nexus VI, Inc. All significant intercompany accounts and transactions have been eliminated in consolidation.

Basis of Presentation

The Company’s accompanying unaudited condensed consolidated financial statements as of March 31, 2014 and for the three months ended March 31, 2014 and 2013 have been prepared in accordance with accounting principles generally accepted in the United States 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 for annual financial statements. The Company’s condensed consolidated balance sheet at December 31, 2013 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 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, 2014 are not necessarily indicative of the results that may be expected for the year ending December 31, 2014. 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, 2013.

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Use of Estimates

The preparation of condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States requires the use of estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, expenses, contingent assets and liabilities, definite and indefinite lived intangible assets, goodwill, co-promote termination payments receivable and co-promote termination liabilities, uncertain tax positions, deferred revenue, lease exit liability and income tax net operating loss carryforwards 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 condensed consolidated financial statements, actual results may materially vary from these estimates.

Income Per Share

Basic income per share is calculated by dividing net income by the weighted-average number of common shares and vested restricted stock units outstanding. Diluted income per share is computed by dividing net income 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 income per share calculation when their effect is dilutive. The total number of potential common shares excluded from the computation of diluted income per share because their inclusion would have been anti-dilutive was 1.0 million and 1.1 million, at March 31, 2014 and 2013, respectively.

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

	Three months ended March 31,	
	2014	2013
Net income from continuing operations	$2,097	$1,304
Net income from discontinued operations	—	191
Net income	$2,097	$1,495
Shares used to compute basic income per share	20,600,683	20,189,378
Dilutive potential common shares:		
Restricted stock	60,602	74,323
Stock options	546,738	16,329
Shares used to compute diluted income per share	21,208,023	20,280,030
Basic per share amounts:		
Income from continuing operations	$0.10	$0.06
Income from discontinued operations	—	0.01
Net income	$0.10	$0.07
Diluted per share amounts:		
Income from continuing operations	$0.10	$0.06
Income from discontinued operations	—	0.01
Net income	$0.10	$0.07

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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. Securities received by the Company as a result of a milestone payment from a licensee are considered short-term investments and have been classified by management as available-for-sale. Such investments are carried at fair value, with unrealized gains and losses included in the statement of comprehensive income. The Company determines the cost of investments based on the specific identification method.

Restricted Cash and Investments

Restricted cash and investments consist of certificates of deposit held with a financial institution as collateral under a facility lease and third-party service provider arrangements.

The following table summarizes the various investment categories at March 31, 2014 and December 31, 2013 (in thousands):

	Cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
March 31, 2014				
Short-term investments	$1,332	$10,943	$—	$12,275
Certificates of deposit-restricted	1,341	—	—	1,341
	$2,673	$10,943	$—	$13,616
December 31, 2013				
Short-term investments	$1,426	$2,914	$—	$4,340
Certificates of deposit-restricted	1,341	—	—	1,341
	$2,767	$2,914	$—	$5,681

Concentrations of Credit Risk

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

The Company invests its excess cash principally in U.S. 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 did not experience any significant losses on its cash equivalents, short-term investments or restricted investments for the periods ending March 31, 2014 and December 31, 2013.

As of March 31, 2014 and December 31, 2013, cash deposits held at financial institutions in excess of FDIC insured amounts of $250,000 were approximately $12.3 million and $11.1 million, respectively.

Accounts receivable from two customers was 65% of total accounts receivable at March 31, 2014. Accounts receivable from two customers was 75% of total accounts receivable at December 31, 2013.

The Company currently obtains Captisol from a single supplier. If this supplier were 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 value. 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. There were no write downs related to obsolete inventory recorded for the three months ended March 31, 2014 and 2013.

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Property and Equipment

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

	March 31, 2014	December 31, 2013
Lab and office equipment	$3,728	$3,737
Leasehold improvements	273	387
Computer equipment and software	631	616
	4,632	4,740
Less accumulated depreciation and amortization	(3,942)	(3,873)
Total property and equipment, net	$690	$867

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 each of the three months ended March 31, 2014 and 2013, and is included in operating expenses.

Other Current Assets

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

	March 31, 2014	December 31, 2013
Prepaid expenses	$521	$786
Other receivables	320	173
Total current assets	$841	$959

Goodwill and Other Identifiable Intangible Assets

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

	March 31, 2014	December 31, 2013
Indefinite lived intangible assets		
Acquired in-process research and development	$12,556	$12,556
Goodwill	12,238	12,238
Definite lived intangible assets		
Complete technology	15,267	15,267
Less: Accumulated amortization	(2,425)	(2,235)
Trade name	2,642	2,642
Less: Accumulated amortization	(421)	(387)
Customer relationships	29,600	29,600
Less: Accumulated amortization	(4,714)	(4,344)
Total goodwill and other identifiable intangible assets, net	$64,743	$65,337

The Company accounts for goodwill and other intangible assets in accordance with Accounting Standards Codification ("ASC") Topic 350 -Intangibles-Goodwill and Other 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-

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amortizing intangibles to be evaluated for impairment on an annual basis. The Company uses the income approach and the market approach, each weighted at 50%, when performing its goodwill impairment analysis. For the income approach, the Company considers the present value of future cash flows and the carrying value of its assets and liabilities, including goodwill. The market approach is based on an analysis of revenue multiples of peer public companies. 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 and other intangibles as of December 31 of each year, absent any indicators of earlier impairment, to ensure that impairment charges, if applicable, are reflected in the Company's 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.

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 each of the three months ended March 31, 2014 and 2013, respectively. Estimated amortization expense for the year ending December 31, 2014 through 2018 is $2.4 million per year.

Acquired In-Process Research and Development

Intangible assets related to acquired in-process research and development (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 definite-lived and would then be amortized based on their respective estimated useful lives at that point in time. For the three months ended March 31, 2014 and 2013, there was no impairment of IPR&D.

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, 2014, 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.

Commercial license rights

Commercial license rights represent a portfolio of future milestone and royalty payment rights acquired in accordance with the Royalty Stream and Milestone Payments Purchase Agreement entered into with Selexis SA ("Selexis") in April 2013. The portfolio consists of over 15 Selexis commercial license agreement programs with various pharmaceutical-company counterparties. The purchase price was $4.6 million, inclusive of acquisition costs. The Company paid $3.6 million upon closing and paid an additional $1.0 million in April 2014. Individual commercial license rights acquired under the agreement are carried at allocated cost and approximate fair value. The carrying

value of the license rights will be reduced on a pro-rata basis as revenue is realized over the term of the agreement. Declines in the fair value of individual license rights below their carrying value that are deemed to be other than temporary are reflected in earnings in the period such determination is made. As of March 31, 2014, management does not believe there have been any events or circumstances indicating that the carrying amount of its commercial license rights may not be recoverable.

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Accrued Liabilities

Accrued liabilities consist of the following (in thousands):

	March 31, 2014	December 31, 2013
Compensation	$777	$1,929
Professional fees	537	697
Other	4,137	2,711
Total accrued liabilities	$5,451	$5,337

Other Long-Term Liabilities

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

	March 31, 2014	December 31, 2013
Deposits	$353	$345
Deferred rent	346	350
Total other long-term liabilities	$699	$695

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, royalties and material sales. 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, 2014 and December 31, 2013 was $7.2 million and $9.3 million, respectively. The Company recorded a fair-value adjustment to decrease the liability for CyDex-related contingent liabilities of $0.5 million for the three months ended March 31, 2014 and an adjustment to increase the liability by $1.8 million for the three months ended March 31, 2013. The Company recorded a revenue-sharing payment of $1.6 million for the three months ended March 31, 2014. There was no revenue-sharing payment made 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 CVRs will entitle Metabasis stockholders to cash payments as frequently as every six months as cash is received by the Company from proceeds from 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 $6.7 million and $4.2 million as of March 31, 2014 and December 31, 2013, respectively. The Company recorded an increase in the liability for Metabasis-related CVRs of $2.5 million for the three months ended March 31, 2014 and no change for the three months ended March 31, 2013.

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:

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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 ; and
Level 3 - Unobservable inputs in which there is little or no market data, which require the Company to develop its own assumptions.

The Company's short-term-term investments include investments in equity securities which were received by the Company in December 2012 as a result of a milestone payment from a licensee. Additionally, there is a liability related to the investment in equity securities for amounts owed to former license holders. The fair value of the investments was previously determined using quoted market prices in active markets and discounted for the trading restriction. During the year ended December 31, 2013, the trading restrictions were removed and the investments were reclassified to short-term investments. 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. The co-promote termination payments receivable represents a non-interest-bearing receivable for future payments to be made by Pfizer and is recorded at its fair value. The receivable and liability will remain equal, and are adjusted each quarter for changes in the fair value of the obligation including any changes in the estimate of future net Avinza product sales.

The Company evaluates its financial instruments at each reporting period to determine if any transfers between the various three-level hierarchy have occurred and appropriately reclassifies its financial instruments to the appropriate level within the hierarchy.

Treasury Stock

The Company may on occasion repurchase its common stock on the open market or in private transactions. When such stock is repurchased it is not constructively or formally retired and may be reissued if certain regulatory requirements are met; however, the Company may from time to time choose to retire the shares of common stock held in its treasury. The purchase price of the common stock repurchased is charged to treasury stock. During the year ended December 31, 2013, the Company retired 1,118,222 shares of its common stock held in treasury.

Revenue Recognition

Royalties on sales of products commercialized by the Company's partners are recognized in the quarter reported by the respective partner. Generally, the Company receives royalty reports from its licensees approximately one quarter in arrears due to the fact that its agreements require partners to report product sales between 30 and 60 days after the end of the quarter. The Company recognizes royalty revenues when it can reliably estimate such amounts and collectability is reasonably assured. Under this accounting policy, the royalty revenues reported are not based upon estimates and such royalty revenues are typically reported in the same period in which payment is received.

Revenue from material sales of Captisol 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 the Company under its 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.

Sales-based milestone revenue is accounted for similarly to royalties, with revenue recognized upon achievement of the milestone assuming all other revenue recognition criteria for milestones are met. Revenue from development and regulatory 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.

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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 the customer is able to procure inventory from another manufacturer in the absence of contractual provisions for exclusive supply by the Company.

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, 2014 and December 31, 2013.

Accounting for Stock-Based Compensation

Stock-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 stock-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,	
	2014	2013
Stock-based compensation expense as a component of:		
Research and development expenses	$689	$386
General and administrative expenses	1,378	738
	$2,067	$1,124

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,	
	2014	2013
Risk-free interest rate	1.9%	1.1%
Dividend yield	—	—

Expected volatility	69%	70%
Expected term	6.4	6.3
Forfeiture rate	9.7%	9.8%

The risk-free interest rate is based on the U.S. Treasury yield curve at the time of the grant. The expected term of the employee and non-employee director options is the estimated weighted-average period until exercise or cancellation of vested

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options (forfeited unvested options are not considered) based on historical experience. The expected term for consultant awards is the remaining period to contractual expiration. Volatility is a measure of the expected amount of variability in the stock price over the expected life of an option expressed as a standard deviation. In making this assumption, the Company used the historical volatility of the Company's stock price over a period equal to the expected term. The forfeiture rate is based on historical data at the time of the grant.

Preclinical Study and Clinical Trial Accruals

Substantial portions of the Company's preclinical studies and all of the Company's clinical trials have been performed by third-party laboratories, contract research organizations, or other vendors (collectively "CROs"). Some CROs bill monthly for services performed, while others bill based upon milestone achievement. The Company accrues for each of the agreements it has with CROs on a monthly basis. For preclinical studies, accruals are estimated based upon the percentage of work completed and the contract milestones achieved. For clinical studies, accruals are estimated based upon a percentage of work completed, the number of patients enrolled and the duration of the study. The Company monitors patient enrollment, the progress of clinical studies and related activities to the extent possible through internal reviews of data reported to it by the CROs, correspondence with the CROs and clinical site visits. The Company's estimates are dependent upon the timelines and accuracy of the data provided by its CROs regarding the status of each program and total program spending. The Company periodically evaluates its estimates to determine if adjustments are necessary or appropriate based on information it receives concerning changing circumstances, and conditions or events that may affect such estimates. No material adjustments to preclinical study and clinical trial accrued expenses have been recognized to date.

Sale of Royalty Rights

The Company previously sold to third parties the rights to future royalties of certain of its products. As part of the underlying royalty agreements, the partners have the right to offset a portion of any future royalty payments owed to the Company to the extent of previous milestone payments. Accordingly, the Company deferred a portion of the revenue associated with each tranche of royalty right sold, equal to the pro-rata share of the potential royalty offset. Such amounts associated with the offset rights against future royalty payments will be recognized as revenue upon receipt of future royalties from the respective partners. As of March 31, 2014 there was no deferred revenue remaining related to the sale of royalty rights. As of December 31, 2013, the Company had deferred $0.1 million of revenue related to the sale of royalty rights.

Product Returns

In connection with the sale of the Avinza and Oncology product lines, the Company retained the obligation for returns of product that were shipped to wholesalers prior to the close of the transactions. The accruals for product returns, which were recorded as part of the accounting for the sales transactions, are based on historical experience. Any subsequent changes to the Company's estimate of product returns are accounted for as a component of discontinued operations.

Cost of Goods Sold

The Company determines cost using the first-in, first-out method. Cost of goods sold include all costs of purchase and other costs incurred in bringing the inventories to their present location and condition, including costs to store and distribute.

Costs and Expenses

Collaborative research and development expense consists of labor, material, equipment and allocated facility costs of the Company's scientific staff who are working pursuant to the Company's collaborative agreements. From time to time, collaborative research and development expense includes costs related to research efforts in excess of those

required under certain collaborative agreements. Management has the discretion to set the scope of such excess efforts and may increase or decrease the level of such efforts depending on the Company's strategic priorities.

Proprietary research and development expense consists of intellectual property in-licensing costs, labor, materials, contracted services, and allocated facility costs that are incurred in connection with internally funded drug discovery and development programs.

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Income Taxes

Income taxes are accounted for under the liability method. This approach requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of differences between the tax basis of assets or liabilities and their carrying amounts in the consolidated financial statements. A valuation allowance is provided for deferred tax assets if it is more likely than not that these items will either expire before the Company is able to realize their benefit or if future deductibility is uncertain. As of March 31, 2014, the Company had provided a full valuation allowance against its deferred tax assets as recoverability was uncertain. Developing the provision for income taxes requires significant judgment and expertise in federal and state income tax laws, regulations and strategies, including the determination of deferred tax assets and liabilities and, if necessary, any valuation allowances that may be required for deferred tax assets. The Company's judgments and tax strategies are subject to audit by various taxing authorities. While management believes the Company has provided adequately for its income tax liabilities in its consolidated financial statements, adverse determinations by these taxing authorities could have a material adverse effect on the Company's consolidated financial condition and results of operations.

The Company's ending deferred tax liability represents a future tax obligation for current tax amortization claimed on acquired IPR&D. As the Company cannot estimate when the IPR&D assets will be amortizable for financial reporting purposes, the deferred tax liability associated with the IPR&D assets cannot be used to support the realization of the Company's deferred tax assets. As a result, the Company is required to increase its valuation allowance and record a charge to deferred taxes.

Discontinued Operations-Oncology Product Line

In September, 2006, the Company and Eisai Inc. and Eisai Co., Ltd., (collectively "Eisai"), entered into a purchase agreement, ("the Oncology Purchase Agreement"), pursuant to which Eisai agreed to acquire all of the Company's worldwide rights in and to its oncology products, including, among other things, all related inventory, equipment, records and intellectual property, and to assume certain liabilities as set forth in the Oncology Purchase Agreement. The Oncology product line included the Company's four marketed oncology drugs: Ontak, Targretin capsules, Targretin gel and Panretin gel.

Discontinued Operations-Avinza Product Line

In September, 2006, the Company and King Pharmaceuticals, now a subsidiary of Pfizer, entered into a purchase agreement, (the "Avinza Purchase Agreement"), pursuant to which Pfizer acquired all of the rights in and to Avinza in the United States, its territories and Canada, including, among other things, all Avinza inventory, records and related intellectual property, and to assume certain liabilities as set forth in the Avinza Purchase Agreement.

Pursuant to the terms of the Avinza Purchase Agreement, the Company retained the liability for returns of product from wholesalers that had been sold by the Company prior to the close of the transaction. Accordingly, as part of the accounting for the gain on the sale of Avinza, the Company recorded a reserve for Avinza product returns.

During the three months ended March 31, 2014 the Company did not recognize any gain or loss on the sale of the Avinza product line. The Company recognized a pre-tax gain of $0.2 million for the three months ended March 31, 2013, due to subsequent changes in certain estimates and liabilities recorded as of the sale date.

Segment Reporting

Under ASC 280, Segment Reporting, ("ASC 280"), operating segments are defined as components of an enterprise about which separate financial information is available that is regularly evaluated by the entity’s chief operating decision maker, in deciding how to allocate resources and in assessing performance. The Company has evaluated this

Codification and has identified two reportable segments: the development and commercialization of drugs using Captisol technology by CyDex and the biopharmaceutical company with a business model that is based upon the concept of developing or acquiring royalty revenue generating assets and coupling them with a lean corporate cost structure.

Comprehensive Income

Comprehensive income represents net income adjusted for the change during the periods presented in unrealized gains and losses on available-for-sale securities less reclassification adjustments for realized gains or losses included in net income. The unrealized gains or losses are reported on the consolidated statements of comprehensive income.

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New Accounting Pronouncements

In February 2013, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2013-02, Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. Under ASU 2013-02, an entity is required to provide information about the amounts reclassified out of Accumulated Other Comprehensive Income ("AOCI") by component. In addition, an entity is required to present, either on the face of the financial statements or in the notes, significant amounts reclassified out of AOCI by the respective line items of net income, but only if the amount reclassified is required to be reclassified in its entirety in the same reporting period. For amounts that are not required to be reclassified in their entirety to net income, an entity is required to cross-reference to other disclosures that provide additional details about those amounts. Implementing ASU 2013-02 did not change the current requirements for reporting net income or other comprehensive income in the financial statements. The amendments in this ASU are effective for the Company for fiscal years, and interim periods within those years, beginning after January 1, 2014. The Company's adoption of this standard did not materially affect the consolidated financial statements.

In July, 2013, FASB issued ASU No. 2013-11, Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists. ASU 2013-11 requires the netting of unrecognized tax benefits (UTBs) against a deferred tax asset for a loss or other carryforward that would apply in settlement of the uncertain tax positions. UTBs are required to be netted against all available same-jurisdiction loss or other tax carryforwards that would be utilized, rather than only against carryforwards that are created by the UTBs. ASU 2013-11 is effective for the Company for interim and annual periods beginning after December 15, 2013. The Company's adoption of this standard did not materially affect the consolidated financial statements.

2. Financial Instruments

The Company measures certain financial assets and liabilities at fair value on a recurring basis, including available-for-sale fixed income, equity securities, co-promote termination payments receivable and the related liability, and contingent liabilities.

The fair value of the Company’s investments which were classified as short-term investments for the three months ended March 31, 2014 and year ended December 31, 2013 is determined using quoted market prices in active markets. These securities were received by the Company in December 2012 as a result of a milestone payment from a licensee. Additionally, the liability for CVRs for Metabasis are determined using quoted market prices in active markets. The co-promote termination payments receivable represents a non-interest bearing receivable for future payments to be made by Pfizer and is recorded at its fair value. The fair value is subjective and is affected by changes in inputs to the valuation model including management’s assumptions regarding future Avinza product sales. The receivable and liability will remain equal and adjusted each quarter for changes in the fair value of the obligation including any changes in the estimate of future net Avinza product sales. The fair value of the liabilities for CyDex contingent liabilities were determined based on the income approach using a Monte Carlo analysis. The fair value is subjective and is affected by changes in inputs to the valuation model including management’s assumptions regarding revenue volatility, probability of commercialization of products, estimates of timing and probability of achievement of certain revenue thresholds and developmental and regulatory milestones which may be achieved and affect amounts owed to former license holders and CVR holders. Changes in these assumptions can materially affect the fair value estimate.

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The following table provides a summary of the assets and liabilities that are measured at fair value on a recurring basis as of March 31, 2014 (in thousands):

	Fair Value Measurements at Reporting Date Using		
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Current portion of co-promote termination payments receivable	$688	$—	$—	$688
Available-for-sale securities	12,275	12,275	—	—
Long-term portion of co-promote termination payments receivable	448	—	—	448
Total assets	$13,411	$12,275	$—	$1,136
Liabilities:				
Current portion of contingent liabilities-CyDex	$1,094	$—	$—	$1,094
Current portion of co-promote termination liability	688	—	—	688
Long-term portion of contingent liabilities-Metabasis	6,657	6,657	—	—
Long-term portion of contingent liabilities-CyDex	6,086	—	—	6,086
Liability for short-term investments owed to former licensees	1,841	1,841	—	—
Long-term portion of co-promote termination liability	448	—	—	448
Total liabilities	$16,814	$8,498	$—	$8,316

The following table provides a summary of the assets and liabilities that are measured at fair value on a recurring basis as of December 31, 2013 (in thousands):

	Fair Value Measurements at Reporting Date Using		
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Current portion of co-promote termination payments receivable	$4,329	$—	$—	$4,329
Available-for-sale securities	4,340	4,340	—	—
Long-term portion of co-promote termination payments receivable	7,417	—	—	7,417
Total assets	$16,086	$4,340	$—	$11,746
Liabilities:				
Current portion of contingent liabilities-CyDex	$1,712	$—	$—	$1,712
Current portion of co-promote termination liability	4,329	—	—	4,329
Long-term portion of contingent liabilities-Metabasis	4,196	4,196	—	—
Long-term portion of contingent liabilities-CyDex	7,599	—	—	7,599

Liability for short-term investments owed to former licensees	651	651