

Altus Pharmaceuticals Inc.
Form 10-Q
November 14, 2006

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

FORM 10-Q

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

For the quarterly period ended September 30, 2006

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 No. 000-51711
ALTUS PHARMACEUTICALS INC.**

(Exact Name of Registrant as Specified in its Charter)

Delaware

*(State or Other Jurisdiction of Incorporation or
Organization)*

125 Sidney Street, Cambridge, Massachusetts

(Address of Principal Executive Offices)

04-3573277

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

02139

(Zip Code)

Registrant's telephone number, including area code: (617) 299-2900

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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer" and "large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer

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

YES NO

The number of shares outstanding of the registrant's Common Stock, \$0.01 par value per share, as of November 3, 2006 was 22,948,986.

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FOR THE QUARTER ENDED SEPTEMBER 30, 2006**

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ITEM 1. Unaudited Condensed Consolidated Financial Statements
ALTUS PHARMACEUTICALS INC. AND SUBSIDIARY
CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)
(In thousands, except share and per share amounts)

| | September 30, 2006 | December 31, 2005 |
|---|-------------------------------|------------------------------|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | \$ 44,230 | \$ 12,872 |
| Investments | 53,439 | 17,189 |
| Prepaid expenses and other current assets | 1,922 | 2,406 |
| | | |
| Total current assets | 99,591 | 32,467 |
| | | |
| PROPERTY AND EQUIPMENT, Net | 6,242 | 6,763 |
| OTHER ASSETS, Net | 1,312 | 1,354 |
| | | |
| TOTAL ASSETS | \$ 107,145 | \$ 40,584 |
| | | |
| LIABILITIES, REDEEMABLE PREFERRED STOCK AND STOCKHOLDERS EQUITY (DEFICIT) | | |
| CURRENT LIABILITIES: | | |
| Accounts payable and accrued expenses | \$ 5,766 | \$ 6,535 |
| Current portion of long-term debt | 1,873 | 2,271 |
| Current portion of deferred revenue | 8,984 | 9,412 |
| | | |
| Total current liabilities | 16,623 | 18,218 |
| | | |
| Long-term debt | 2,956 | 3,708 |
| Long-term portion of deferred revenue | 563 | 4,232 |
| | | |
| TOTAL LIABILITIES | 20,142 | 26,158 |
| | | |
| CONTINGENCIES (Note 8) | | |
| REDEEMABLE PREFERRED STOCK: | | |
| Redeemable Preferred Stock, par value \$.01 per share; 450,000 shares authorized, issued and outstanding at September 30, 2006 and December 31, 2005 (liquidation value of \$6,195 at September 30, 2006 and \$6,056 at December 31, 2005) at accrued redemption value | 6,181 | 5,879 |
| | | 62,159 |

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Series B Convertible Preferred Stock, par value \$.01 per share; no shares authorized, issued or outstanding at September 30, 2006; 12,928,155 shares authorized, 11,773,609 shares issued and outstanding at December 31, 2005 (liquidation value of \$63,614 at December 31, 2005) at accreted redemption value

Series C Convertible Preferred Stock, par value \$.01 per share; no shares authorized, issued or outstanding at September 30, 2006; 14,420,359 shares authorized, 11,819,959 shares issued and outstanding at December 31, 2005 (liquidation value of \$58,407 at December 31, 2005) at accreted redemption value 51,335

STOCKHOLDERS EQUITY (DEFICIT):

Series A Convertible Preferred Stock, par value \$.01 per share; no shares authorized, issued or outstanding at September 30, 2006; 87,500 shares authorized, issued and outstanding at December 31, 2005 (liquidation value of \$4) 897

Common Stock, par value \$.01 per share; 100,000,000 shares authorized, 22,674,735 shares issued and outstanding at September 30, 2006; 47,113,986 shares authorized, 1,842,809 shares issued and outstanding at December 31, 2005 227 18

Additional paid-in capital 242,027 14,272

Accumulated deficit (161,432) (120,134)

TOTAL STOCKHOLDERS EQUITY (DEFICIT) 80,822 (104,947)

TOTAL LIABILITIES, REDEEMABLE PREFERRED STOCK AND STOCKHOLDERS EQUITY (DEFICIT) \$ 107,145 \$ 40,584

See notes to unaudited condensed consolidated financial statements.

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ALTUS PHARMACEUTICALS INC. AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)
(In thousands, except per share amounts)

| | Three Months Ended | | Nine Months Ended | |
|---|---------------------------|-------------------|--------------------------|--------------------|
| | September 30, | | September 30, | |
| | 2006 | 2005 | 2006 | 2005 |
| CONTRACT REVENUE | \$ (1,955) | \$ 4,125 | \$ 3,967 | \$ 6,727 |
| COSTS AND EXPENSES: | | | | |
| Research and development | 10,898 | 6,112 | 38,001 | 19,792 |
| General, sales and administrative | 4,171 | 2,203 | 10,608 | 6,003 |
| Total costs and expenses | 15,069 | 8,315 | 48,609 | 25,795 |
| LOSS FROM OPERATIONS | (17,024) | (4,190) | (44,642) | (19,068) |
| OTHER INCOME (EXPENSE): | | | | |
| Interest income | 1,337 | 217 | 3,877 | 701 |
| Interest expense | (165) | (220) | (533) | (617) |
| Foreign currency loss | | | | (125) |
| Other income (expense) net | 1,172 | (3) | 3,344 | (41) |
| NET LOSS | (15,852) | (4,193) | (41,298) | (19,109) |
| PREFERRED STOCK DIVIDENDS AND ACCRETION | (100) | (2,740) | (1,186) | (8,169) |
| NET LOSS ATTRIBUTABLE TO COMMON STOCKHOLDERS | \$ (15,952) | \$ (6,933) | \$ (42,484) | \$ (27,278) |
| NET LOSS ATTRIBUTABLE TO COMMON STOCKHOLDERS PER SHARE BASIC AND DILUTED | \$ (0.71) | \$ (4.01) | \$ (2.13) | \$ (15.84) |
| WEIGHTED AVERAGE SHARES OUTSTANDING BASIC AND DILUTED | 22,431 | 1,727 | 19,952 | 1,722 |

See notes to unaudited condensed consolidated financial statements.

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ALTUS PHARMACEUTICALS INC. AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)
(In thousands)

| | Nine Months Ended | |
|---|--------------------------|-------------|
| | September 30, | |
| | 2006 | 2005 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net loss | \$ (41,298) | \$ (19,109) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation and amortization | 2,261 | 2,116 |
| Stock-based compensation expense related to the issuance of stock options | 2,174 | 571 |
| Noncash interest expense related to advance against a future milestone | 169 | 169 |
| Loss on disposal of equipment | 35 | |
| Noncash interest expense related to Common Stock warrants | | 6 |
| Changes in assets and liabilities: | | |
| Prepaid expenses and other current assets | 484 | (279) |
| Other non-current assets | (89) | |
| Accounts payable and accrued expenses | (298) | (661) |
| Milestones received as deferred revenue | | 3,974 |
| Deferred revenue recognized | (4,097) | (6,664) |
| | | |
| Net cash used in operating activities | (40,659) | (19,877) |
| | | |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchases of investments | (202,464) | (31,844) |
| Maturities of investments | 166,214 | 50,204 |
| Purchases of property and equipment | (1,664) | (1,930) |
| | | |
| Net cash (used in) provided by investing activities | (37,914) | 16,430 |
| | | |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Net proceeds from initial public offering of Common Stock | 110,164 | |
| Proceeds from exercise of stock options and warrants | 1,536 | 296 |
| Proceeds from long-term debt | | 2,569 |
| Repayment of long-term debt | (1,769) | (1,687) |
| | | |
| Net cash provided by financing activities | 109,931 | 1,178 |
| | | |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | 31,358 | (2,269) |
| | | |
| CASH AND CASH EQUIVALENTS Beginning of period | 12,872 | 9,489 |

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| | | |
|---|-----------|----------|
| CASH AND CASH EQUIVALENTS End of period | \$ 44,230 | \$ 7,220 |
|---|-----------|----------|

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:

| | | |
|------------------------|--------|--------|
| Cash paid for interest | \$ 364 | \$ 491 |
|------------------------|--------|--------|

SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING AND FINANCING ACTIVITIES:

| | | |
|--|----|-------|
| First month's payments withheld from long-term debt proceeds | \$ | \$ 70 |
|--|----|-------|

| | | |
|---|-------------|----|
| Dividends accrued for Series B Convertible Preferred Stock and Series C Convertible Preferred Stock converted to Common Stock | \$ (20,877) | \$ |
|---|-------------|----|

See notes to unaudited condensed consolidated financial statements.

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**ALTUS PHARMACEUTICALS INC. AND SUBSIDIARY
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

1. BASIS OF PRESENTATION

The accompanying condensed consolidated financial statements are unaudited and have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim reporting. Certain information and footnote disclosures included in the Altus Pharmaceuticals Inc. (the Company) annual consolidated financial statements have been condensed or omitted. Accordingly, the interim consolidated financial statements do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. The interim financial statements have been prepared on the same basis as the annual consolidated financial statements and, in the opinion of management, reflect all adjustments (including normal recurring adjustments) considered necessary to present fairly the Company s financial position and results of operations and cash flows for the interim periods presented. The results of operations for the interim periods are not necessarily indicative of the results that may be expected for any future period or the year ending December 31, 2006. These condensed consolidated financial statements should be read in conjunction with the audited financial statements as of and for the year ended December 31, 2005, which are included in the Company s Annual Report on Form 10-K, as filed with the Securities and Exchange Commission (SEC).

The condensed consolidated financial statements reflect the operations of the Company and its wholly-owned subsidiary. All intercompany accounts and transactions have been eliminated.

2. INITIAL PUBLIC OFFERING

In January 2006, the Company completed an initial public offering of 8,050,000 shares of its common stock at a public offering price of \$15.00 per share. Net proceeds to the Company were approximately \$110.2 million, after deducting underwriting discounts and commissions and offering expenses totaling approximately \$10.6 million. Also in January 2006, prior to the initial public offering, the Company effected a 1-for-2.293 reverse stock split of its common stock. All share and per share amounts in the condensed consolidated financial statements have been retroactively adjusted for all periods presented to give effect to the reverse stock split, including reclassifying an amount equal to the reduction in par value to additional paid-in-capital.

In connection with the initial public offering, all shares of Series B Convertible Preferred Stock (Series B Preferred Stock) were converted into 5,182,651 shares of common stock, all shares of Series C Convertible Preferred Stock (Series C Preferred Stock) were converted into 5,203,059 shares of common stock and all shares of Series A Convertible Preferred Stock were converted into 381,596 shares of common stock. As a result, the Company no longer recognizes dividend and accretion expense for these classes of preferred stock. Furthermore, the Company issued an additional 872,054 shares of common stock in satisfaction of \$13.1 million of accrued but unpaid dividends on the Series B Preferred Stock, and 519,774 shares of common stock were issued in satisfaction of \$7.1 million of accrued but unpaid dividends on the Series C Preferred Stock. All warrants to purchase Series B Preferred Stock were automatically converted into warrants to purchase 508,214 shares of the Company s common stock at an exercise price of \$9.80 per share, and all warrants to purchase Series C Preferred Stock were automatically converted into warrants to purchase 1,144,670 shares of the Company s common stock at an exercise price of \$9.80 per share. All of these converted warrants became exercisable immediately upon conversion.

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3. REVENUE RECOGNITION

Contract revenue consists of non-refundable research and development funding under collaborative agreements with corporate collaborators and grants from various United States government and non-government institutions. Research and development funding generally compensates the Company for a portion or all of the costs associated with the development and testing related to the collaborative research programs or grants.

Revenue under collaboration agreements with collaborators and non-government institutions is generally recognized using the proportional performance method and is based on the percentage of costs incurred relative to the total costs estimated to be incurred to complete the research program, to the extent such amount is not greater than the cash received. The Company uses an input based measure, specifically direct costs, to determine proportional performance because, for its current agreements, the Company believes that the use of an input based measure is a more accurate representation of proportional performance than an output based measure, such as milestones. The Company believes that the direct cost method also most closely reflects the level of effort related to the Company's research and development collaborations. The impact of fluctuation in exchange rates under collaborative agreements that are denominated in a foreign currency is reflected in deferred revenue at the time cash is received and in revenue at each reporting period. The Company periodically reviews the estimated development costs and, to the extent such estimates change, the cumulative impact of such change is recorded in operations at that time. As a result, the possibility exists that revenue may increase or decrease in future periods as estimated costs increase or decrease, without additional cash inflows from the collaborative partner or non-government institution.

Specifically, with respect to its product candidate ALTU-135, the Company recognizes revenue earned under collaboration agreements using the proportional performance method of revenue recognition. During the three months ended September 30, 2006, the Company reviewed and increased the total estimated development costs relating to ALTU-135 from \$118.0 million to \$137.5 million. The effect of increasing total estimated development costs, using the proportional performance method of revenue recognition, resulted in a cumulative negative revenue adjustment through September 30, 2006 of \$3.7 million which resulted in negative revenue of \$2.0 million and revenue of \$4.0 million for the three and nine-months ended September 30, 2006, respectively.

Payments received in advance of revenue recognized under collaborative agreements are recorded as deferred revenue. Since the payments received under the collaborative agreements are non-refundable, the termination of a collaborative agreement prior to its completion could result in an immediate recognition of deferred revenue relating to payments already received from the collaborative partner but not previously recognized as revenue.

Research and development funding under grants from the United States government and its agencies is recognized as revenue as development costs are incurred and billed in accordance with the terms of the grant.

4. STOCK-BASED COMPENSATION

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123(R), *Share-Based Payment* (SFAS 123(R)). On January 1, 2006, the Company adopted SFAS 123(R), as required, using the modified prospective application method. The Company will continue to determine the fair value of equity instruments using the Black-Scholes option-pricing model and to recognize compensation cost ratably over the appropriate vesting period.

Prior to January 1, 2006, the Company had accounted for stock-based compensation in accordance with the fair value recognition provisions of SFAS 123, *Accounting for Stock-Based Compensation*, which are similar to those in SFAS 123(R), except that SFAS 123 allowed forfeitures to be accounted for as they occur. Under the modified prospective application method, the compensation expense relating to the unvested portion of previously granted

awards at the adoption date is adjusted for estimated forfeitures, and the adjusted compensation expense is recognized ratably over the remaining vesting period. Pre-vesting forfeitures for all grants awarded after January 1, 2006 and for the unvested portion of previously granted

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awards that were outstanding at the date of adoption of SFAS 123(R) were estimated to be approximately 2.5% per annum based on historical experience.

The following table represents stock-based compensation expense included in the Company's Condensed Consolidated Statements of Operations:

| (In thousands) | Three Months Ended | | Nine Months Ended | |
|-----------------------------------|---------------------------|---------------|--------------------------|---------------|
| | September 30, | | September 30, | |
| | 2006 | 2005 | 2006 | 2005 |
| Research and development | \$ 531 | \$ 105 | \$ 1,217 | \$ 235 |
| General, sales and administrative | 439 | 117 | 957 | 336 |
| Total | \$ 970 | \$ 222 | \$ 2,174 | \$ 571 |

Because the Company had utilized the fair value method prescribed by SFAS 123 prior to January 1, 2006, the impact of the adoption of SFAS 123(R) did not have a material impact on the Company's comparative results.

The fair value of the stock options granted was estimated on the date of grant using all relevant information, including application of the Black-Scholes option-pricing model. When applying the Black-Scholes option-pricing model to compute stock-based compensation, the Company assumed the following:

| | Three Months Ended | | Nine Months Ended | |
|---|---------------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2006 | 2005 | 2006 | 2005 |
| Range of risk-free interest rates | 4.7% - 5.1% | 4.0% - 4.1% | 4.4% - 5.1% | 3.7% - 4.2% |
| Expected average option life (in years) | 6.25 | 5.00 | 6.25 | 5.00 |
| Volatility | 75% | None | 75% | None |
| Dividends | None | None | None | None |

The expected term assumption is based upon the simplified or plain-vanilla method, provided under SAB 107 which averages the contractual term of the Company's options (10 years) with the vesting term (4 years) taking into consideration multiple vesting tranches. The Company is allowed to use the plain-vanilla method for all options granted prior to or on December 31, 2007. Upon the Company's initial filing of its Form S-1 Registration Statement on October 17, 2005, the Company began utilizing a volatility factor in valuing options granted to employees. To determine an appropriate volatility factor, the Company reviewed volatility factors being used by a group of peer companies, and selected a volatility factor consistent with those used by this group of peers. Prior to October 17, 2005, the Company had excluded a volatility factor, as permitted for private companies under the provisions of SFAS 123(R). The Company has continued to utilize this methodology for the three and nine month periods ended September 30, 2006 due to the short length of time the Company's common stock has been publicly traded.

The Company operates the 2002 Employee, Director, and Consultant Stock Option Plan (the 2002 Plan), which replaced the 1993 Stock Option Plan (the 1993 Plan) on February 7, 2002. In January 2006, the Board of Directors authorized an additional 1,200,000 shares for future grant under the 2002 Plan. Under the 1993 and 2002 Plans, the total number of shares issuable upon exercise of outstanding stock options or available for future grant to employees, directors and consultants at September 30, 2006 was 4,281,596 shares.

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All option grants are nonstatutory (nonqualified) stock options except option grants to employees (including officers and directors) intended to qualify as incentive stock options under the Internal Revenue Code. Incentive stock options may not be granted at less than the fair market value of the Company's common stock on the date of grant.

Nonqualified stock options may be granted at an exercise price established by the Board of Directors at its sole discretion. Vesting periods are generally based on a service period of four years and are determined by the Board of Directors or a delegated subcommittee or officer. Options and awards granted prior to January 25, 2006 are generally exercisable immediately, but the shares purchased are subject to restriction on transfer until vested. At September 30, 2006, the Company had no such shares outstanding. In the event of termination of an employee or the business relationship with a non-employee, the Company must repurchase all unvested shares from the optionee at the original issue price. Options granted under the 1993 and 2002 Plans expire no more than 10 years from the date of grant.

A summary of the stock option activity under the 1993 Plan and 2002 Plan is as follows:

| | Shares | Weighted Average Exercise Price | Weighed Average Contractual Term (in years) | Aggregate Intrinsic Value (in thousands) |
|---|-----------|--|---|--|
| Options outstanding January 1, 2006 (1,247,805 options vested) | 3,056,795 | \$ 4.27 | | |
| Granted | 1,226,034 | 16.29 | | |
| Exercised | (272,243) | 4.33 | | |
| Canceled | (267,142) | 6.28 | | |
| | | | | |
| Options outstanding September 30, 2006 | 3,743,444 | \$ 8.06 | 8.2 | \$ 32,174* |
| | | | | |
| Options exercisable September 30, 2006 | 2,849,751 | \$ 5.07 | 7.8 | \$ 31,251* |
| | | | | |
| Options vested September 30, 2006 | 1,574,186 | \$ 4.71 | 7.2 | \$ 17,910* |

* The intrinsic value of a stock option is the amount by which the market value of the underlying stock exceeds the exercise price of the option. The closing price of the Company's common stock was \$15.97 at

September 30,
2006.

During the nine months ended September 30, 2006 and 2005, a total of 272,243 and 102,335 options were exercised, respectively. The intrinsic value of these options was \$2,576,000 and \$150,000, respectively. Cash received upon the exercise of stock options during these periods was \$1,178,000 and \$296,000, respectively, and no tax benefit was recognized from the exercises due to the Company's net operating losses. The Company issues shares for the exercise of stock options from unissued reserved shares.

The weighted-average fair value of employee options granted at exercise prices equal to fair market value during the nine months ended September 30, 2006 and 2005 was \$11.81 and \$1.57, respectively.

As of September 30, 2006, total unrecognized stock-based compensation expense relating to unvested employee stock awards, adjusted for estimated forfeitures, was \$15,140,000. This amount is expected to be recognized over a weighted-average period of 2.9 years. If actual forfeitures differ from current estimates, total unrecognized stock-based compensation expense will be adjusted for future changes in estimated forfeitures.

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In November 2005, the FASB issued FASB Staff Position (FSP) No. FAS123(R)-3 *Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards*. The Company is considering whether to adopt the alternative transition method provided in the FSP for calculating the tax effects of stock-based compensation pursuant to SFAS 123(R). The alternative transition method includes simplified methods to establish the beginning balance of the additional paid-in-capital pool (APIC pool) related to the excess tax benefits available to absorb tax deficiencies recognized subsequent to the adoption of SFAS 123(R). The Company is evaluating which transition method it will use for calculating its APIC pool. An entity may take up to one year from the later of its initial adoption of SFAS 123(R) or the effective date of this FSP to evaluate its available transition alternatives and make its one-time election. Until and unless the Company elects the transition method described in the FSP, the transition method provided in SFAS 123(R) will be used.

5. NET LOSS PER SHARE

Basic and diluted net loss per common share is calculated by dividing net loss attributable to common stockholders by the weighted average number of common shares outstanding during the period. Diluted net loss per common share is the same as basic net loss per common share, since the effects of potentially dilutive securities are antidilutive for all periods presented.

Outstanding dilutive securities not included in the calculation of diluted net loss attributable to common stockholders per share were as follows for the three and nine months ended September 30:

| (In thousands) | 2006 | 2005 |
|--|-------|--------|
| Series A, B and C Convertible Preferred Stock: | | |
| Preferred shares | | 10,767 |
| Preferred stock warrants | | 1,653 |
| Options to purchase Common Stock | 3,743 | 3,034 |
| Warrants to purchase Common Stock | 3,653 | 2,468 |
| Total | 7,396 | 17,922 |

6. INVESTMENTS

The Company invests available cash primarily in bank certificates of deposit and investment-grade commercial paper, corporate notes and government securities. Securities that the Company has the positive intent and ability to hold to maturity are reported at amortized cost and are classified as held-to-maturity at September 30, 2006. All of the Company's investments are classified as held-to-maturity.

Investments consisted of the following at September 30, 2006:

| (In thousands) | Amortized Cost | Net Unrealized Losses | Aggregate Fair Value |
|------------------------|-------------------|-----------------------------|----------------------------|
| Corporate fixed income | \$ 2,938 | \$ (1) | \$ 2,937 |
| Government securities | 47,788 | (2) | 47,786 |
| Commercial paper | 2,713 | (1) | 2,712 |
| Total | | | |