CRITICAL THERAPEUTICS INC
Form 10-Q
November 09, 2006

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

þ **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

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: 000-50767

Critical Therapeutics, Inc.

(Exact Name of Registrant as Specified in Its Charter)

Delaware	**04-3523569**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
60 Westview Street Lexington, Massachusetts	**02421**
(Address of Principal Executive Offices)	(Zip Code)

(781) 402-5700

(Registrant s Telephone Number, Including Area Code)

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

Indicate by check mark whether the registrant is 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 o Accelerated Filer þ Non-Accelerated Filer o

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

As of November 7, 2006, the registrant had 42,005,530 shares of Common Stock, $0.001 par value per share, outstanding.

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PART I. Financial Information

Cautionary Statement Regarding Forward-Looking Statements

This quarterly report on Form 10-Q includes forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, which we refer to as the Exchange Act. For this purpose, any statements contained herein, other than statements of historical fact, including statements regarding the expected timing and outcome of the New Drug Application, or NDA, submission for the controlled-release formulation of zileuton, or zileuton CR, the expected timing and amounts of restructuring charges, possible therapeutic benefits and market acceptance of ZYFLO® (zileuton tablets), and, if approved, zileuton CR, the progress and timing of our drug development programs and related trials, the efficacy of our drug candidates, our strategy, future operations, financial position, future revenues, projected costs, prospects, plans and objectives of management, may be forward-looking statements under the provisions of The Private Securities Litigation Reform Act of 1995. We may, in some cases, use words such as anticipate, believe, could, estimate, expect, intend, may, plan, project, should, wi words that convey uncertainty of future events or outcomes to identify these forward-looking statements. Actual results may differ materially from those indicated by such forward-looking statements as a result of various important factors, including our critical accounting estimates and risks relating to: the expected timing and outcome of the NDA for zileuton CR and related discussions with the FDA; our ability to transition our management team effectively; our ability to rely on historical data in seeking marketing approval for zileuton CR, including the sufficiency and acceptability of the results of the pharmacokinetic studies of zileuton CR for U.S. Food and Drug Administration, or FDA, purposes; our ability to develop and maintain the necessary sales, marketing, distribution and manufacturing capabilities to commercialize ZYFLO, and, if approved, zileuton CR; our ability to successfully market and sell ZYFLO with a reduced sales force; patient physician and third-party payor acceptance of ZYFLO and, if approved, zileuton CR, as a safe and effective therapeutic product; adverse side effects experienced by patients taking ZYFLO and, if approved, zileuton CR; the results of preclinical studies and clinical trials with respect to our products under development and whether such results will be indicative of results obtained in later clinical trials; our heavy dependence on the commercial success of ZYFLO and, if approved, zileuton CR; our ability to obtain the substantial additional funding required to conduct our research, development and commercialization activities; our dependence on our strategic collaboration with MedImmune, Inc; and our ability to obtain, maintain and enforce patent and other intellectual property protection for ZYFLO, our discoveries and drug candidates. These and other risks are described in greater detail below under the caption Risk Factors in Part II, Item 1A. If one or more of these factors materialize, or if any underlying assumptions prove incorrect, our actual results, performance or achievements may vary materially from any future results, performance or achievements expressed or implied by these forward-looking statements. In addition, any forward-looking statements in this quarterly report represent our views only as of the date of this quarterly report and should not be relied upon as representing our views as of any subsequent date. We anticipate that subsequent events and developments will cause our views to change. However, while we may elect to update these forward-looking statements publicly at some point in the future, we specifically disclaim any obligation to do so, whether as a result of new information, future events or otherwise. Our forward-looking statements do not reflect the potential impact of any future acquisitions, mergers, dispositions, joint ventures or investments we may make.

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Item 1. Financial Statements

CRITICAL THERAPEUTICS, INC. AND SUBSIDIARY
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)

in thousands, except share data	September 30, 2006	December 31, 2005
Assets:		
Current assets:		
Cash and cash equivalents	$ 35,557	$ 57,257
Accounts receivable, net	895	1,024
Amount due under collaboration agreements	250	205
Short-term investments	4,638	25,554
Inventory, net	2,863	1,869
Prepaid expenses and other	1,086	2,179
Total current assets	45,289	88,088
Fixed assets, net	3,143	3,563
Other assets	168	168
Total assets	$ 48,600	$ 91,819
Liabilities and Stockholders Equity:		
Current liabilities:		
Current portion of long-term debt and capital lease obligations	$ 1,106	$ 1,179
Accounts payable	1,508	4,615
Accrued expenses	4,639	4,876
Revenue deferred under collaboration agreements	1,010	5,706
Deferred product revenue	1,262	1,707
Total current liabilities	9,525	18,083
Long-term debt and capital lease obligations, less current portion	663	1,489
Stockholders equity:		
Preferred stock, par value $0.001; authorized 5,000,000 shares; no shares issued and outstanding		
Common stock, par value $0.001; authorized 90,000,000 shares; issued and outstanding 34,295,866 and 34,126,977 shares at September 30, 2006 and December 31, 2005, respectively	34	34
Additional paid-in capital	184,209	181,718
Deferred stock-based compensation	(155)	(3,794)
Accumulated deficit	(145,647)	(105,617)
Accumulated other comprehensive loss	(29)	(94)
Total stockholders equity	38,412	72,247

Total liabilities and stockholders equity	$ 48,600	$ 91,819

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

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CRITICAL THERAPEUTICS, INC. AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

in thousands except share and per share data	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Revenues:				
Net product sales	$ 1,879	$	$ 4,710	$
Revenue under collaboration agreements	2,499	1,335	5,446	4,125
Total revenues	4,378	1,335	10,156	4,125
Costs and expenses:				
Cost of products sold	267		1,662	
Research and development	6,736	8,873	23,063	22,188
Sales and marketing	3,906	4,049	16,476	7,042
General and administrative	2,907	3,103	10,916	8,777
Total costs and expenses	13,816	16,025	52,117	38,007
Operating loss	(9,438)	(14,690)	(41,961)	(33,882)
Other income (expense):				
Interest income	612	794	2,100	1,619
Interest expense	(54)	(61)	(169)	(140)
Total other income	558	733	1,931	1,479
Net loss	($ 8,880)	($ 13,957)	($ 40,030)	($ 32,403)
Net loss per share	($ 0.26)	($ 0.41)	($ 1.17)	($ 1.17)
Basic and diluted weighted-average common shares outstanding	34,251,656	33,976,026	34,184,551	27,664,953

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

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CRITICAL THERAPEUTICS, INC. AND SUBSIDIARY CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

in thousands	September 30, 2006	2005
Cash flows from operating activities:		
Net loss	($ 40,030)	($ 32,403)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization expense	745	566
Amortization of premiums on short-term investments and other	(72)	791
Loss on disposal of fixed assets	51	
Reserve for inventory	757	
Stock-based compensation expense	6,009	1,983
Changes in assets and liabilities:		
Accounts receivable	129	
Amount due under collaboration agreements	(45)	(423)
Inventory	(1,751)	(1,309)
Prepaid expenses and other	1,093	(131)
Accounts payable	(3,107)	434
Accrued expenses	(237)	2,682
Revenue deferred under collaboration agreements	(4,696)	(2,580)
Deferred product revenue	(445)	
Net cash used in operating activities	(41,599)	(30,390)
Cash flows from investing activities:		
Purchases of fixed assets	(376)	(1,674)
Proceeds from sales and maturities of short-term investments	32,855	55,423
Purchases of short-term investments	(11,802)	(31,261)
Net cash provided by investing activities	20,677	22,488
Cash flows from financing activities:		
Net proceeds from private placement of common stock		51,362
Proceeds from exercise of stock options	121	66
Repayments of long-term debt and capital lease obligations	(899)	(300)
Net cash provided by (used in) financing activities	(778)	51,128
Net increase (decrease) in cash and cash equivalents	(21,700)	43,226
Cash and cash equivalents at beginning of period	57,257	11,980
Cash and cash equivalents at end of period	$ 35,557	$ 55,206
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	$ 173	$ 140

Non-cash investing and financing activities:		
Fixed assets acquired under capital lease obligation		$ 125
Unrealized gain on investments	$ 65	$ 184

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

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CRITICAL THERAPEUTICS, INC. AND SUBSIDIARY
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

(1) Basis of Presentation

The accompanying unaudited condensed consolidated financial statements include the accounts of Critical Therapeutics, Inc. and its subsidiary (the Company), and have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. The Company believes that all adjustments, consisting of normal recurring adjustments, considered necessary for a fair presentation, have been included. The information included in this quarterly report on Form 10-Q should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements and footnotes thereto included in the Company s annual report on Form 10-K for the year ended December 31, 2005 filed with the Securities and Exchange Commission, or SEC.

Operating results for the three and nine-month periods ended September 30, 2006 and 2005 are not necessarily indicative of the results for the full year.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates or assumptions. The more significant estimates reflected in these financial statements include certain judgments regarding revenue recognition, inventory valuation, accrued and prepaid expenses and valuation of stock-based compensation.

Recent Accounting Pronouncements

In July 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109* (FIN 48), which clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FAS 109 and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 will be effective beginning with the first annual period after December 15, 2006. The Company is evaluating what impact, if any, the adoption of this standard will have on its financial position or results of operations.

(2) Revenue Recognition

Revenue Recognition and Deferred Revenue

The Company recognizes revenue in accordance with the Securities and Exchange Commission s Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements*, or SAB 101, as amended by SEC Staff Accounting Bulletin No. 104, *Revenue Recognition,* or SAB 104. Specifically, revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the price is fixed and determinable and collectibility is reasonably assured. The Company s revenue is currently derived from product sales of its only commercial product, ZYFLO, and its collaboration agreements. These collaboration agreements provide for various payments, including research and development funding, license fees, milestone payments and royalties.

The Company sells ZYFLO, a tablet formulation of zileuton, to wholesalers, distributors and pharmacies, which have the right to return purchased product. In accordance with SFAS No. 48, *Revenue Recognition When Right of Return Exists*, the Company cannot recognize revenue on product shipments until it can reasonably estimate returns relating to these shipments. Under SFAS No. 48, the Company defers recognition of revenue on product shipments of ZYFLO to its customers until the product is dispensed through patient prescriptions. The Company estimates prescription units dispensed based on distribution channel data provided by external, independent sources. ZYFLO received by patients through prescription is not subject to return. For the quarter ended September 30, 2006, product sales, net of discounts and rebates, were $1.9 million. Product shipments not recognized are included in deferred

product revenue on the accompanying consolidated balance sheet. The Company will continue to recognize revenue upon prescription units dispensed until it can reasonably estimate product returns based on its product returns experience. At that time, the

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Company will record a one-time increase in net product sales related to the recognition of revenue previously deferred. In addition, the Company s product sales are subject to various rebates, discounts and incentives that are customary in the pharmaceutical industry.

Under the Company s collaboration agreements with MedImmune and Beckman Coulter, the Company is entitled to receive non-refundable license fees, milestone payments and other research and development payments. Payments received are initially deferred from revenue and subsequently recognized in the Company s statement of operations when earned. The Company must make significant estimates in determining the performance period and periodically review these estimates, based on joint management committees and other information shared by the Company s collaborators. The Company recognizes these revenues over the estimated performance period as set forth in the contracts based on proportional performance and adjusted from time to time for any delays or acceleration in the development of the product. For example, a delay or acceleration of the performance period by the Company s collaborator may result in further deferral of revenue or the acceleration of revenue previously deferred. Because MedImmune and Beckman Coulter can each cancel its agreement with the Company, the Company does not recognize revenues in excess of cumulative cash collections. In September 2006, the Company revised its cost estimate to reflect lower than expected costs to be incurred over the remainder of the MedImmune contract. The change in estimate resulted in an increase in revenue recognized of approximately $1.3 million in the third quarter of 2006.

At September 30, 2006, the Company s account receivable balance was net of cash allowances of $18,000.

(3) Cash Equivalents and Short-Term Investments

The Company considers all highly-liquid investments with original maturities of three months or less when purchased to be cash equivalents.

Short-term investments consist primarily of U.S. government treasury and agency notes, corporate debt obligations, municipal debt obligations, auction rate securities and money market funds, each of investment-grade quality, which have a maturity date greater than 90 days that can be sold within one year. These securities are held until such time as the Company intends to use them to meet the ongoing liquidity needs to support its operations. These investments are recorded at fair value and accounted for as available-for-sale securities. The unrealized gain (loss) during the period is recorded as an adjustment to stockholders equity. The Company recorded unrealized gains on investments of $2,000 and $65,000 during the three and nine months ended September 30, 2006, respectively. The Company recorded unrealized gains on investments of $83,000 and $184,000 during the three and nine months ended September 30, 2005, respectively. The cost of the debt securities is adjusted for amortization of premiums and accretion of discounts to maturity. The amortization or accretion is included in interest income (expense) in the corresponding period. The Company has concluded that the unrealized gain (loss) on investments is temporary and therefore no impairment as of September 30, 2006.

(4) Inventory

Inventory is stated at the lower of cost or market with cost determined under the first-in, first-out (FIFO) method. As of September 30, 2006, the Company held $2.9 million in inventory to be used for sales related to its commercial product, ZYFLO. The Company analyzes its inventory levels quarterly and writes-down inventory that has become obsolete, inventory that has a cost basis in excess of its expected net realizable value and inventory in excess of expected requirements. Expired inventory or inventory that does not meet certain Company specifications is disposed of and the related costs are written off. In the third quarter of 2006, the Company recorded a reserve of approximately $55,000 related to costs associated with the active pharmaceutical ingredient, or API, not meeting the Company s manufacturing specifications and inventory that is unlikely to be sold. In addition, in the third quarter of 2006, the Company received a credit of $132,000 for product which failed during manufacturing in the third quarter and for product reserved for in the

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second quarter of 2006 that did not meet certain Company specifications for which the Company negotiated a settlement in the third quarter of 2006. This credit was recorded as a reduction to cost of products sold and a reduction to inventory reserve in the third quarter of 2006. At September 30, 2006, the inventory related to these lots has not yet been disposed.

Inventory consisted of the following at September 30, 2006 and December 31, 2005, respectively (in thousands):

	September 30, 2006	December 31, 2005
Raw material	$ 3,366	$ 1,425
Work in process		332
Finished goods	534	392
Total inventory	3,900	2,149
Less: reserve	(1,037)	(280)
Inventory, net	$ 2,863	$ 1,869

The Company currently purchases the API for its commercial requirements for ZYFLO from a single source. In addition, the Company currently manufactures ZYFLO with a single third-party manufacturer. The disruption or termination of the supply of API, a significant increase in the cost of the API from this single source or the disruption or termination of the manufacturing of the commercial product could have a material adverse effect on the Company s business, financial position and results of operations.

(5) Comprehensive Loss

Comprehensive loss is the total of net loss and all other non-owner changes in equity. The difference between net loss, as reported in the accompanying condensed consolidated statements of operations for the three and nine months ended September 30, 2006 and 2005, and comprehensive loss is the unrealized gain (loss) on short-term investments for the period. Total comprehensive loss was $8.9 million and $40.0 million for the three and nine months ended September 30, 2006, respectively, and was $13.9 million and $32.2 million for the three and nine months ended September 30, 2005, respectively. The unrealized gain (loss) on investments is the only component of accumulated other comprehensive loss in the accompanying condensed consolidated balance sheet.

(6) Stock-Based Compensation

Prior to January 1, 2006, the Company accounted for stock-based awards to employees using the intrinsic-value method as prescribed by APB No. 25 and related interpretations. Accordingly, no compensation expense was recorded for options issued to employees in fixed amounts and with fixed exercise prices at least equal to the fair market value of the Company s common stock at the date of grant. Conversely, when the exercise price for accounting purposes was below fair value of the Company s common stock on the date of grant, a non-cash charge to compensation expense was recorded ratably over the term of the option vesting period in an amount equal to the difference between the value calculated using the exercise price and the fair value. The Company issued options prior to March 19, 2004, the date it filed its initial registration statement on Form S-1, or S-1, with the SEC, at values less than deemed fair market value. This resulted in recording deferred compensation. Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123(R), using the modified prospective application method, which allows the Company to recognize compensation cost for granted, but unvested, awards, new awards and awards modified, repurchased, or cancelled after the required effective date. Options granted prior to the date of the initial S-1 filing continue to be accounted for under APB No. 25.

All stock-based awards to non-employees are accounted for at their fair market value in accordance with SFAS 123(R) and Emerging Issues Task Force No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*, or EITF No. 96-18. The Company periodically remeasures the fair value of the unvested portion of stock-based awards to non-employees, resulting in

charges or credits

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to operations in periods when such remeasurement results in differences between the fair value of the underlying common stock and the exercise price of the options that is greater than or less than the differences, if any, between the fair value of the underlying common stock and the exercise price of the options at their respective previous measurement dates. For the three and nine months ended September 30, 2006 the Company reduced its previously recorded deferred stock-based compensation by approximately $85,000 and $370,000, respectively.

For the three and nine months ended September 30, 2005, had employee compensation expense been determined based on the fair value at the date of grant consistent with SFAS No. 123(R), the Company s pro forma net loss and pro forma net loss per share would have been as follows:

(in thousands, except loss per share data)	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Net loss as reported	$ (13,957)	$ (32,403)
Add: Stock-based compensation expense included in reported net loss	439	1,335
Deduct: Stock-based compensation expense determined under fair value method	(982)	(2,655)
Net loss pro forma	$ (14,500)	$ (33,723)
Net loss per share (basic and diluted):		
As reported	$ (0.41)	$ (1.17)
Pro forma	$ (0.43)	$ (1.22)

Stock option activity for the nine months ended September 30, 2006 and September 30, 2005 was as follows:

	2006		2005	
	Number of Shares	Weighted-Average Exercise Price Per Share	Number of Shares	Weighted-Average Exercise Price Per Share
Outstanding January 1	6,200,106	$ 5.03	4,500,270	$ 4.23
Granted	741,250	6.97	358,500	7.27
Exercised	(89,204)	0.46	(13,668)	1.50
Cancelled	(62,594)	6.34	(3,540)	5.28
Outstanding March 31	6,789,558	$ 5.29	4,841,562	$ 4.46
Granted	1,661,250	3.99	311,000	5.64
Exercised	(21,609)	1.04	(1,383)	5.86
Cancelled	(1,020,344)	5.85	(58,000)	6.50
Outstanding June 30	7,408,855	4.93	5,093,179	$ 4.51
Granted	93,000	3.52	695,250	6.54
Exercised	(58,076)	0.89	(34,811)	6.16
Cancelled	(396,392)	6.12	(86,914)	3.35

Outstanding September 30	7,047,387	$	4.88	5,666,704	$	4.78
Exercisable September 30	2,700,177	$	4.29	1,388,238	$	3.04

The weighted average remaining contractual term and the aggregate intrinsic value for options outstanding at September 30, 2006 were 8.5 years and $1.8 million, respectively. The weighted average remaining contractual term and the aggregate intrinsic value for options exercisable at September 30, 2006 were 7.8 years and $1.5 million, respectively. The total intrinsic value of the options exercised during the three months ended September 30, 2006 was approximately $69,000.

As of September 30, 2006, $155,000 of deferred compensation, relating to awards granted prior to the Company s S-1, has yet to be recognized. Such amounts will be recognized over the next 39 months. The Company expenses this deferred stock-based compensation to operations over the vesting period of the options and recorded stock-based compensation expense of $105,000 for the nine months ended September 30, 2006 and $2.0 million for the nine months ended September 30, 2005. For the three and nine months ended September 30, 2006, in accordance with the adoption of SFAS No. 123(R), the Company recorded incremental stock-based compensation expense of $1.5 million and $5.9 million, respectively.

The total fair value of the shares vested (other than pre S-1 shares vested) and expensed during the three months ended September 30, 2006 was $407,000. As of September 30, 2006 there was $15.4 million of total unrecognized compensation

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expense (including the pre S-1 shares) related to unvested share-based compensation awards granted under the Company s stock incentive plans, which is expected to be recognized over a weighted average period of 1.5 years.

The Company anticipates recording additional stock-based compensation expense of $1.7 million in the fourth quarter of 2006, $6.3 million in 2007, $4.4 million in 2008 and $3.0 million thereafter relating to the amortization of unrecognized compensation expense as of September 30, 2006. These anticipated compensation expenses do not include any adjustment for new or additional options to purchase common stock granted to employees. These amounts are expected to be reduced as a result of the Company s restructuring plan announced in October of 2006 and as described in Note 10.

Option valuation models require the input of highly subjective assumptions. Because changes in subjective input assumptions can materially affect the fair value estimate, in management s opinion, the calculated fair value may not necessarily be indicative of the actual fair value of the stock options. The Company has computed the impact under SFAS No. 123(R) for options granted using the Black-Scholes option-pricing model for the quarter ended September 30, 2006 and has computed the pro forma disclosures required under the modified prospective method for the quarter ended September 30, 2005. The Company increased its assumption for the three and nine months ended September 30, 2006 regarding expected volatility to 61% and 60%, respectively, from 59% and 58% in the corresponding periods of 2005. The revised rate is based on the Company s actual historical volatility since its initial public offering. In addition, the Company increased its assumption for the three and nine months ended September 30, 2006 regarding expected life to 6.25 years from 4 years in prior years. The expected life of options granted was estimated using the simplified method calculation as prescribed by SFAS No. 123(R). The assumptions used and weighted-average information are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Risk free interest rate	4.7%	4.1%	4.9%	4.0%
Expected dividend yield	0%	0%	0%	0%
Expected forfeiture rate	4.2%		4.2%	
Expected life	6.25 years	4 years	6.25 years	4 years
Expected volatility	61%	59%	60%	58%
Weighted-average fair value of options granted	$2.17	$3.20	$2.96	$3.11

The Company has had three stock option plans since its inception: the 2004 Stock Incentive Plan (the 2004 Stock Plan), the 2003 Stock Incentive Plan (the 2003 Stock Plan) and the 2000 Equity Incentive Plan (the 2000 Equity Plan). These plans permit the granting of stock awards to key employees, directors, consultants, and vendors of the Company and its affiliates. Awards under the 2004 Stock Plan, the 2003 Stock Plan and the 2000 Equity Plan may include incentive stock options, nonqualified stock options, and restricted common stock. Awards can only be made currently under the 2004 Stock Plan.

In April 2006, the stockholders of the Company approved the Company s 2006 Employee Stock Purchase Plan (the 2006 Stock Purchase Plan). The 2006 Stock Purchase Plan was adopted by the Company s board of directors in February 2006. The 2006 Stock Purchase Plan provides for the issuance of up to 400,000 shares of the Company s common stock to participating employees and is implemented by offering periods with a duration of six months. Offerings begin each June 1 and December 1, or the first business day thereafter, and first commenced June 1, 2006.

On the first day of an offering period, the Company will grant to each eligible employee who has elected to participate in this plan a purchase right for shares of common stock. The employee may authorize up to 15% of his or her compensation to be deducted during the offering period. On the last business day of the offering period, the employee will be deemed to have exercised the purchase right, at the applicable purchase price per share, to the extent of accumulated payroll deductions. The purchase price per share under this plan will be 85% of the lesser of the closing price per share of the common stock on the Nasdaq Global Market on the first day of the offering period or the last business day of the offering period. The 2006 Stock Purchase Plan may be terminated at any time by the

Company s board of directors.

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(7) May 2006 Restructuring

In May 2006, the Company recorded charges of $499,000 for a restructuring of its operations that was intended to better align costs with revenue and operating expectations. The restructuring charges, which included $95,000 in general and administrative expense, $231,000 in research and development expense and $173,000 in sales and marketing expense, pertain to employee severance benefits, outplacement services, automobile lease termination fees and impairment of assets. The restructuring charges were recorded in accordance with SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, and SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*.

In connection with the May 2006 restructuring plan, the Company terminated 27 employees or approximately 16% of the Company s workforce at the time, resulting in a severance charge of $383,000, which was accrued in May 2006. None of these employees remained employed as of May 31, 2006. As a result of terminating these employees, the Company recorded an automobile lease termination fee of $54,000, an outplacement service fee of $39,000 and an impairment charge of $23,000 for computer equipment for which the future use is currently uncertain. In the second quarter of 2006 the Company paid $203,000 of severance and other related charges which include $35,000 in general and administrative expense, $111,000 in research and development expense and $57,000 in sales and marketing expense. At September 30, 2006, the Company had $10,000 remaining in accrued expense related to its May restructuring.

In addition, at September 30, 2006, the Company had $976,000 of accrued severance and bonus expense related to the resignation of its former President and Chief Executive Officer and its former Senior Vice President of Sales and Marketing, which is not included in the restructuring charges above. These amounts are expected to be paid in December 2006 in accordance with the contractual terms of the severance and release agreements signed by the individuals.

(8) Basic and Diluted Loss per Share

Basic and diluted net loss per common share is calculated by dividing the net loss by the weighted-average number of unrestricted 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 anti-dilutive for all periods presented. Anti-dilutive securities that are not included in the diluted net loss per share calculation aggregated 10,541,881 and 9,214,279 as of September 30, 2006 and 2005, respectively. These anti-dilutive securities consist of outstanding stock options, warrants, and unvested restricted co