

DEPOMED INC  
Form 10-Q  
May 09, 2007

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

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**FORM 10-Q**

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

**FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2007**

**OR**

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

**FOR THE TRANSITION PERIOD FROM      TO**

**COMMISSION FILE NUMBER 000-23267**

## **DEPOMED, INC.**

(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

**CALIFORNIA**

(STATE OR OTHER JURISDICTION OF  
INCORPORATION OR ORGANIZATION)

**94-3229046**

(I.R.S. EMPLOYER  
IDENTIFICATION NUMBER)

**1360 O BRIEN DRIVE**

**MENLO PARK, CALIFORNIA 94025**

(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES, INCLUDING ZIP CODE)

**(650) 462-5900**

(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 Exchange Act 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, as defined in Rule 12b-2 of the Exchange Act.

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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 issued and outstanding shares of the Registrant's Common Stock, no par value, as of May 3, 2007 was 47,470,067.

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DEPOMED, INC.

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**PART I FINANCIAL INFORMATION**

**ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

## DEPOMED, INC.

## CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

	March 31, 2007	December 31, 2006
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 5,164,531	\$ 14,574,110
Marketable securities	20,605,784	16,984,503
Accounts receivable	945,180	7,126,895
Unbilled accounts receivable	136,901	1,954,904
Inventories	4,390,834	4,483,157
Prepaid and other current assets	3,261,273	2,756,174
Total current assets	34,504,503	47,879,743
Marketable securities		1,998,760
Property and equipment, net	2,281,894	2,541,463
Other assets	197,218	197,218
	\$ 36,983,615	\$ 52,617,184
<b>LIABILITIES AND SHAREHOLDERS DEFICIT</b>		
Current liabilities:		
Accounts payable	\$ 4,567,652	\$ 4,886,222
Accrued compensation	1,215,588	1,817,418
Accrued clinical trial expense	918,103	726,379
Accrued promotion fee expense	246,461	2,339,925
Other accrued liabilities	3,246,232	3,087,998
Deferred product sales	4,024,209	4,825,099
Deferred license revenue	4,437,848	4,599,947
Other current liabilities	55,845	55,845
Total current liabilities	18,711,938	22,338,833
Deferred license revenue, non-current portion	55,682,302	57,483,045
Other long-term liabilities	69,805	83,766
Commitments		
Shareholders' deficit:		
Preferred stock, no par value, 5,000,000 shares authorized; Series A convertible preferred stock, 25,000 shares designated, 18,158 shares issued and outstanding at March 31, 2007 and December 31, 2006, respectively, with an aggregate liquidation preference of \$18,158,848	12,015,000	12,015,000
Common stock, no par value, 100,000,000 shares authorized; 42,091,255 and 42,029,411 shares issued and outstanding at March 31, 2007 and December 31, 2006, respectively	145,482,641	144,820,534
Accumulated deficit	(194,977,497)	(184,111,185)
Accumulated other comprehensive loss	(574)	(12,809)
Total shareholders' deficit	(37,480,430)	(27,288,460)
	\$ 36,983,615	\$ 52,617,184

See accompanying notes to Condensed Consolidated Financial Statements.

## DEPOMED, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	Three Months Ended March 31,	
	2007	2006
Revenue:		
Product sales	\$ 1,331,766	\$ 99,673
Royalties	34,225	349,321
License revenue	2,462,842	893,165
Total revenues	3,828,833	1,342,159
Costs and expenses:		
Cost of sales	305,660	74,353
Research and development	8,572,341	5,684,082
Selling, general and administrative	6,226,646	3,931,293
Total costs and expenses	15,104,647	9,689,728
Loss from operations	(11,275,814 )	(8,347,569 )
Interest and other income	410,228	594,859
Net loss before income taxes	(10,865,586 )	(7,752,710 )
Provision for income taxes	(726 )	
Net loss	(10,866,312 )	(7,752,710 )
Deemed dividend on preferred stock	(167,016 )	(172,632 )
Net loss applicable to common stock shareholders	\$ (11,033,328 )	\$ (7,925,342 )
Basic and diluted net loss applicable to common stock shareholders per common share	\$ (0.26 )	\$ (0.19 )
Shares used in computing basic and diluted net loss per common share	42,076,197	40,843,512

See accompanying notes to Condensed Consolidated Financial Statements.

## DEPOMED, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Three Months Ended March 31,	
	2007	2006
<b>Operating Activities</b>		
Net loss	\$ (10,866,312 )	\$ (7,752,710 )
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	226,149	377,103
Employee and director stock-based compensation	489,251	548,313
Stock-based compensation related to consultants	4,034	
Changes in assets and liabilities:		
Accounts receivable	7,999,718	226,197
Inventories	92,323	(481,934 )
Prepaid and other current assets	(505,099 )	(109,287 )
Accounts payable and other accrued liabilities	(2,062,076 )	1,649,768
Accrued compensation	(601,830 )	(976,857 )
Royalty advances		697,198
Deferred revenue	(2,763,732 )	(20,156 )
Net cash (used in) operating activities	(7,987,574 )	(5,842,365 )
<b>Investing Activities</b>		
Purchases of property and equipment	(34,030 )	(228,453 )
Purchases of marketable securities	(10,551,281 )	(8,524,040 )
Maturities of marketable securities	8,994,484	12,046,674
Sales of marketable securities		1,497,210
Net cash (used in) provided by investing activities	(1,590,827 )	4,791,391
<b>Financing Activities</b>		
Proceeds from issuance of common stock	168,822	1,680,286
Net cash provided by financing activities	168,822	1,680,286
Net (decrease) increase in cash and cash equivalents	(9,409,579 )	629,312
Cash and cash equivalents at beginning of period	14,574,110	7,565,556
Cash and cash equivalents at end of period	\$ 5,164,531	\$ 8,194,868

See accompanying notes to Condensed Consolidated Financial Statements.



**DEPOMED, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

*Basis of Presentation*

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These unaudited condensed consolidated financial statements and the related footnote information of Depomed, Inc. (the Company or Depomed) have been prepared pursuant to the requirements of the Securities and Exchange Commission (SEC) for interim reporting. As permitted under those rules, certain footnotes or other financial information that are normally required by U.S. generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. In the opinion of the Company's management, the accompanying interim unaudited condensed consolidated financial statements include all adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation of the information for the periods presented. The results for the interim period ended March 31, 2007 are not necessarily indicative of results to be expected for the entire year ending December 31, 2007 or future operating periods.

The balance sheet as of December 31, 2006 has been derived from the audited financial statements at that date. The balance sheet does not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. For further information, refer to the financial statements and footnotes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 2006 filed with the SEC.

### *Principles of Consolidation*

The consolidated financial statements for the three months ended March 31, 2007 and 2006 include the accounts of the Company and Depomed Development, Ltd., DDL. DDL does not have any fixed assets, liabilities or employees and will not perform any further product development on behalf of Depomed or any other entity. Material intercompany accounts and transactions have been eliminated. DDL was dissolved in April 2007.

### *Use of Estimates*

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

### *Stock-Based Compensation*

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Effective January 1, 2006, Depomed implemented the provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* (FAS 123(R)), as interpreted by SEC Staff Accounting Bulletin No. 107 (SAB 107), using the modified prospective transition method. FAS 123(R) is a revision of Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (FAS 123), and supercedes APB Opinion No. 25, *Accounting for Stock Issued to Employees* (APB No. 25). FAS 123(R) requires companies to recognize the cost of employee and director services received in exchange for awards of equity instruments, based on the grant-date fair value of those awards, in the statement of operations. Using the modified prospective transition method of FAS 123(R), Depomed began recognizing fair-value compensation expense for stock-based awards, including stock options granted and purchase rights issued under its employee purchase plan after January 1, 2006. Compensation expense for stock-based awards granted prior to implementation that were unvested and outstanding as of January 1, 2006 is recognized over the requisite service period based on the grant-date fair value of those options and awards as previously calculated under FAS 123. The compensation expense for stock-based compensation is based on the single-option approach, includes an estimate for forfeitures and is recognized over the vesting term of the options using the straight-line method. FAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Depomed estimates forfeitures based on historical experience. Under the modified prospective transition method of implementation, no restatement of prior periods has been made. See Note 4 of the Notes to Condensed Consolidated Financial Statements for further information regarding Depomed's stock-based compensation expense.

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**Revenue Recognition**

Revenue arrangements with multiple elements are divided into separate units of accounting if certain criteria are met, including whether the delivered element has stand-alone value to the customer and whether there is objective and reliable evidence of the fair value of the undelivered items. The consideration received is allocated among the separate units based on their respective fair values, and the applicable revenue recognition criteria are applied to each of the separate units.

Revenue is recognized when there is persuasive evidence that an arrangement exists, delivery has occurred and title has passed, the price is fixed or determinable and the Company is reasonably assured of collecting the resulting receivable.

The Company sells GLUMETZA product to wholesalers and retail pharmacies that is subject to rights of return up to twelve months after product expiration. Given the limited sales history of GLUMETZA, the Company currently cannot reliably estimate expected returns of the product at the time of shipment. Accordingly, the Company defers recognition of revenue on product shipments of GLUMETZA until the right of return no longer exists, which occurs at the earlier of the time GLUMETZA units are dispensed through patient prescriptions or expiration of the right of return. The Company estimates patient prescriptions dispensed using an analysis of third-party information, including third-party market research data, information obtained from certain wholesalers with respect to inventory levels and out-movement and retail pharmacy re-stocking activity. As a result of this policy, the Company has a deferred revenue balance of \$4.0 million at March 31, 2007 related to GLUMETZA product shipments that have not been recognized as revenue, which is net of estimated patient support program discounts, wholesaler fees, stocking allowances, prompt payment discounts and chargebacks. The Company will recognize revenue upon the earlier of prescription units dispensed or expiration of the right of return until it can reliably estimate product returns, at which time the Company will record a one-time increase in net revenue related to the recognition of revenue previously deferred. In addition, the costs of manufacturing GLUMETZA associated with the deferred revenue are recorded as deferred costs, which are included in inventory, until such time the deferred revenue is recognized.

Product sales revenue related to the Company's supply agreement with Esprit is recognized after the expiration of a 30-day period in which Esprit may reject product that does not meet agreed-upon specifications.

Royalties are recognized as earned in accordance with the contract terms when royalties from licensees can be reliably measured and collectibility is reasonably assured. The Company recognizes royalties under its agreement with Esprit based on Esprit's sales of ProQuin XR, net of any estimated returns, discounts, rebates and chargebacks. Esprit is obligated to pay the Company annual minimum royalties. Total royalty revenue recognized by the Company to date has been equal to Esprit's minimum royalty obligation under the agreement. Royalties received under the Company's agreements with Biovail and LG are recognized when the royalty payments are received as they are not estimable. Royalty payments received in excess of amounts earned are classified as royalty advances until earned.

Revenue from license arrangements, including license fees creditable against future royalty obligations (if any), of the licensee, is recognized when an arrangement is entered into if the Company has substantially completed its obligations under the terms of the arrangement and the Company's remaining involvement is inconsequential and perfunctory. If the Company has significant continuing involvement under such an arrangement, license fees are deferred and recognized over the estimated performance period. License fee payments received in excess of amounts earned are classified as deferred revenue until earned.

Collaborative revenue recognized relates to services rendered in connection with collaborative arrangements and the achievements of milestones under such arrangements. Revenue related to collaborative agreements with corporate partners is recognized as the expenses are incurred under each contract. The Company is required to perform services as specified in each respective agreement and the Company is reimbursed based on the costs incurred on each specific contract. Nonrefundable substantive milestone payments are recognized pursuant to collaborative agreements upon the achievement of specified milestones where no further obligation to perform exists under that milestone provision of the arrangement and when collectibility is reasonably assured.

**NOTE 2. CASH, CASH EQUIVALENTS AND MARKETABLE SECURITIES**

The Company considers all highly liquid investments with an original maturity (at date of purchase) of three months or less to be cash equivalents. Cash and cash equivalents consist of cash on deposit with banks, money market instruments and commercial paper. The Company places its cash, cash equivalents and marketable securities with high quality, U.S. financial institutions and, to date, has not experienced material losses on any of its balances. The Company records cash and cash equivalents at amortized cost, which approximates the fair value. All marketable securities are classified as available-for-sale since these instruments are readily marketable. These securities are carried at fair value, which is based on readily available market information, with unrealized gains and losses included in accumulated other comprehensive income (loss) within shareholders' equity. The Company uses the specific identification method to determine the amount of realized gains or losses on sales of marketable securities. Realized gains or losses have been insignificant and are included in interest and other income in the condensed consolidated statement of operations. At March 31, 2007, the individual contractual period for all available-for-sale debt securities is less than two years.

The following table shows the gross unrealized losses and fair value of the Company's investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at March 31, 2007:

U.S. Debt Securities	Less than 12 months		12 months or greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
U.S. government debt securities	\$ 2,794,764	\$ (513 )	\$ 3,994,760	\$ (3,828 )	\$ 6,789,524	\$ (4,341 )
U.S. corporate debt securities	5,853,893	(1,757 )			5,853,893	(1,757 )
Total available-for-sale	\$ 8,648,657	\$ (2,270 )	\$ 3,994,760	\$ (3,828 )	\$ 12,643,417	\$ (6,098 )

The gross unrealized losses above were caused by interest rate increases. No significant facts or circumstances have arisen to indicate that there has been any deterioration in the creditworthiness of the issuers of the Company's securities. Based on the Company's review of these securities, including the assessment of the duration and severity of the unrealized losses and the Company's ability and intent to hold the investments until maturity, there were no other-than-temporary impairments for these securities at March 31, 2007.

**NOTE 3. NET LOSS PER COMMON SHARE**

Net loss per common share is computed using the weighted-average number of shares of common stock outstanding. Common stock equivalent shares, which are based on the number of shares underlying outstanding stock options, warrants and other convertible securities, are not included as their effect is antidilutive. At March 31, 2007 and 2006, the total number of outstanding common stock equivalent shares excluded from the loss per share computation was 8,550,392 and 9,098,968, respectively.

**NOTE 4. STOCK-BASED COMPENSATION**

The Company adopted FAS 123(R) on January 1, 2006 as described in Note 1 of the Notes to Condensed Consolidated Financial Statements. Stock-based compensation expense recognized under FAS 123(R) in the condensed consolidated statements of operations related to stock options and the Company's employee stock purchase program (ESPP) was approximately \$493,000 and \$548,000 for the three months ended March 31, 2007 and 2006, respectively. Stock-based compensation expense for the three months ended March 31, 2007 consisted of \$201,000 in research and development expense, \$288,000 in selling, general and administrative expense and \$4,000 in cost of sales. Stock-based compensation expense for the three months ended March 31, 2006 consisted of \$238,000 in research and development expense and \$310,000 in selling, general and administrative expense. At March 31, 2007, Depomed had \$5.2 million of total unrecognized compensation expense, net of estimated forfeitures, related to stock option grants that will be recognized over an average vesting period of 2.5 years.

**NOTE 5. COMPREHENSIVE LOSS**

Total comprehensive loss for the three months ended March 31, 2007 and 2006 approximates net loss and includes unrealized losses on marketable securities.

**NOTE 6. COLLABORATIVE ARRANGEMENTS AND CONTRACTS**

*LG Life Sciences*

In January 2007, the Company and LG Life Sciences further amended the parties' license and distribution agreement, originally entered into in August 2004 and subsequently amended in November 2006. The amendment grants LG a license to manufacture the 500mg GLUMETZA in exchange for royalties on net sales of GLUMETZA in Korea and removes the provisions of the original agreement providing for the supply of 500mg GLUMETZA tablets by the Company to LG. The Company received a \$600,000 upfront license fee in August 2004 and a \$500,000 milestone payment in November 2006 with respect to LG's approval to market GLUMETZA in the Republic of Korea, both of which were originally deferred and amortized as revenue over the estimated length of time the Company was obligated to provide assistance to LG in development and manufacturing. Under the amended agreement, the Company no longer has continuing performance obligations to LG that are other than inconsequential or perfunctory and accordingly, the remaining \$905,000 of previously deferred revenue was recognized as license revenue in the quarter ended March 31, 2007.

*Biovail*

In February 2007, the Company entered into a license and development agreement with Biovail granting Biovail an option to license the AcuForm drug delivery technology to develop and commercialize up to two pharmaceutical products. Pursuant to the agreement, Biovail paid the Company an upfront fee of \$500,000 in February 2007, and is contingently obligated to pay the Company additional fees related to the exercise of the license option, the initiation of the first Phase 3 trial for each product and upon receipt of U.S. regulatory approval for each product. The agreement also requires that Biovail make royalty payments to the Company on net commercial sales of any product developed under the agreement. As the Company has no continuing obligations to Biovail under the agreement that are other than inconsequential or perfunctory, the \$500,000 upfront license fee was recognized as license revenue in the quarter ended March 31, 2007.

Also in February 2007, the Company amended its stock purchase agreement with Biovail originally entered into in May 2002. The amended stock purchase agreement removed Biovail's observer rights on the Company's board of directors and removed the right of first negotiation in favor of Biovail with respect to acquisition transactions involving the Company.

**NOTE 7. INVENTORIES**

Inventories relate to the manufacture of the Company's GLUMETZA and ProQuin XR products. Inventories are stated at the lower of cost or market and consist of the following:

	March 31, 2007	December 31, 2006
Raw materials	\$ 1,119,198	\$ 1,343,421
Work-in-process	1,239,270	1,387,359
Finished goods	1,392,723	969,619
Deferred costs	639,643	782,758
Total	\$ 4,390,834	\$ 4,483,157

Deferred costs represent the costs of GLUMETZA product shipped for which recognition of revenue has been deferred.

**NOTE 8. SHAREHOLDERS' EQUITY***Series A Preferred Stock*

The Series A Preferred Stock accrued a dividend of 7% per annum, compounded semi-annually and payable in shares of Series A Preferred Stock. The Series A Preferred Stock was convertible at anytime between January 2002 and January 2006 into the Company's common stock. The original conversion price of the Series A Preferred Stock was \$12.00; however, as a result of the Company's March 2002 and October 2003 financings, the conversion price had been adjusted to \$9.51 per share. In December 2004, the Company entered into an agreement with the Series A Preferred stockholder to resolve a misunderstanding between the Company and the stockholder relating primarily to prior adjustments to the conversion price of the Series A Preferred Stock. Pursuant to the agreement, among other matters, the Company agreed to adjust the conversion price to \$7.50 per share. The Company and the stockholder also agreed to binding interpretations of certain other terms related to the Series A Preferred Stock conversion price.

Prior to December 2004, the amounts calculated as Series A Preferred stock dividends were accounted for as an adjustment to the conversion price following EITF Issue No. 98-5, *Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios* (Issue No. 98-5). As a result of the modifications to the preferred stock agreement in December 2004, the Company determined that a significant modification of the agreement had been made, and, therefore, a new commitment date for accounting purposes had been established on December 10, 2004. The Company measured the difference between the carrying value of the preferred stock and the fair value of the modified preferred stock pursuant to EITF Topic No. D-42, *The Effect on the Calculation of Earnings per Share for the Redemption or Induced Conversion of Preferred Stock* and determined that the fair value of the modified security was less than the carrying value of the security prior to the modification. The Company also evaluated the effective conversion rate, after considering the reset rate of \$7.50 per share in addition to the common stock issuable upon conversion of the unpaid, accumulated dividends. The fair value of the underlying common stock on December 10, 2004 was \$5.06 per share. The Company determined that the conversion rate, after including the effect of the unpaid dividends, did not result in a beneficial conversion feature, which could have had the effect of also providing a deemed dividend to the preferred stockholder. However, an anti-dilution provision of the Series A Preferred Stock was triggered by the Company's January 2005 financing, which adjusted the conversion price of the Series A Preferred Stock to \$7.12. As a result of the adjusted conversion price and an increase in the amount of common stock issuable upon conversion of the Series A Preferred Stock due to additional accumulated dividends, the Series A Preferred Stock now contains a beneficial conversion feature subject to recognition pursuant to Issue No. 98-5.

In conjunction with the modification of the agreement, the Company issued a warrant to the Series A Preferred stockholder. The value of the warrant was considered in determining the value of the modified security. The warrant is convertible into shares of the Company's common stock during the period between January 2006 and January 2009. The conversion price of the warrant initially was \$7.12, which was equal to the Series A Preferred Stock conversion price in effect as of January 20, 2006. The conversion price of the warrant decreases by approximately 4.8% per year during the conversion period, such that the number of shares of the Company's common stock issuable upon conversion of the warrant will increase by approximately 5.1% per year. The conversion of the warrant will be satisfied only by surrender of the outstanding shares of Series A Preferred Stock.

The Series A Preferred Stock accrued dividends through January 20, 2006, which is the date the warrant initially became exercisable. As a result of the issuance of the warrant, the preferred stock may be surrendered in exchange for common stock for an additional three years through January 20, 2009. As long as the Series A Preferred Stock remains outstanding, the number of shares into which the warrant can be converted increases as the conversion price of the warrant decreases resulting in additional deemed dividends on the Series A Preferred Stock. For the three months ended March 31, 2007 and 2006, the Company recognized Series A Preferred Stock deemed dividends of approximately \$167,000 and \$173,000, respectively, attributable to the beneficial conversion feature from the accrued dividends and decreasing warrant price. The Company will continue to recognize Series A Preferred Stock deemed dividends until the earlier of, the time the Series A Preferred Stock is surrendered or until January 2009.

As of March 31, 2007, there were 18,158 shares of Series A Preferred Stock outstanding with an aggregate liquidation preference of approximately \$18,159,000. The warrant was convertible into 2,705,430 shares of the Company's common stock at a conversion price of \$6.71 as of March 31, 2007.

#### ***Option Exercises***

During the three months ended March 31, 2007, employees and consultants exercised options to purchase 61,844 shares of the Company's common stock with net proceeds to the Company of approximately \$169,000.

#### **NOTE 9. INCOME TAXES**

In July 2006, the Financial Accounting Standards Board, or FASB, issued FASB Interpretation No. 48, "*Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109*" (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements. Tax positions are evaluated for recognition using a more-likely-than-not threshold, and those tax positions requiring recognition are measured as the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information. FIN 48 is effective for fiscal years beginning after December 15, 2006.

The Company adopted the provisions of FIN 48 on January 1, 2007. As of the adoption date, the Company had \$1.9 million of unrecognized tax benefits. Upon adoption of FIN 48, no adjustment was made to the Company's liability for uncertain tax positions or the Company's beginning accumulated deficit balance. The adoption of FIN 48 did not have a material impact on the Company's financial statements, results of operations or cash flows.

All tax years since inception remain open to examination by the Internal Revenue Service and the California Franchise Tax Board until such time the Company's net operating losses and credits are either utilized or expire. Interest and penalties, if any, related to unrecognized tax benefits, would be recognized as income tax expense by the Company. As of the date of adoption of FIN 48, the Company did not have any accrued interest or penalties associated with unrecognized tax benefits. The Company does not foresee any material changes to unrecognized tax benefits within the next twelve months.

#### **NOTE 10. SUBSEQUENT EVENTS**

##### ***Registered Direct Equity Offering***

Basis of Presentation



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In April 2007, the Company completed a registered direct offering of 5,300,000 shares of common stock with selected institutional investors. The shares were sold at a price of \$3.775 per share, with net proceeds totaling approximately \$20,000,000.

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**  
**FORWARD-LOOKING INFORMATION**

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Statements made in this Management's Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this Quarterly Report on Form 10-Q that are not statements of historical fact are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended. We have based these forward-looking statements on our current expectations and projections about future events. Our actual results could differ materially from those discussed in, or implied by, these forward-looking statements. Forward-looking statements are identified by words such as believe, anticipate, expect, intend, plan, will, may and other similar expressions. In addition, any statements that refer to expectations, projections or other characterizations of future events or circumstances are forward-looking statements. Forward-looking statements include, but are not necessarily limited to, those relating to:

- the success of GLUMETZA in the United States;
- the success of our collaborative arrangement with King Pharmaceuticals with respect to GLUMETZA;
- our ability to obtain marketing partners for Gabapentin GR and other product candidates;
- market acceptance of ProQuin® XR and GLUMETZA;
- the results of our discussions with Esprit Pharma related to our ProQuin XR license agreement and the commercialization of ProQuin XR;
- the efforts of Esprit Pharma with respect to the marketing of ProQuin XR;
- the efforts of Biovail with respect to the marketing of GLUMETZA in Canada;
- our collaborative partners' compliance or non-compliance with their obligations under our agreements with them;
- results and timing of our clinical trials, including the results of Gabapentin GR trials and publication of those results;
- our ability to raise additional capital; and
- our plans to develop other product candidates.

Factors that could cause actual results or conditions to differ from those anticipated by these and other forward-looking statements include those more fully described under **RISK FACTORS** in Item 1A of Part II and elsewhere in this Quarterly Report on Form 10-Q. We disclaim any intent to update or revise these forward-looking statements to reflect new events or circumstances.

### ABOUT DEPOMED

Depomed is a specialty pharmaceutical company focused on the development and commercialization of differentiated products that address large and growing markets and are based on proprietary oral drug delivery technologies. We have developed two commercial products. GLUMETZA (metformin hydrochloride extended release tablets) is a once-daily treatment for adults with type 2 diabetes that we jointly commercialize in the United States with King Pharmaceuticals, Inc. ProQuin XR (ciprofloxacin hydrochloride extended release tablets) is a once-daily treatment for uncomplicated urinary tract infections that Esprit Pharma, Inc. markets in the United States.

We have a three-pronged approach to product development designed to optimize the use and value of our drug delivery technologies, while managing the costs and risks associated with developing and commercializing pharmaceutical products. We develop products for our own account that are designed to compete in large growing markets and that can be highly differentiated from immediate release versions of the compounds upon which they are based. Second, we selectively enter into collaborative partnerships with other companies where the unique capabilities of our technology can provide superior value to a partner's compound, resulting in significantly greater value for Depomed than a traditional fee-for-service arrangement. Third, we enter into arrangements that enable our technology to be applied by other companies to a greater number of compounds than our infrastructure can support, so as to derive additional value from our technology. In the future, we plan to

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commercialize our proprietary products, relying on partners to cover the large primary care audiences, while maintaining co-promotion and distribution rights in order to be in a position to create our own sales force when appropriate, thereby increasing the value to us of our products, and our control over them.

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Our most advanced product candidate in development is Gabapentin GR, an extended release form of gabapentin. With respect to Gabapentin GR, we have completed enrollment of a Phase 3 clinical trial for the treatment of postherpetic neuralgia (PHN), completed and announced positive results of a Phase 2 clinical trial for the treatment of diabetic peripheral neuropathy (DPN), and submitted an investigational new drug application, or IND, for a Phase 2 clinical trial for the treatment of menopausal hot flashes. Additionally, we have other product candidates in earlier stages of development, including a treatment for gastroesophageal reflux disease (GERD).

Our intellectual property position includes nine issued patents and fourteen patent applications pending in the United States.

***Highlights for the Quarter Ended March 31, 2007***

- In March 2007, we completed enrollment in our Phase 3 clinical trial for Gabapentin GR for the treatment of postherpetic neuralgia, or PHN;
- In March 2007, we submitted an Investigational New Drug application with the U.S. Food and Drug Administration, or FDA, for Gabapentin GR for the treatment of postmenopausal hot flashes;
- Revenue for the three months ended March 31, 2007 was \$3.8 million compared to \$1.3 million for the three months ended March 31, 2006;
- Operating expenses for the three months ended March 31, 2007 were \$14.8 million compared to \$9.6 million for the three months ended March 31, 2006;
- Cash, cash equivalents and marketable securities were \$25.8 million as of March 31, 2007 compared to \$33.6 million as of December 31, 2006.

**RECENT PRODUCT DEVELOPMENTS**

***MARKETED PRODUCTS***

***GLUMETZA***

In April 2007, we submitted a supplemental New Drug Application, or NDA, to the FDA covering the 1000mg GLUMETZA seeking approval to market the product in the United States. If approved, we expect the 1000mg GLUMETZA to be available late in 2007, or in the first quarter of 2008.

*LG Life Sciences.* In January 2007, we amended our GLUMETZA license agreement with LG covering Korea. We granted LG a license to manufacture the 500mg GLUMETZA in exchange for royalties on net sales of GLUMETZA in Korea, and removed the provisions of the original agreement providing for the supply of 500mg GLUMETZA tablets by the Company to LG.

***ProQuin® XR***

*Esprit Pharma.* In January 2007, we commenced discussions with Esprit toward a mutually agreeable, long-term restructuring of our ProQuin XR license agreement with Esprit. Those discussions are continuing. The agreement will remain in effect unless and until we and Esprit agree to any modifications to it.

***PRODUCT CANDIDATES***

*Gabapentin GR*

Postherpetic Neuralgia. In May 2006, we initiated a Phase 3 clinical trial for Gabapentin GR for the treatment of PHN. The study is a randomized, double-blind, placebo-controlled study of approximately 400 PHN patients. The study was fully enrolled in early March 2007. Patients in the study are randomized into three treatment arms: placebo, a total daily dose of 1800mg of Gabapentin GR dosed once daily, and a total daily dose of 1800mg of Gabapentin GR dosed twice daily.

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The primary objective of the study is to assess the efficacy of Gabapentin GR in reducing the pain associated with PHN, measured from baseline pain scores to the end of a ten-week treatment period on the basis of the Likert pain scale. Secondary objectives include an assessment of changes from baseline in sleep interference, and additional patient and clinician assessments of pain and quality of life.

We expect to report the results of the study in mid-2007. If the results of the study are positive, we expect to file an NDA for Gabapentin GR for PHN in the fourth quarter of 2007.

Menopausal Hot Flashes. In March 2007, we submitted to the FDA an IND for a Phase 2 study of Gabapentin GR for the treatment of menopausal hot flashes. The FDA did not raise an objection to the IND application, and we commenced a Phase 2 study assessing the safety and efficacy of Gabapentin GR for the treatment of menopausal hot flashes in April 2007.

#### ***Gastroesophageal Reflux Disease Program***

In 2006, we conducted a Phase 1 GERD study designed to provide us with insight into our formulation strategy for our GERD program. We are now conducting Phase 2a proof-of-concept GERD studies designed to assess our potential formulation approach. We expect to complete these studies before the end of June 2007. Depending on those results, and interest in the project from potential collaborative partners, we may proceed with a Phase 2 GERD study.

#### ***OTHER RESEARCH AND DEVELOPMENT AND COLLABORATIVE PROGRAMS***

New River. In April 2007, Shire Pharmaceuticals, Inc. completed its acquisition of New River Pharmaceuticals, Inc. We do not know whether the acquisition may impact our license and development agreement with New River.

Supernus. In September 2006, we entered into a collaboration agreement with Supernus Pharmaceuticals, Inc. to develop through a Phase 1 study a product candidate leveraging our AcuForm drug delivery technology. The cost and ownership of the program will be shared between the parties equally. We continue to participate with Supernus on this collaborative program.

Biovail. In February 2007, we entered into a license and development agreement with Biovail granting Biovail an option to license our AcuForm drug delivery technology to develop and commercialize up to two pharmaceutical products. Pursuant to the agreement, Biovail paid us an upfront fee of \$500,000 in February 2007, and is contingently obligated to pay us additional fees related to the exercise of the license option, the initiation of the first Phase 3 trial for each product and upon receipt of U.S. regulatory approval for each product. The agreement also stipulates that Biovail make royalty payments to us on net commercial sales of any product developed under the agreement.

Also in February 2007, we amended our stock purchase agreement with Biovail, which was originally entered into in May 2002. The amended stock purchase agreement removed Biovail's observer rights on our board of directors and removed the right of first negotiation in favor of Biovail with respect to any acquisition transactions of Depomed.

#### **CRITICAL ACCOUNTING POLICIES**

Critical accounting policies are those that require significant judgment and/or estimates by management at the time that the financial statements are prepared such that materially different results might have been reported if other assumptions had been made. We consider certain accounting policies related to revenue recognition, accrued liabilities and stock-based compensation to be critical policies. There have been no changes to our critical accounting policies since we filed our 2006 Annual Report on Form 10-K with the Securities and Exchange Commission on March 16, 2007. For a description of our critical accounting policies, please refer to our 2006 Annual Report on Form 10-K.







**RESULTS OF OPERATIONS**

*Three Months Ended March 31, 2007 and 2006*

**Revenue**

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Total revenues are summarized in the following table:

	<b>Three Months Ended March 31,</b>	
	<b>2007</b>	<b>2006</b>
<b>Product sales:</b>		
GLUMETZA	\$ 1,332,000	\$
ProQuin XR		100,000
Total product sales	1,332,000	100,000
<b>Royalties:</b>		
GLUMETZA	34,000	89,000
ProQuin XR		260,000
Total royalties	34,000	349,000
<b>License revenue:</b>		
GLUMETZA	1,269,000	382,000
ProQuin XR	694,000	511,000
AcuForm technology	500,000	
Total license revenue	2,463,000	893,000
<b>Total revenues</b>	<b>\$ 3,829,000</b>	<b>\$ 1,342,000</b>

**Product sales**

The GLUMETZA product that we began selling to wholesalers and retail pharmacies in September 2006 is subject to rights of return of up to twelve months after product expiration. Given the limited sales history of GLUMETZA and return privileges, we currently cannot reliably estimate expected returns of the product at the time of shipment. We defer recognition of revenue on product shipments of GLUMETZA to our customers until the right of return no longer exists, which occurs at the earlier of the time GLUMETZA units are dispensed through patient prescriptions or expiration of the right of return. We estimate the volume of prescription units dispensed by pharmacies based on an analysis of third-party information, including third-party market research data, information obtained from certain wholesalers with respect to inventory levels and out-movement and retail pharmacy re-stocking activity. For the quarter ended March 31, 2007, we recognized approximately \$1.3 million of product sales of GLUMETZA, which is net of estimated patient support program discounts, wholesaler fees, stocking allowances, prompt payment discounts and chargebacks. We have deferred recognition of revenue on GLUMETZA product shipments to customers which we estimate have not been dispensed through patient prescriptions. At March 31, 2007, we have a deferred revenue balance, which is classified as a liability on the consolidated balance sheet, of \$4.0 million associated with the deferral of revenue on GLUMETZA product shipments, which is net of estimated patient support program discounts, wholesaler fees, stocking allowances, prompt payment discounts and chargebacks.

ProQuin XR product sales relate to our supply agreement with Esprit. We began supplying Esprit with commercial quantities of ProQuin XR in the fourth quarter of 2005. Esprit did not make any purchases from us in the first quarter of 2007.

### ***Royalties***

GLUMETZA royalties for quarter ended March 31, 2007 relate to royalties we received from Biovail based on net sales of GLUMETZA in Canada and royalties we received from LG based on net sales of GLUMETZA in Korea. GLUMETZA royalties for the quarter ended March 31, 2006 relate to royalties we received on Biovail's product launch of GLUMETZA in Canada.

Our agreement with Esprit provides for royalty payments by Esprit to us of 15 percent to 25 percent of ProQuin XR net sales in the United States, based on escalating net sales and subject to certain minimum royalty amounts. Esprit's minimum royalty obligation for 2007 is \$5.0 million, and in subsequent years is \$5.0 million per year, subject to annual increases in the consumer price index beginning in 2008. As a result of returns of product to Esprit, Esprit was not obligated to pay us any royalties for the quarter ended March 31, 2007. Accordingly, we recognized no royalty revenue on ProQuin XR for the quarter ended March 31, 2007.

### ***License revenue***

We received \$25.0 million in GLUMETZA license fees from Biovail in July 2005. We are recognizing the \$25.0 million license fee payment as revenue ratably until February 2023, which represents the estimated length of time our obligations exist under the arrangement related to royalties we are obligated to pay Biovail on net sales of GLUMETZA in the United States and for our obligation to use Biovail as our sole supplier of the 1000mg GLUMETZA, should the 1000mg GLUMETZA obtain approval in the United States.

We also received a \$600,000 upfront license fee from LG in August 2004 and a \$500,000 milestone payment received in November 2006 with respect to LG's approval to market GLUMETZA in the Republic of Korea. These payments were originally deferred and amortized as license revenue over the estimated length of time that we were obligated to provide LG with assistance in development and manufacturing. In January 2007, we amended our agreement with LG, granted LG a license to manufacture the 500mg GLUMETZA in exchange for royalties on net sales of GLUMETZA in Korea, and removed the provisions of the original agreement providing for the supply of 500mg GLUMETZA tablets by us to LG. Under the amended agreement, we no longer have continuing performance obligations that are other than inconsequential or perfunctory to LG. Accordingly, the remaining \$905,000 of previously deferred revenue was recognized as license revenue in the quarter ended March 31, 2007.

As of March 31, 2007, we have received \$40.0 million in license fees under our license agreement with Esprit for ProQuin XR. We received \$30.0 million in license fees in July 2005 and an additional \$10.0 million in December 2006. The license fees received are being recognized as revenue ratably commencing on our receipt of the fees through June 2020, which represents the length of time we are obligated to manufacture ProQuin XR under our ProQuin XR supply agreement with Esprit. License revenue increased in the quarter ended March 31, 2007 over the quarter ended March 31, 2006 as a result of additional amortization of license revenue resulting from the receipt of the \$10.0 million in December 2006. Esprit is obligated to pay us an additional \$10.0 million in July 2007. Should Esprit not pay us the final \$10.0 million license fee installment, it could result in a material adverse effect on our financial condition.

In February 2007, we received \$500,000 from Biovail upon entering into a license and development agreement with Biovail granting Biovail an option to license our AcuForm drug delivery technology to develop and commercialize up to two pharmaceutical products. We have no continuing performance obligations that are other than inconsequential or perfunctory under the agreement and have recognized the entire upfront license fee as revenue in the quarter ended March 31, 2007.

### **Research and Development Expense**

Our research and development expenses currently include costs for scientific personnel, supplies, equipment, outsourced clinical and other research activities, consultants, depreciation, facilities and utilities. The scope and magnitude of future research and development expenses cannot be predicted at this time for our product candidates in the early phases of research and development, as it is not possible to determine the nature, timing and extent of clinical trials and studies, the FDA's requirements for a particular drug and the requirements and level of participation, if any, by potential partners. As potential products proceed through the development process, each step is typically more extensive, and therefore more expensive, than the previous step. Success in development therefore, generally results in increasing expenditures until actual product launch. Furthermore, our business strategy involves licensing certain of our drug candidates to collaborative partners.

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Depending upon when such collaborative arrangements are executed, the amount of costs incurred solely by us will be impacted. Total research and development expense for the first quarter of 2007, as compared to the prior year, was as follows:

	Three Months Ended March 31,	
	2007	2006
Research and development expense	\$ 8,572,000	\$ 5,684,000
Dollar change from prior year	2,888,000	
Percentage change from prior year	51	%

The increase in research and development expense in the quarter ended March 31, 2007 from the quarter ended March 31, 2006 was primarily due to expense related to our ongoing Phase 3 clinical trials for Gabapentin GR for the treatment of postherpetic neuralgia. We expect to complete our Phase 3 clinical trial for Gabapentin GR for the treatment of postherpetic neuralgia in 2007. Stock-based compensation included in research and development expense was \$201,000 and \$238,000 for three months ended March 31, 2007 and 2006, respectively.

### Selling, General and Administrative Expense

Selling, general and administrative expenses primarily consist of personnel expenses to support our operating activities, marketing and promotion expenses associated with GLUMETZA, facility costs and professional expenses, such as legal and accounting fees. Total selling, general and administrative expenses, as compared to the prior year, were as follows:

	Three Months Ended March 31,	
	2007	2006
Selling, general, and administrative expense	\$ 6,227,000	\$ 3,931,000
Dollar change from prior year	2,296,000	
Percentage change from prior year	58	%

The increase in selling, general and administrative expense for the quarter ended March 31, 2007 from the quarter ended March 31, 2006 was primarily due to approximately \$0.8 million in expense related to marketing costs associated with GLUMETZA, which was launched in September 2006, \$0.2 million in promotion fees due to King under the promotion agreement related to GLUMETZA and an increase of \$0.8 million in legal fees due to our patent infringement case against IVAX Corporation. Stock-based compensation included in selling, general and administrative expense was \$288,000 and \$310,000 for three months ended March 31, 2007 and 2006, respectively.

### Interest and Other Income

	Three Months Ended March 31,	
	2007	2006
Interest and other income	\$ 410,000	\$ 595,000
Dollar change from prior year	(185,000)	
Percentage change from prior year	(31)	)%

Interest and other income decreased during quarter ended March 31, 2007 as compared to the quarter ended March 31, 2006 as a result of lower investment balances in 2007.

### Series A Preferred Stock and Deemed Dividends



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In January 2000, we issued 12,015 shares of Series A Preferred Stock at a price of \$1,000 per share. The Series A Preferred Stock accrued a dividend of 7% per annum, compounded semi-annually and payable in shares of Series A Preferred Stock. The Series A Preferred Stock was convertible at anytime between January 2002 and January 2006 into our common stock. The original conversion price of the Series A Preferred Stock was \$12.00. However, as a result of our March 2002 and October 2003 financings, the conversion price was adjusted to \$9.51 per share. In December 2004, we entered into an agreement with the Series A Preferred shareholder to resolve a misunderstanding between us and the shareholder relating primarily to prior adjustments to the conversion price of the Series A Preferred Stock (the December 2004 Agreement). Pursuant to the December 2004 Agreement, among other matters, we agreed to adjust the conversion price to \$7.50 per share. We and the shareholder also agreed to binding interpretations of certain other terms related to the Series A conversion price.

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Prior to December 2004, the amounts calculated as Series A Preferred stock dividends were accounted for as an adjustment to the conversion price following EITF Issue No. 98-5, *Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios* (Issue No. 98-5). As a result of the December 2004 Agreement, we determined that a significant modification of the preferred stock agreement had occurred, and, therefore, a new commitment date was established for the Series A Preferred Stock. Further, we determined that the fair value of the modified preferred stock was below the carrying value of such securities as of the date of the modification, therefore, no deemed dividend resulted from this modification. Also, we determined that although a new commitment date had been established, this change did not result in a beneficial conversion feature subject to recognition pursuant to Emerging Issues Task Force Issue No. 00-27, *Application of Issue No. 98-5 to Certain Convertible Instruments*. However, an anti-dilution provision of the Series A Preferred Stock was triggered by our January 2005 financing, which adjusted the conversion price of the Series A Preferred Stock to \$7.12. As a result of the adjusted conversion price and an increase in the amount of common stock issuable upon conversion of the Series A Preferred Stock due to additional accumulated dividends, the Series A Preferred Stock now contains a beneficial conversion feature subject to recognition pursuant to Issue No. 98-5.

In conjunction with the modification of the agreement, we issued a warrant to the Series A Preferred shareholder. The value of the warrant was considered in determining the value of the modified security. The warrant is convertible into shares of our common stock during the period between January 2006 and January 2009. The conversion price of the warrant initially was \$7.12, which was equal to the Series A Preferred Stock conversion price in effect as of January 20, 2006. The conversion price of the warrant decreases by approximately 4.8% per year during the conversion period, such that the number of shares of our common stock issuable upon conversion of the warrant will increase by approximately 5.1% per year. The conversion of the warrant may be satisfied only by surrender of the outstanding shares of Series A Preferred Stock.

The Series A Preferred Stock accrued dividends through January 20, 2006, the date the warrant initially became exercisable. As a result of the issuance of the warrant, the preferred stock may be surrendered in exchange for common stock for an additional three years through January 20, 2009. As long as the Series A Preferred Stock remains outstanding, the number of shares into which the warrant can be converted increases as the conversion price of the warrant decreases resulting in additional deemed dividends on the Series A Preferred Stock. For the quarters ended March 31, 2007 and 2006, we recognized Series A Preferred Stock deemed dividends of approximately \$167,000 and \$173,000, respectively, attributable to the beneficial conversion feature from the accrued dividends and decreasing warrant price. We will continue to recognize Series A Preferred Stock deemed dividends until the earlier of the time the Series A Preferred Stock is surrendered or January 2009.

As of March 31, 2007, there were 18,158 shares of Series A Preferred Stock outstanding with an aggregate liquidation preference of approximately \$18,159,000. The warrant was convertible into 2,705,430 shares of our common stock at a conversion price of \$6.71 as of March 31, 2007.

## LIQUIDITY AND CAPITAL RESOURCES

	March 31, 2007	December 31, 2006
Cash, cash equivalents and marketable securities	\$ 25,770,000	\$ 33,557,000

Since inception through March 31, 2007, we have financed our product development efforts and operations primarily from private and public sales of equity securities and receipts of upfront license fees from collaborative and license partners. In July 2005, we received \$25.0 million under our license agreement with Biovail and \$30.0 million under our license agreement with Esprit. In December 2006, we received an additional \$10.0 million from Esprit. Esprit is obligated to pay us an additional \$10.0 million in July 2007.

In December 2006, we entered into a common stock purchase agreement with Azimuth Opportunity, Ltd., pursuant to which Azimuth is committed to purchase, from time to time and at our sole discretion, up to the lesser of (a) \$30,000,000 of our common stock, or (b) 8,399,654 shares of common stock. Sales to Azimuth under the agreement, if any, will occur over a 24-month term and will be made at a price equal to the average closing price of our common stock over a given pricing period, minus a discount ranging from 3.775% to 6.375%, which varies based on a threshold price set by us. Upon each sale of the our common stock to Azimuth under the agreement, we have also agreed to pay Reedland Capital Partners a placement fee equal to 1.125% of the aggregate dollar amount of common stock purchased by Azimuth. Azimuth is not required to purchase our common stock when the price of our common stock is below \$2 per share. As of March 31, 2007, we have not sold any common stock to Azimuth under this common stock purchase agreement.

In April 2007, we completed a registered direct offering of 5,300,000 shares of common stock with selected institutional investors. The shares were sold at a price of \$3.775 per share, with net proceeds totaling approximately \$20,000,000.

As of March 31, 2007, we have accumulated net losses of \$195.0 million. We expect to continue to incur operating losses for at least the next year. We anticipate that our existing capital resources and contractual amounts due to us will permit us to meet our capital and operational requirements through at least the first quarter of 2008. We base this expectation on our current operating plan, which may change as a result of many factors.

Our cash needs may also vary materially from our current expectations because of numerous factors, including:

- expenditures related to our commercialization efforts;
- results of research and development efforts;
- financial terms of definitive license agreements or other commercial agreements we enter into, if any;
- receipt of payments due to us under our contracts with collaborative partners;
- results of ongoing discussions with Esprit related to the commercialization of ProQuin XR, and our ProQuin XR license agreement;
- results of our litigation against IVAX Corporation;
- changes in the focus and direction of our research and development programs;
- technological advances;
- results of clinical testing, requirements of the FDA and comparable foreign regulatory agencies; and
- acquisitions or investment in complimentary businesses, products or technologies.

We will need substantial funds of our own or from third parties to:

- conduct research and development programs;
- conduct preclinical and clinical testing; and
- manufacture (or have manufactured) and market (or have marketed) potential products using the AcuForm technology.

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Our existing capital resources may not be sufficient to fund our operations until such time as we may be able to generate sufficient revenues to support our operations. We have limited credit facilities and except for the common stock purchase agreement with Azimuth, we have no other committed sources of capital. To the extent that our capital resources are insufficient to meet our future capital requirements, we will have to raise additional funds through the sale of our equity securities or from development and licensing arrangements to continue our development programs. We may be unable to raise such additional capital on favorable terms, or at all. If we raise additional capital by selling our equity or convertible debt securities, the issuance of such securities could result in dilution of our shareholders' equity positions. If adequate funds are not available we may have to:

- delay, postpone or terminate clinical trials;
- curtail other operations significantly; and/or
- obtain funds through entering into collaboration agreements on unattractive terms.

The inability to raise additional capital would have a material adverse effect on our company.

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**Cash Flows from Operating Activities**

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Cash used in operating activities for the three months ended March 31, 2007 was approximately \$8.0 million, compared to cash used in operating activities of approximately \$5.8 million for the three months ended March 31, 2006. During the three months ended March 31, 2007 and 2006, cash used in operating activities was primarily due to our net loss for the quarter adjusted for stock-based compensation, depreciation expense and movements in working capital. The increase in cash used in operating activities for the three months ended March 31, 2007 as compared to the prior year was primarily due to an increase in net loss.

### Cash Flows from Investing Activities

Cash used in investing activities in the three months ended March 31, 2007 was approximately \$1.6 million and consisted of a net increase in marketable securities. Net cash provided by investing activities in the three months ended March 31, 2006 totaled approximately \$4.8 million and consisted of a \$5.0 million net decrease in marketable securities offset by \$0.2 million in purchases of laboratory and office equipment.

### Cash Flows from Financing Activities

Cash provided by financing activities in the three months ended March 31, 2007 was approximately \$0.2 million compared to cash provided by financing activities of approximately \$1.7 million for the same period in 2006. In the three months ended March 31, 2007, the amount consisted of cash proceeds from exercises of stock options. In the three months ended March 31, 2006, the amount consisted primarily of cash proceeds from the exercises of warrants and stock options.

### Contractual Obligations

As of March 31, 2007, our aggregate contractual obligations are as shown in the following table.

	Less than 1 year	1-3 years	3-5 years	Total
Operating leases	\$ 1,239,000	\$ 1,883,000	\$ 15,000	\$ 3,137,000
Purchase commitments	531,000			531,000
	\$ 1,770,000	\$ 1,883,000	\$ 15,000	\$ 3,668,000

At March 31, 2007, we had non-cancelable purchase orders and minimum purchase obligations of \$411,000 under our manufacturing agreement with MOVA Pharmaceuticals for the manufacture of GLUMETZA. The amounts disclosed only represent minimum purchase requirements. Actual purchases are expected to exceed these amounts. We are also contractually obligated to pay PharmaNova consultancy fees of \$120,000 under a consulting agreement related to our Gabapentin GR product candidate for the treatment of menopausal hot flashes.

The contractual obligations reflected in this table exclude \$3.5 million of contingent milestone payments we may be obligated to pay in the future under our sublicense agreement with PharmaNova. These payments relate to various milestones for the product candidate under the sublicense agreement, including dosing of the first patient in any Phase 3 trial, submission to the FDA of an NDA, and FDA approval of an NDA. The table above also excludes any future royalty payments we may be required to pay on products we have licensed or any promotion fees associated with our promotion agreement with King.

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There have been no significant changes in our market risk compared to the disclosures in Item 7A of our Annual Report on Form 10-K for the year ended December 31, 2006.

**ITEM 4. CONTROLS AND PROCEDURES**

*Evaluation of Disclosure Controls and Procedures*

An evaluation was performed under the supervision and with the participation of our management, including the President and Chief Executive Officer along with the Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this quarterly report. Based on that evaluation, our management, including the President and Chief Executive Officer along with the Chief Financial Officer, concluded that our disclosure controls and procedures were effective.

We review and evaluate the design and effectiveness of our disclosure controls and procedures on an ongoing basis and to improve our controls and procedures over time and to correct any deficiencies that we may discover in the future. Our goal is to ensure that our senior management has timely access to all material financial and non-financial information concerning our business. While we believe the present design of our disclosure controls and procedures is effective to achieve our goal, future events affecting our business may cause us to significantly modify our disclosure controls and procedures.

*Changes in Internal Controls*

There were no changes in our internal controls over financial reporting during the quarter ended March 31, 2007 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.



## **PART II OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS**

We are involved in legal proceedings relating to some of our intellectual property rights. In January 2006, Depomed filed a complaint against IVAX Corporation in the U.S. District Court for the Northern District of California for infringement of U.S. Patent Nos. 6,340,475 and 6,635,280, both of which are owned by Depomed. The patents relate to our AcuForm delivery technology. The complaint alleges infringement of our patents by IVAX's extended release metformin hydrochloride tablet. In April 2006, IVAX filed an answer and counterclaim, in which it alleged that the patents in the suit are not infringed by IVAX and are invalid and unenforceable. In December 2006, the court issued an order construing certain of the claim terms appearing in the patents. Discovery in the case is ongoing, and the court has not yet set a deadline for the close of discovery.

### **ITEM 1A. RISK FACTORS**

In addition to other information in this report, the following factors should be considered carefully in evaluating an investment in our securities. We believe the following risks and uncertainties, along with the risks and uncertainties described above under **MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS LIQUIDITY AND CAPITAL RESOURCES** are the material risks and uncertainties we face at the present time. If any of the following risks or uncertainties actually occurs, our business, financial condition or results of operations could be materially adversely affected. There were no material changes to the risk factors set forth in the Risk Factors section of our Annual Report on Form 10-K for the fiscal year ended December 31, 2006.

#### **We depend heavily on King Pharmaceuticals for the successful commercialization of GLUMETZA in the United States.**

In June 2006, we entered into a promotion agreement with King Pharmaceuticals pursuant to which King promotes GLUMETZA in the United States through its sales force. Under the agreement, in exchange for promotion fees, King is required to promote GLUMETZA to physicians in the United States, to deliver a minimum number of annual detail calls to potential GLUMETZA prescribers, and to maintain a sales force of a minimum size. Although we have retained rights to promote GLUMETZA to certain physicians and to retain revenues from incremental sales generated by physicians we call upon, we have not yet established a sales force, or contracted with a third party to act as our sales force, and we do not have immediate plans to do so. Accordingly, the success of the initial commercialization of GLUMETZA will depend in large part on the efforts of King's sales force in the promotion of the product. Factors that may affect the success of our promotion arrangement with King include the following:

- King may acquire or develop alternative products;
- King may pursue higher-priority programs, or change the focus of its marketing programs;
- King may in the future choose to devote fewer resources to GLUMETZA;
- GLUMETZA may fail to achieve market acceptance; and
- King may fail to comply with its obligations under our promotion agreement.

Any of the preceding factors could affect King's commitment to the collaboration, which, in turn, could adversely affect the commercial success of GLUMETZA. Any failure to successfully commercialize GLUMETZA could have a material adverse effect on our business, financial conditions, results of operations and cash flows.

**We are responsible for the distribution of GLUMETZA, and we have limited experience with distribution of pharmaceutical products.**

We are responsible for the distribution of GLUMETZA, which is the first product that we have distributed ourselves. Although we have enhanced our in-house commercial operations and distribution capabilities in connection with the commercial launch of GLUMETZA, our internal resources remain limited. In addition, we have entered into distribution arrangements with third parties related to GLUMETZA, including Cardinal Health, AmeriSource Bergen and McKesson, and we will depend on them to ensure that GLUMETZA is widely available to support its commercial availability. To continue to support our commercialization effort related to GLUMETZA and any other product we choose to market and distribute, we must continue to enhance our internal commercial infrastructure, and continue to contract with capable third parties to assist us in our commercialization efforts. The development of that infrastructure will also require substantial resources, which may divert the attention of our management and key personnel. The efforts of third parties with whom we contract for distribution of our products may not be successful. Any failure on our part to successfully develop distribution capabilities could cause delays in product sales and incur increased costs.

**We have limited in-house sales and marketing resources, which we will require in order to successfully co-promote GLUMETZA and ProQuin XR through our own sales force.**

Although we have the right to co-promote GLUMETZA and ProQuin XR through our own sales force, or through third parties, we have no sales force and limited marketing and sales staff. The success of our own promotion efforts for GLUMETZA, ProQuin XR and any other product candidates that receive regulatory approval that we choose to market or co-market will require that we substantially enhance our in-house marketing and sales force with technical expertise, or make arrangements with third parties to perform these services for us. The development of the infrastructure associated with these activities involves substantial resources, and considerable attention of our management and key personnel. To the extent that we enter into marketing and sales arrangements with other companies, our revenues will depend on the efforts of others. These efforts may not be successful. If we fail to fully develop marketing and sales capabilities, or enter into arrangements with third parties, our revenues may suffer.

**We depend on Esprit Pharma for the successful commercialization of ProQuin XR in the United States.**

Esprit has exclusive marketing rights to ProQuin XR in the United States. Esprit launched ProQuin XR in November 2005. In July 2006, we agreed to extend to December 2006 the due date on the \$10 million license fee payment to Depomed that had been due in July 2006. In December 2006, we did not receive the license fee payment on its due date, and we initiated arbitration proceedings related to alleged breaches by Esprit of our license agreement with Esprit. Later in December 2006, Esprit paid us the \$10 million license fee payment and we withdrew without prejudice the notice and demand for arbitration. We also agreed to commence discussions with Esprit toward a mutually agreeable, long-term restructuring of the license agreement. Those discussions began in January 2007 and are continuing. The results of those discussions are uncertain, and we may not be able to negotiate mutually agreeable modifications to the license agreement.

Esprit is a private company with a limited operating history and has not yet established a proven track record of successfully commercializing its products. In addition, Esprit has limited financial resources relative to many other pharmaceutical companies. Any financial difficulties experienced by Esprit, or complications in the promotion of ProQuin XR or Esprit's other products, or execution of its business plan, may adversely affect the ProQuin XR commercialization effort and Esprit's ability to comply with its obligations to us under our license agreement.

If Esprit fails to successfully commercialize ProQuin XR, or to comply with its obligations under our license agreement, including its future license fee and minimum royalty obligations, our business, financial condition and results of operations may be materially and adversely affected.

**We depend on our marketing partners for the successful commercialization of GLUMETZA in Canada and Korea, and of ProQuin XR in Europe.**

We have licensed exclusive marketing rights to the 500mg GLUMETZA in Canada to Biovail, and to LG Life Sciences in Korea. Biovail launched the 500mg GLUMETZA in Canada in November 2005, and LG launched the 500mg GLUMETZA in Korea in 2006 under the trade name Novamet GR. We have also entered into a supply and distribution agreement with Madaus related to the commercialization of ProQuin XR in Europe. If Biovail or LG fail to successfully commercialize GLUMETZA in Canada or Korea, respectively, or if Madaus fails to successfully commercialize ProQuin XR in Europe, our business and future revenues may be adversely affected.

**Our product candidates are at early stages of development and may not be successful or achieve market acceptance.**

We have completed enrollment of a Phase 3 clinical trial of Gabapentin GR for the treatment of postherpetic neuralgia, and we have completed a Phase 2 trial of Gabapentin GR for diabetic neuropathy. We initiated a clinical development program for Gabapentin GR for the treatment of hot flashes associated with menopause and a clinical development program of our gastroesophageal reflux disease product candidate. In April 2007, we submitted a prior approval supplement to the GLUMETZA NDA seeking approval to market in the United States the 1000mg formulation of GLUMETZA, for which we have an exclusive license in the United States. We have other product candidates in earlier stages of development. Our own product candidates and those of our collaborative partners are subject to the risk that any or all of them are found to be ineffective or unsafe, or otherwise may fail to receive necessary regulatory clearances. We are unable to predict whether any of these other product candidates will receive regulatory clearances or be successfully manufactured or marketed. Further, due to the extended testing and regulatory review process required before marketing clearance can be obtained, the time frames for commercialization of any products are long and uncertain. Even if these other product candidates receive regulatory clearance, they may not achieve or maintain market acceptance. Also, substantially all of our product candidates, other than the 1000mg formulation of GLUMETZA, use our AcuForm technology. If it is discovered that the AcuForm technology could have adverse effects or other characteristics that indicate it is unlikely to be effective as a delivery system for drugs or therapeutics, our product development efforts and our business would be significantly harmed.

**We are expecting operating losses in the future.**

To date, we have recorded limited revenues from license fees, product sales, royalties, collaborative research and development arrangements and feasibility studies. For the three months ended March 31, 2007, we recorded total revenues of \$3.8 million, and for the years ended December 31, 2006, 2005 and 2004, we recorded total revenues of \$9.6 million, \$4.4 million and \$200,000, respectively. For the three months ended March 31, 2007, we incurred a net loss of \$10.9 million, and for the years ended December 31, 2006, 2005 and 2004 we incurred net losses of \$39.7 million, \$24.5 million and \$26.9 million, respectively. As we incur expenses related to the commercialization of GLUMETZA, continue our research and development efforts, preclinical testing and clinical trial activities, and expand our sales and marketing organization, we anticipate that we will continue to incur substantial operating losses for at least the next year. Therefore, we expect our cumulative losses to increase. These losses, among other things, have had, and we expect that they will continue to have, an adverse impact on our total assets, shareholders' equity and working capital.

**Our operating results may fluctuate and affect our stock price.**

The following factors will affect our operating results and may result in a material adverse effect on our stock price:

- the degree of commercial success of ProQuin XR and GLUMETZA;
- our collaborative partners' compliance or non-compliance with their obligations under our agreements with them;
- results of clinical trials for our product candidates;
- regulatory actions;
- results of litigation, including our pending litigation against IVAX Corporation;

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- developments concerning proprietary rights, including patents, infringement allegations and litigation matters;
- variations in revenues obtained from collaborative agreements, including milestone payments, royalties, license fees and other contract revenues;
- decisions by collaborative partners to proceed or not to proceed with subsequent phases of a collaboration or program;

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- market acceptance of the AcuForm technology;
- adoption of new technologies by us or our competitors;
- the introduction of new products by our competitors;
- manufacturing costs and difficulties;
- changes in government funding;
- third-party reimbursement policies; and
- the status of our compliance with the provisions of the Sarbanes-Oxley Act of 2002.

**Our collaborative arrangements may give rise to disputes over commercial terms, contract interpretation and ownership of our intellectual property and may adversely affect the commercial success of our products.**

We currently have a collaboration agreement for development of product candidates through the feasibility phase with New River Pharmaceuticals, and we have a collaboration arrangement with Patheon, Inc. related to the potential development of product candidates for third parties. We also have a collaboration agreement with Supernus, Inc. providing for the development of a product candidate through feasibility, with the possibility to enter into a definitive agreement providing for the further development of the product candidate by either or both parties. In addition, we have in the past and may in the future enter into other collaborative arrangements, some of which have been based on less definitive agreements, such as memoranda of understanding, material transfer agreements, options or feasibility agreements. We may not execute definitive agreements formalizing these arrangements. Collaborative relationships are generally complex and may give rise to disputes regarding the relative rights, obligations and revenues of the parties, including the ownership of intellectual property and associated rights and obligations, especially when the applicable collaborative provisions have not been fully negotiated and documented. Such disputes can delay collaborative research, development or commercialization of potential products, and can lead to lengthy, expensive litigation or arbitration. The terms of collaborative arrangements may also limit or preclude us from developing products or technologies developed pursuant to such collaborations. Additionally, the collaborators under these arrangements might breach the terms of their respective agreements or fail to prevent infringement of the licensed patents by third parties. Moreover, negotiating collaborative arrangements often takes considerably longer to conclude than the parties initially anticipate, which could cause us to agree to less favorable agreement terms that delay or defer recovery of our development costs and reduce the funding available to support key programs.

We may be unable to enter into future collaborative arrangements on acceptable terms, which would harm our ability to develop and commercialize our current and potential future products. Further, even if we do enter into collaboration arrangements, it is possible that our collaborative partners may not choose to develop and commercialize products using the AcuForm technology. Other factors relating to collaborations that may adversely affect the commercial success of our products include:

- any parallel development by a collaborative partner of competitive technologies or products;
- arrangements with collaborative partners that limit or preclude us from developing products or technologies;
- premature termination of a collaboration agreement; or
- failure by a collaborative partner to devote sufficient resources to the development and commercial sales of products using the AcuForm technology.

Generally, our collaborative arrangements do not restrict our collaborative partners from competing with us or restrict their ability to market or sell competitive products. Our current and any future collaborative partners may pursue existing or other development-stage products or alternative technologies in preference to those being developed in collaboration with us. Our collaborative partners may also terminate their collaborative relationships with us or otherwise decide not to proceed with development and commercialization of our products.



**We may be unable to protect our intellectual property and may be liable for infringing the intellectual property of others.**

Our success will depend in part on our ability to obtain and maintain patent protection for our technologies and to preserve our trade secrets. Our policy is to seek to protect our proprietary rights, by among other methods, filing patent applications in the United States and foreign jurisdictions to cover certain aspects of our technology. We currently hold nine issued patents, and have fourteen patent applications pending in the United States. In addition, we are preparing patent applications relating to our expanding technology for filing in the United States and abroad. We have also applied for patents in numerous foreign countries. Some of those countries have granted our applications and other applications are still pending. Our pending patent applications may lack priority over others' applications or may not result in the issuance of patents. Even if issued, our patents may not be sufficiently broad to provide protection against competitors with similar technologies and may be challenged, invalidated or circumvented, which could limit our ability to stop competitors from marketing related products or may not provide us with competitive advantages against competing products. We also rely on trade secrets and proprietary know-how, which are difficult to protect. We seek to protect such information, in part, through entering into confidentiality agreements with employees, consultants, collaborative partners and others before such persons or entities have access to our proprietary trade secrets and know-how. These confidentiality agreements may not be effective in certain cases, due to, among other things, the lack of an adequate remedy for breach of an agreement or a finding that an agreement is unenforceable. In addition, our trade secrets may otherwise become known or be independently developed by competitors.

Our ability to develop our technologies and to make commercial sales of products using our technologies also depends on not infringing others' patents or other intellectual property rights. We are not aware of any intellectual property claims against us. However, the pharmaceutical industry has experienced extensive litigation regarding patents and other intellectual property rights. For example, we are aware that patents issued to third parties relating to sustained release drug formulations or particular pharmaceutical compounds could in the future be asserted against us, although we believe that we do not infringe any valid claim of any patents. If claims concerning any of our products were to arise and it was determined that these products infringe a third party's proprietary rights, we could be subject to substantial damages for past infringement or be forced to stop or delay our activities with respect to any infringing product, unless we can obtain a license, or we may have to redesign our product so that it does not infringe upon others' patent rights, which may not be possible or could require substantial funds or time. Such a license may not be available on acceptable terms, or at all. Even if we, our collaborators or our licensors were able to obtain a license, the rights may be nonexclusive, which would give our competitors access to the same intellectual property. In addition, any public announcements related to litigation or interference proceedings initiated or threatened against us, even if such claims are without merit, could cause our stock price to decline.

From time to time, we may become aware of activities by third parties that may infringe our patents. Infringement by others of our patents may reduce our market shares (if a related product is approved) and, consequently, our potential future revenues and adversely affect our patent rights if we do not take appropriate enforcement action. We may need to engage in litigation in the future to enforce any patents issued or licensed to us or to determine the scope and validity of third-party proprietary rights. Our issued or licensed patents may not be held valid by a court of competent jurisdiction. Whether or not the outcome of litigation is favorable to us, defending a lawsuit takes significant time, may be expensive and may divert management attention from other business concerns. We may also be required to participate in interference proceedings declared by the United States Patent and Trademark Office for the purpose of determining the priority of inventions in connection with our patent applications or other parties' patent applications. Adverse determinations in litigation or interference proceedings could require us to seek licenses which may not be available on commercially reasonable terms, or at all, or subject us to significant liabilities to third parties. If we need but cannot obtain a license, we may be prevented from marketing the affected product.

In January 2006, we filed a complaint against IVAX Corporation in federal court for infringement of two of our U.S. patents related to the AcuForm delivery technology. The complaint alleged infringement of our patents by IVAX's extended release metformin hydrochloride tablet. Although we intend to vigorously enforce our intellectual property rights, litigation is expensive and unpredictable and there can be no assurance that we will be successful in our litigation against IVAX. If one or more of our patents is declared invalid or key claims are disallowed, the patent protection for our products and product candidates could be substantially weakened and our business and business prospects could be severely impacted.

**Our licensed patent covering the use of gabapentin to treat hot flashes associated with menopause is a method-of-use patent, which increases the risk that prescriptions for gabapentin to treat hot flashes in menopausal women could be written for, or filled with, generic gabapentin.**

We have an exclusive sublicense from PharmaNova, Inc. to a patent held by the University of Rochester to develop and commercialize in the United States a gabapentin product for the treatment of hot flashes associated with menopause in women. Because a method-of-use patent, such as the patent we have sublicensed from PharmaNova, covers only a specified use of a particular compound, not a particular composition of matter, we cannot prevent others from commercializing gabapentin. Accordingly, physicians could prescribe another manufacturer's gabapentin to treat hot flashes in menopausal women rather than Gabapentin GR, or pharmacists could seek to fill prescriptions for Gabapentin GR with another manufacturer's gabapentin. Although any such off-label use would violate our licensed patent, effectively monitoring compliance with our licensed patent may be difficult and costly.

**It is difficult to develop a successful product. If we do not develop a successful product we may not be able to raise additional funds.**

The drug development process is costly, time-consuming and subject to unpredictable delays and failures. Before we or others make commercial sales of products using the AcuForm technology, other than GLUMETZA and ProQuin XR, we, our current and any future collaborative partners will need to:

- conduct preclinical and clinical tests showing that these products are safe and effective; and
- obtain regulatory approval from the FDA or foreign regulatory authorities.

We will have to curtail, redirect or eliminate our product development programs if we or our collaborative partners find that:

- the AcuForm technology has unintended or undesirable side effects; or
- product candidates that appear promising in preclinical or early-stage clinical studies do not demonstrate efficacy in later-stage, larger scale clinical trials.

Even when or if our products obtain regulatory approval, successful commercialization requires:

- market acceptance;
- cost-effective commercial scale production; and
- reimbursement under private or governmental health plans.

Any material delay or failure in the governmental approval process and/or the successful commercialization of our potential products would adversely impact our financial position and liquidity and would make it difficult for us to raise financing on favorable terms, if at all.



**If we do not achieve our projected development and commercialization goals in the timeframes we announce and expect, the commercialization of our product candidates may be delayed and our business will be harmed and our stock price may decline.**

For planning purposes, we estimate the timing of the accomplishment of various scientific, clinical, regulatory and other product development and commercialization goals. These milestones may include our expectations regarding the commercial launch of our products by us or our licensees, and the commencement or completion of scientific studies and clinical trials and the submission of regulatory filings. From time to time, we may publicly announce the expected timing of some of these milestones, such as the completion of our ongoing Phase 3 clinical trial of Gabapentin GR, or the initiation of other clinical programs. All of these milestones are based on a variety of assumptions. The actual timing of these milestones can vary considerably from our estimates depending on numerous factors, some of which are beyond our control, including:

- our available capital resources;
- the efforts of our marketing partners with respect to the commercialization of our products;
- the rate of progress, costs and results of our clinical trial and research and development activities, including the extent of scheduling conflicts with participating clinicians and clinical institutions and our ability to identify and enroll patients who meet clinical trial eligibility criteria;
- our receipt of approvals by the FDA and other regulatory agencies and the timing thereof;
- other actions by regulators;
- our ability to access sufficient, reliable and affordable supplies of components used in the manufacture of our product candidates, including insulin and materials for our AcuForm technology; and
- the costs of ramping up and maintaining manufacturing operations, as necessary.

If we fail to achieve our announced milestones in the timeframes we announce and expect, our business and results of operations may be harmed and the price of our stock may decline.

**We depend on clinical investigators and clinical sites to enroll patients in our clinical trials and other third parties to manage the trials and to perform related data collection and analysis, and, as a result, we may face costs and delays outside of our control.**

We rely on clinical investigators and clinical sites to enroll patients and other third parties to manage our trials and to perform related data collection and analysis. However, we may be unable to control the amount and timing of resources that the clinical sites that conduct the clinical testing may devote to our clinical trials. If our clinical investigators and clinical sites fail to enroll a sufficient number of patients in our clinical trials or fail to enroll them on our planned schedule, we will be unable to complete these trials or to complete them as planned, which could delay or prevent us from obtaining regulatory approvals for our product candidates.

Our agreements with clinical investigators and clinical sites for clinical testing and for trial management services place substantial responsibilities on these parties, which could result in delays in, or termination of, our clinical trials if these parties fail to perform as expected. For example, if any of our clinical trial sites fail to comply with FDA-approved good clinical practices, we may be unable to use the data gathered at those sites. If these clinical investigators, clinical sites or other third parties do not carry out their contractual duties or obligations or fail to meet expected deadlines, or if the quality or accuracy of the clinical data they obtain is compromised due to their failure to adhere to our clinical protocols or for other reasons, our clinical trials may be extended, delayed or terminated, and we may be unable to obtain regulatory approval for, or successfully commercialize, our product candidates.

**If we are unable to obtain or maintain regulatory approval, we will be limited in our ability to commercialize our products, and our business will be harmed.**

The regulatory process is expensive and time consuming. Even after investing significant time and expenditures on clinical trials, we may not obtain regulatory approval of our product candidates. Data obtained from clinical trials are susceptible to varying interpretations, which could delay, limit or prevent regulatory approval, and the FDA may not agree with our methods of clinical data analysis or our conclusions regarding safety and/or efficacy. Significant clinical trial delays would impair our ability to commercialize our products and could allow our competitors to bring products to market before we do. In addition, changes in regulatory policy for product approval during the period of product development and regulatory agency review of each submitted new application may cause delays or rejections. Even if we receive regulatory approval, this approval may entail limitations on the indicated uses for which we can market a product.

Further, with respect to our approved products, once regulatory approval is obtained, a marketed product and its manufacturer are subject to continual review. The discovery of previously unknown problems with a product or manufacturer may result in restrictions on the product, manufacturer or manufacturing facility, including withdrawal of the product from the market. Manufacturers of approved products are also subject to ongoing regulation, including compliance with FDA regulations governing current Good Manufacturing Practices (cGMP). Failure to comply with manufacturing regulations can result in, among other things, warning letters, fines, injunctions, civil penalties, recall or seizure of products, total or partial suspension of production, refusal of the government to renew marketing applications and criminal prosecution.

**Pharmaceutical marketing is subject to substantial regulation in the United States.**

All marketing activities associated with ProQuin XR and GLUMETZA, as well as marketing activities related to any other products for which we obtain regulatory approval, will be subject to numerous federal and state laws governing the marketing and promotion of pharmaceutical products. The FDA regulates post-approval promotional labeling and advertising to ensure that they conform to statutory and regulatory requirements. In addition to FDA restrictions, the marketing of prescription drugs is subject to laws and regulations prohibiting fraud and abuse under government healthcare programs. For example, the federal healthcare program antikickback statute prohibits giving things of value to induce the prescribing or purchase of products that are reimbursed by federal healthcare programs, such as Medicare and Medicaid. In addition, federal false claims laws prohibit any person from knowingly presenting, or causing to be presented, a false claim for payment to the federal government. Under this law, the federal government in recent years has brought claims against drug manufacturers alleging that certain marketing activities caused false claims for prescription drugs to be submitted to federal programs. Many states have similar statutes or regulations, which apply to items and services reimbursed under Medicaid and other state programs, or, in some states, regardless of the payer. If we, or our collaborative partners, fail to comply with applicable FDA regulations or other laws or regulations relating to the marketing of our products, we could be subject to criminal prosecution, civil penalties, seizure of products, injunction, and exclusion of our products from reimbursement under government programs, as well as other regulatory actions against our product candidates, our collaborative partners or us.

**The approval process outside the United States is uncertain and may limit our ability to develop, manufacture and sell our products internationally.**

To market any of our products outside of the United States, we and our collaborative partners, including Madaus, which has the exclusive rights to commercialize ProQuin XR in Europe, are subject to numerous and varying foreign regulatory requirements, implemented by foreign health authorities, governing the design and conduct of human clinical trials and marketing approval for drug products. The approval procedure varies among countries and can involve additional testing, and the time required to obtain approval may differ from that required to obtain FDA approval. The foreign regulatory approval process includes all of the risks associated with obtaining FDA approval set forth above, and approval by the FDA does not ensure approval by the health authorities of any other country, nor does the approval by foreign health authorities ensure approval by the FDA.

**If we or our marketing partners are unable to obtain acceptable prices or adequate reimbursement for our products from third-party payers, we will be unable to generate significant revenues.**

In both domestic and foreign markets, sales of our product candidates will depend in part on the availability of adequate reimbursement from third-party payers such as:

- government health administration authorities;
- private health insurers;
- health maintenance organizations;
- pharmacy benefit management companies; and
- other healthcare-related organizations.

If reimbursement is not available for our products or product candidates, demand for these products may be limited. Further, any delay in receiving approval for reimbursement from third-party payers would have an adverse effect on our future revenues. Third-party payers are increasingly challenging the price and cost-effectiveness of medical products and services. Significant uncertainty exists as to the reimbursement status of newly approved healthcare products, including pharmaceuticals. Our products may not be considered cost effective, and adequate third-party reimbursement may be unavailable to enable us to maintain price levels sufficient to realize an acceptable return on our investment.

Federal and state governments in the United States and foreign governments continue to propose and pass new legislation designed to contain or reduce the cost of healthcare. Existing regulations affecting pricing may also change before many of our product candidates are approved for marketing. Cost control initiatives could decrease the price that we receive for any product we may develop.

**We may be unable to compete successfully in the pharmaceutical product and drug delivery system industries.**

Other companies that have oral drug delivery technologies competitive with the AcuForm technology include Bristol-Myers Squibb, IVAX Corporation (a subsidiary of TEVA Pharmaceutical Industries, Ltd.), ALZA Corporation (a subsidiary of Johnson & Johnson), SkyePharma plc, Biovail Corporation, Flamel Technologies S.A., Ranbaxy Laboratories, Ltd., Kos Pharmaceuticals, Inc., Intec Pharma and Alpharma, Inc., all of which develop oral tablet products designed to release the incorporated drugs over time. Each of these companies has patented technologies with attributes different from ours, and in some cases with different sites of delivery to the gastrointestinal tract.

Bristol-Myers Squibb is currently marketing a sustained release formulation of metformin, Glucophage XR, with which GLUMETZA competes. The limited license that Bristol-Myers Squibb obtained from us under our November 2002 settlement agreement extends to certain current and internally-developed future compounds, which may increase the likelihood that we will face competition from Bristol-Myers Squibb in the future on products in addition to GLUMETZA. Several other companies, including Barr Pharmaceuticals, Inc., Mylan Laboratories, Inc. and Teva Pharmaceutical Industries, Ltd. have received FDA approval for and are selling a controlled-release metformin product. Flamel Technologies has a controlled-release microparticle-based formulation of metformin product in Phase 2 clinical trials.

Bayer Corporation developed a once-daily ciprofloxacin product for the treatment of urinary tract infections, which is currently marketed by Schering-Plough Corporation. There may be other companies developing products competitive with GLUMETZA and ProQuin XR of which we are unaware.

Gabapentin is currently marketed by Pfizer as Neurontin for adjunctive therapy for epileptic seizures and for postherpetic pain. Pfizer's basic U.S. patents relating to Neurontin have expired, and at least seven companies have received approval to market generic versions of the immediate release product. In addition, Pfizer has developed a new product, Lyrica (pregabalin), which has been approved for marketing in the U.S. and the European Union.

Competition in pharmaceutical products and drug delivery systems is intense. We expect competition to increase. Competing technologies or products developed in the future may prove superior to the AcuForm technology or products using the AcuForm technology, either generally or in particular market segments. These developments could make the AcuForm technology or products using the AcuForm technology

noncompetitive or obsolete.

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Most of our principal competitors have substantially greater financial, sales, marketing, personnel and research and development resources than we do. In addition, many of our potential collaborative partners have devoted, and continue to devote, significant resources to the development of their own drug delivery systems and technologies.

**We depend on third parties who are single source suppliers to manufacture ProQuin XR, GLUMETZA and our later stage product candidates. If these suppliers are unable to manufacture ProQuin XR, GLUMETZA or our product candidates, our business will be harmed.**

We are responsible for the supply and distribution of GLUMETZA. MOVA Pharmaceuticals, a subsidiary of Patheon, Inc., is our sole supplier for tablets of the 500mg strength of GLUMETZA pursuant to a supply agreement we entered into with MOVA Pharmaceuticals in December 2006. We purchase the active ingredient for the 500mg GLUMETZA from Farmhispania, S.A., a sole supplier to us, on a purchase order basis. If the new formulation of 1000mg GLUMETZA is approved, we will rely on Biovail as our sole supplier. We will be unable to supply GLUMETZA in a timely manner if we are unable to obtain GLUMETZA 500mg tablets from our contract manufacturer or active pharmaceutical ingredient from suppliers, or GLUMETZA 1000mg tablets from Biovail.

We are also responsible for supplying commercial quantities of ProQuin XR to Esprit. For the manufacture of ProQuin XR tablets, we have entered into an agreement with MOVA Pharmaceuticals, as our sole supplier. Uquifa Mexico, S.A., our supplier of the active pharmaceutical ingredient to ProQuin XR, is also a sole supplier to us. We obtain the active pharmaceutical ingredient to ProQuin XR on a purchase order basis only. We will also be responsible for the manufacture of bulk ProQuin XR tablets to Madaus for the European market, if the product is approved for marketing in European jurisdictions. We intend to purchase ProQuin XR tablets from MOVA Pharmaceuticals for that purpose. If we are unable, for whatever reason, to obtain the active pharmaceutical ingredient or ProQuin XR tablets from our contract manufacturers, we may be unable to manufacture ProQuin XR in a timely manner, if at all.

Although we have obtained clinical batches of Gabapentin GR from a contract manufacturer, we currently have no long-term supply arrangement with respect to Gabapentin GR. Any failure to obtain clinical supplies of Gabapentin GR could adversely affect our Gabapentin GR clinical development programs.

**We could become subject to product liability litigation and may not have adequate insurance to cover product liability claims.**

Our business involves exposure to potential product liability risks that are inherent in the production and manufacture of pharmaceutical products. We have obtained product liability insurance for clinical trials currently underway and forecasted 2007 sales of our products, but:

- we may be unable to obtain product liability insurance for future trials;
- we may be unable to obtain product liability insurance for future products;
- we may be unable to maintain product liability insurance on acceptable terms;
- we may be unable to secure increased coverage as the commercialization of the AcuForm technology proceeds; or
- our insurance may not provide adequate protection against potential liabilities.

Our inability to obtain adequate insurance coverage at an acceptable cost could prevent or inhibit the commercialization of our products. Defending a lawsuit would be costly and significantly divert management's attention from conducting our business. If third parties were to bring a successful product liability claim or series of claims against us for uninsured liabilities or in excess of insured liability limits, our business, financial condition and results of operations could be materially harmed.

**If we choose to acquire new and complementary businesses, products or technologies, we may be unable to complete these acquisitions or to successfully integrate them in a cost effective and non-disruptive manner.**

Our success depends on our ability to continually enhance and broaden our product offerings in response to changing customer demands, competitive pressures and technologies. Accordingly, we may in the future pursue the acquisition of complementary businesses, products or technologies instead of developing them ourselves. We have no current commitments with respect to any acquisition or such investment. We do not know if we would be able to successfully complete any acquisitions, or whether we would be able to successfully integrate any acquired business, product or technology or retain any key employees. Integrating any business, product or technology we acquire could be expensive and time consuming, disrupt our ongoing business and distract our management. If we were to be unable to integrate any acquired businesses, products or technologies effectively, our business would suffer. In addition, any amortization or charges resulting from the costs of acquisitions could harm our operating results.

**If we lose our key personnel or are unable to attract and retain key management and operating personnel, we may be unable to pursue our product development and commercialization efforts.**

Our success is dependent in large part upon the continued services of John W. Fara, Ph.D., our Chairman, President and Chief Executive Officer, Carl A. Pelzel, our Executive Vice President and Chief Operating Officer, and other members of our executive management team, and on our ability to attract and retain key management and operating personnel. We do not have agreements with Dr. Fara, Mr. Pelzel or any of our other executive officers that provide for their continued employment with us. Management, scientific and operating personnel are in high demand in our industry and are often subject to competing offers. The loss of the services of one or more members of management or key employees or the inability to hire additional personnel as needed could result in delays in the research, development and commercialization of our products and potential product candidates.

**We have implemented certain anti-takeover provisions.**

Certain provisions of our articles of incorporation and the California General Corporation Law could discourage a third party from acquiring, or make it more difficult for a third party to acquire, control of our company without approval of our board of directors. These provisions could also limit the price that certain investors might be willing to pay in the future for shares of our common stock. Certain provisions allow the board of directors to authorize the issuance of preferred stock with rights superior to those of the common stock. We are also subject to the provisions of Section 1203 of the California General Corporation Law which requires a fairness opinion to be provided to our shareholders in connection with their consideration of any proposed interested party reorganization transaction.

We have adopted a shareholder rights plan, commonly known as a poison pill. The provisions described above, our poison pill and provisions of the California General Corporation Law may discourage, delay or prevent a third party from acquiring us.

**Increased costs associated with corporate governance compliance may significantly impact our results of operations.**

Changing laws, regulations and standards relating to corporate governance, public disclosure and compliance practices, including the Sarbanes-Oxley Act of 2002, new SEC regulations and Nasdaq Global Market rules, are creating uncertainty for companies such as ours in understanding and complying with these laws, regulations and standards. As a result of this uncertainty and other factors, devoting the necessary resources to comply with evolving corporate governance and public disclosure standards has resulted in and may in the future result in increased general and administrative expenses and a diversion of management time and attention to compliance activities. We also expect these developments to increase our legal compliance and financial reporting costs. In addition, these developments may make it more difficult and more expensive for us to obtain director and officer liability insurance, and we may be required to accept reduced coverage or incur substantially higher costs to obtain coverage. Moreover, we may be unable to comply with these new rules and regulations on a timely basis.

These developments could make it more difficult for us to attract and retain qualified members of our board of directors, or qualified executive officers. We are presently evaluating and monitoring regulatory developments and cannot estimate the timing or magnitude of additional costs we may incur as a result. To the extent these costs are significant, our selling, general and administrative expenses are likely to increase.

**If we sell shares of our common stock under our equity line of credit arrangement or in other future financings, existing common shareholders will experience immediate dilution and, as a result, our stock price may go down.**

We may from time to time issue additional shares of common stock at a discount from the current trading price of our common stock. As a result, our existing common shareholders will experience immediate dilution upon the purchase of any shares of our common stock sold at such discount. For example, in December 2006, we entered into a common stock purchase agreement with Azimuth Opportunity Ltd., pursuant to which we may sell shares of common stock at a discount to the prevailing market price ranging from 3.775% to 6.375%, excluding an additional placement agent fee of 1.125% payable by us on the gross offering proceeds. In addition, as other capital raising opportunities present themselves, we may enter into financing or similar arrangements in the future, including the issuance of debt securities, preferred stock or common stock. If we issue common stock or securities convertible into common stock, our common shareholders will experience dilution and this dilution will be greater if we find it necessary to sell securities at a discount to prevailing market prices.

**If we are unable to satisfy regulatory requirements relating to internal controls, our stock price could suffer.**

Section 404 of the Sarbanes-Oxley Act of 2002 requires companies to conduct a comprehensive evaluation of their internal control over financial reporting. At the end of each fiscal year, we must perform an evaluation of our internal control over financial reporting, include in our annual report the results of the evaluation, and have our external auditors publicly attest to such evaluation. If material weaknesses were found in our internal controls in the future, if we fail to complete future evaluations on time, or if our external auditors cannot attest to our future evaluations, we could fail to meet our regulatory reporting requirements and be subject to regulatory scrutiny and a loss of public confidence in our internal controls, which could have an adverse effect on our stock price.

**Business interruptions could limit our ability to operate our business.**

Our operations are vulnerable to damage or interruption from computer viruses, human error, natural disasters, telecommunications failures, intentional acts of vandalism and similar events. In particular, our corporate headquarters are located in the San Francisco Bay area, which has a history of seismic activity. We have not established a formal disaster recovery plan, and our back-up operations and our business interruption insurance may not be adequate to compensate us for losses that occur. A significant business interruption could result in losses or damages incurred by us and require us to cease or curtail our operations.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

Not applicable.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

Not applicable.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

Not applicable.

**ITEM 5. OTHER INFORMATION**

Not applicable.

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**ITEM 6. EXHIBITS**

**(a) Exhibits**

- 31.1 Certification pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934 of John W. Fara, Ph.D.
- 31.2 Certification pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934 of John F. Hamilton
- 32.1 Certification pursuant to 18 U.S.C. Section 1350 of John W. Fara, Ph.D.
- 32.2 Certification pursuant to 18 U.S.C. Section 1350 of John F. Hamilton

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**SIGNATURES**

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Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: May 9, 2007

DEPOMED, INC.

By: /s/ John F. Hamilton  
John F. Hamilton  
Vice President and  
Chief Financial Officer  
(Authorized Officer and  
Principal Accounting  
and Financial Officer)

By: /s/ John W. Fara, Ph.D.  
John W. Fara, Ph.D.  
President, Chairman and  
Chief Executive Officer

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