

ARROWHEAD RESEARCH CORP

Form 10-Q

May 09, 2013

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2013

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission file number 000-21898

ARROWHEAD RESEARCH CORPORATION

(Exact name of registrant as specified in its charter)

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Delaware
(State of incorporation)

46-0408024
(I.R.S. Employer

Identification No.)

225 S. Lake Avenue, Suite 1050

Pasadena, California 91101

(626) 304-3400

(Address and telephone number of principal executive offices)

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

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

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

Large accelerated

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company)

Smaller reporting company

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

The number of shares of the registrant's common stock outstanding as of May 7, 2013 was 31,305,317.

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Table of Contents**PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****Arrowhead Research Corporation and Subsidiaries****(A Development Stage Company)****Consolidated Balance Sheets**

| | March 31, 2013 | September 30, 2012 |
|---|----------------------|----------------------|
| ASSETS | | |
| CURRENT ASSETS | | |
| Cash and cash equivalents | \$ 3,313,483 | \$ 3,377,288 |
| Trade receivable | | 9,375 |
| Other receivables | | 9,930 |
| Prepaid expenses and other current assets | 426,398 | 618,130 |
| Marketable securities | | 106,500 |
| Note receivable, net | | 2,446,113 |
| TOTAL CURRENT ASSETS | 3,739,881 | 6,567,336 |
| PROPERTY AND EQUIPMENT | | |
| Computers, office equipment and furniture | 323,376 | 323,376 |
| Research equipment | 3,186,601 | 3,319,027 |
| Software | 69,623 | 69,623 |
| Leasehold improvements | 2,749,409 | 2,749,409 |
| | 6,329,009 | 6,461,435 |
| Less: Accumulated depreciation and amortization | (2,315,915) | (1,565,783) |
| PROPERTY AND EQUIPMENT, NET | 4,013,094 | 4,895,652 |
| OTHER ASSETS | | |
| Patents and other intangible assets, net | 4,636,339 | 4,784,569 |
| Derivative asset and other non-current assets | 30,011 | 280,261 |
| TOTAL OTHER ASSETS | 4,666,350 | 5,064,830 |
| TOTAL ASSETS | \$ 12,419,325 | \$ 16,527,818 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| CURRENT LIABILITIES | | |
| Accounts payable | \$ 871,707 | \$ 877,986 |
| Accrued expenses | 823,517 | 730,775 |
| Accrued payroll and benefits | 1,222,573 | 1,127,219 |
| Deferred revenue | 65,625 | 37,500 |
| Derivative liabilities | 2,535,910 | 647,213 |
| Capital lease obligation | 218,048 | 214,801 |
| Notes payable | 880,239 | 100,000 |

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| | | |
|---|----------------------|----------------------|
| Other current liabilities | 546,407 | 1,592,394 |
| TOTAL CURRENT LIABILITIES | 7,164,026 | 5,327,888 |
| LONG-TERM LIABILITIES | | |
| Notes payable, net of current portion | 50,000 | 839,421 |
| Capital lease obligation, net of current portion | 1,172,616 | 1,282,458 |
| Other non-current liabilities | 272,179 | 269,142 |
| TOTAL LONG-TERM LIABILITIES | 1,494,795 | 2,391,021 |
| Commitments and contingencies | | |
| STOCKHOLDERS EQUITY | | |
| Arrowhead Research Corporation stockholders equity: | | |
| Preferred stock, \$0.001 par value; 5,000,000 shares authorized; no shares issued or outstanding | | |
| Common stock, \$0.001 par value; 145,000,000 shares authorized; 17,042,764 and 13,579,185 shares issued and outstanding as of March 31, 2013 and September 30, 2012, respectively | 109,402 | 108,354 |
| Additional paid-in capital | 151,573,260 | 145,917,968 |
| Subscription receivable | | (1,016,000) |
| Accumulated deficit during the development stage | (146,369,775) | (134,997,680) |
| Total Arrowhead Research Corporation stockholders equity | 5,312,887 | 10,012,642 |
| Noncontrolling interest | (1,552,383) | (1,203,733) |
| TOTAL STOCKHOLDERS EQUITY | 3,760,504 | 8,808,909 |
| TOTAL LIABILITIES AND STOCKHOLDERS EQUITY | \$ 12,419,325 | \$ 16,527,818 |

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

Table of Contents**Arrowhead Research Corporation and Subsidiaries****(A Development Stage Company)****Consolidated Statements of Operations****(unaudited)**

| | Three Months Ended March 31, 2013 | Three Months Ended March 31, 2012 | Six Months Ended March 31, 2013 | Six Months Ended March 31, 2012 | May 7, 2003 (Inception) to March 31, 2013 |
|--|--------------------------------------|--------------------------------------|------------------------------------|---------------------------------------|--|
| REVENUE | \$ 43,750 | \$ 31,250 | \$ 202,766 | \$ 55,208 | \$ 4,341,600 |
| OPERATING EXPENSES | | | | | |
| Salaries and payroll-related costs | 1,725,176 | 2,017,064 | 3,354,599 | 3,337,757 | 29,746,729 |
| General and administrative expenses | 779,970 | 930,914 | 1,697,646 | 2,197,824 | 33,050,861 |
| Research and development | 2,125,019 | 1,358,691 | 3,701,685 | 2,127,765 | 46,320,433 |
| Stock-based compensation | 355,108 | 169,390 | 750,782 | 421,268 | 14,332,250 |
| Depreciation and amortization | 448,765 | 423,948 | 898,362 | 878,391 | 8,307,648 |
| TOTAL OPERATING EXPENSES | 5,434,038 | 4,900,007 | 10,403,074 | 8,963,005 | 131,757,921 |
| OPERATING LOSS | (5,390,288) | (4,868,757) | (10,200,308) | (8,907,797) | (127,416,321) |
| OTHER INCOME (EXPENSE) | | | | | |
| Equity in income (loss) of unconsolidated affiliates | (157,612) | (64,261) | (221,169) | (170,788) | (1,184,576) |
| Impairment of investment in unconsolidated affiliates | | | | | (1,642,775) |
| Gain on purchase of Roche Madison | | | | 1,576,107 | 1,576,107 |
| Gain (loss) on sale of fixed assets, net | (54,932) | (33,484) | (36,440) | (33,484) | (1,242,905) |
| Realized and unrealized gain (loss) in marketable securities | | | | (58,091) | 62,954 |
| Interest income (expense), net | (27,567) | 5,015 | (20,151) | 12,890 | 2,730,293 |
| Change in value of derivatives | (29,403) | (622,145) | 14,873 | (689,048) | 3,296,277 |
| Gain on sale of stock in subsidiary | | | | | 2,292,800 |
| Other income (expense) | (1,279,881) | | (1,257,196) | | (1,007,196) |
| TOTAL OTHER INCOME (EXPENSE) | (1,549,395) | (714,875) | (1,520,083) | 637,586 | 4,880,979 |
| LOSS FROM CONTINUING OPERATIONS BEFORE INCOME TAXES | (6,939,683) | (5,583,632) | (11,720,391) | (8,270,211) | (122,535,342) |
| Provision for income taxes | | | | | |
| LOSS FROM CONTINUING OPERATIONS | (6,939,683) | (5,583,632) | (11,720,391) | (8,270,211) | (122,535,342) |
| Income (loss) from discontinued operations | (336) | (483) | (354) | (702) | (47,546,996) |
| Gain on disposal of discontinued operations | | | | | 4,708,588 |
| NET INCOME (LOSS) FROM DISCONTINUED OPERATIONS | (336) | (483) | (354) | (702) | (42,838,408) |
| NET LOSS | (6,940,019) | (5,584,115) | (11,720,745) | (8,270,913) | (165,373,750) |

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| | | | | | |
|---|-----------------------|-----------------------|------------------------|-----------------------|-------------------------|
| Net (income) loss attributable to noncontrolling interests | 182,082 | 248,882 | 348,650 | 450,176 | 19,167,935 |
| NET LOSS ATTRIBUTABLE TO ARROWHEAD | \$ (6,757,937) | \$ (5,335,233) | \$ (11,372,095) | \$ (7,820,737) | \$ (146,205,815) |
| Earnings per share - basic and diluted: | | | | | |
| Loss from continuing operations attributable to Arrowhead common shareholders | \$ (0.41) | \$ (0.50) | \$ (0.74) | \$ (0.75) | |
| Income from discontinued operations attributable to Arrowhead common shareholders | | | | | |
| Net loss attributable to Arrowhead shareholders | \$ (0.41) | \$ (0.50) | \$ (0.74) | \$ (0.75) | |
| Weighted average shares outstanding - basic and diluted | 16,461,693 | 10,663,869 | 15,272,703 | 10,390,986 | |

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

Table of Contents**Arrowhead Research Corporation and Subsidiaries****(A Development Stage Company)****Consolidated Statement of Stockholders Equity****from inception through March 31, 2013****(unaudited)**

| | Common Stock | | Preferred Stock | | Additional | Subscription | Accumulated | Noncontrolling | Totals |
|---|------------------|---------------|-----------------|--------|-------------------|--------------|--------------------------------------|------------------|-------------------|
| | Shares | Amount | Shares | Amount | Paid-in Capital | Receivable | Deficit during the Development Stage | interest | |
| Initial Issuance of Stock: | | | | | | | | | |
| Common stock & warrants issued for cash @ \$0.01 per unit | 300,000 | 3,000 | | | | | | | 3,000 |
| Common stock & warrants issued for cash @ \$10.00 per unit | 168,000 | 1,680 | | | 1,678,320 | | | | 1,680,000 |
| Stock issuance cost charged to additional paid-in capital | | | | | (168,000) | | | | (168,000) |
| Net loss for period from inception to September 30, 2003 | | | | | | | (95,238) | | (95,238) |
| Balance at September 30, 2003 | 468,000 | 4,680 | | | 1,510,320 | | (95,238) | | 1,419,762 |
| Exercise of stock options | 7,500 | 75 | | | 14,925 | | | | 15,000 |
| Common stock & warrants issued for cash @ \$10.00 per unit | 47,500 | 475 | | | 474,525 | | | | 475,000 |
| Common stock & warrants issued for marketable securities @ \$10.00 per unit | 50,000 | 500 | | | 499,500 | | | | 500,000 |
| Stock issuance cost charged to additional paid-in capital | | | | | (96,500) | | | | (96,500) |
| Common stock and warrants issued for cash @ \$15.00 per unit | 660,879 | 6,609 | | | 9,906,573 | | | | 9,913,182 |
| Common stock issued in reverse acquisition | 70,553 | 706 | | | (151,175) | | | | (150,469) |
| Common stock issued as a gift for \$10.90 per share | 15,000 | 163 | | | 162,587 | | | | 162,750 |
| Common stock and warrants issued as stock issuance cost @ \$15.00 per unit | 35,623 | 356 | | | 533,988 | | | | 534,344 |
| Stock issuance cost charged to additional paid-in capital | | | | | (991,318) | | | | (991,318) |
| Exercise of stock option @ \$2.00 per share | 7,500 | 75 | | | 14,925 | | | | 15,000 |
| Exercise of stock options @ \$10.00 per share | 600 | 6 | | | 5,994 | | | | 6,000 |
| Stock-based compensation | | | | | 175,653 | | | | 175,653 |
| Net loss for the year ended September 30, 2004 | | | | | | | (2,528,954) | 1,777,699 | (751,255) |
| Balance at September 30, 2004 | 1,363,155 | 13,645 | | | 12,059,997 | | (2,624,192) | 1,777,699 | 11,227,149 |

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|---|------------------|---------------|-------------------|---------------------|------------------|-------------------|
| Exercise of warrants @ \$15.00 per share | 1,381,289 | 13,813 | 20,705,522 | | | 20,719,335 |
| Exercise of stock options @ \$10.00 per share | 2,500 | 25 | 24,975 | | | 25,000 |
| Common stock issued to purchase Insert Therapeutics share @ \$39.80 per share | 50,226 | 502 | 1,999,498 | | | 2,000,000 |
| Common stock issued for services | 1,250 | 12 | 49,988 | | | 50,000 |
| Stock-based compensation | | | 508,513 | | | 508,513 |
| Change in percentage of ownership in subsidiary | | | 230,087 | | | 230,087 |
| Net loss for the year ended September 30, 2005 | | | | (6,854,918) | 121,491 | (6,733,427) |
| Balance at September 30, 2005 | 2,798,419 | 27,997 | 35,578,580 | (9,479,110) | 1,899,190 | 28,026,657 |
| Exercise of stock options | 11,579 | 116 | 341,421 | | | 341,537 |
| Common stock issued @ \$48.80 per share | 20,485 | 205 | 999,795 | | | 1,000,000 |
| Common stock issued @ \$38.40 per share | 1,500 | 15 | 57,585 | | | 57,600 |
| Common stock and warrants issued @ \$35.00 per unit | 559,000 | 5,590 | 19,539,410 | | | 19,545,000 |
| Common stock issued @ \$59.10 per share | 2,536 | 25 | 149,975 | | | 150,000 |
| Common stock issued to purchase Calando Pharmaceuticals, Inc. @ \$51.70 per share | 20,838 | 208 | 1,077,125 | | | 1,077,333 |
| Stock-based compensation | | | 1,369,478 | | | 1,369,478 |
| Net loss for the year ended September 30, 2006 | | | | (18,997,209) | (964,752) | (19,961,961) |
| Balance at September 30, 2006 | 3,414,359 | 34,156 | 59,113,369 | (28,476,319) | 934,438 | 31,605,644 |
| Exercise of stock options | 18,616 | 186 | 434,541 | | | 434,727 |
| Common stock and warrants issued @ \$57.80 per unit | 284,945 | 2,849 | 15,149,366 | | | 15,152,215 |
| Arrowhead's increase in proportionate share of Insert Therapeutics' equity | | | 2,401,394 | | | 2,401,394 |
| Common stock issued for purchase of Carbon Nanotechnologies, Inc. @ \$37.70 per share | 143,122 | 1,431 | 5,398,569 | | | 5,400,000 |
| Stock-based compensation | | | 2,175,544 | | | 2,175,544 |
| Net loss for the year ended September 30, 2007 | | | | (29,931,118) | (781,829) | (30,712,947) |
| Balance at September 30, 2007 | 3,861,042 | 38,622 | 84,672,783 | (58,407,437) | 152,609 | 26,456,577 |
| Exercise of stock options | 10,536 | 106 | 289,921 | | | 290,027 |
| Common stock and warrants issued at approximately \$18.00 per unit | 386,399 | 3,867 | 6,956,718 | | | 6,960,585 |
| Arrowhead's increase in proportionate share of Unidym's equity | | | 1,720,962 | | | 1,720,962 |
| Common stock issued @ \$27.20 per share to Rice University | 5,000 | 50 | 135,950 | | | 136,000 |
| Common stock issued @ \$28.30 per share to purchase shares of Unidym, Inc. | 7,055 | 71 | 199,929 | | | 200,000 |
| Common stock issued @ \$29.50 per share to purchase MASA Energy, LLC | 10,505 | 105 | 309,895 | | | 310,000 |

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|--|------------------|---------------|--------------------|----------------------|----------------------|-------------------|
| Common stock issued @ \$21.90 per share to Unidym for the acquisition of Nanoconduction | 11,416 | 114 | 249,886 | | | 250,000 |
| Common stock issued @ \$21.80 per share | 1,500 | 15 | 32,685 | | | 32,700 |
| Stock-based compensation | | | 3,187,397 | | | 3,187,397 |
| Net loss for the year ended September 30, 2008 | | | | (27,089,030) | (152,609) | (27,241,639) |
| Balance at September 30, 2008 | 4,293,452 | 42,950 | 97,756,126 | (85,496,467) | | 12,302,609 |
| Common Stock issued @ \$5.50 per share to Unidym stockholder in exchange for Unidym s shares | 205,839 | 2,059 | 1,131,617 | | | 1,133,676 |
| Common Stock issued @ \$5.20 per share to TEL Ventures in exchange for Unidym s shares | 222,222 | 2,222 | 1,156,111 | | | 1,158,333 |
| Reclassification of former Unidym mezzanine debt to equity | | | 2,000,000 | | | 2,000,000 |
| Arrowhead s increase in proportionate share of Calando s equity | | | 2,120,250 | | | 2,120,250 |
| Common stock and warrants issued @ \$3.00 per unit | 919,664 | 9,197 | 2,749,796 | | | 2,758,993 |
| Change in percentage ownership in subsidiary | | | 16,297 | | | 16,297 |
| Stock-based compensation | | | 2,676,170 | | | 2,676,170 |
| Issuance of Preferred Stock for Subscription in Unidym | | | 300,000 | (300,000) | | |
| Amortization of discount on Unidym Series D Preferred Stock | | | 163,960 | (163,960) | | |
| Net loss for the year ended September 30, 2009 | | | | (19,308,392) | | (19,308,392) |
| Balance at September 30, 2009 | 5,641,177 | 56,428 | 110,070,327 | (300,000) | (104,968,819) | 4,857,936 |
| Exercise of stock options | 688 | 7 | 7,624 | | | 7,631 |
| Issuance of Preferred Stock for Subscription in Unidym | | | | 300,000 | | 300,000 |
| Issuance of Unidym s common stock to minority shareholders | | | 245,345 | | 54,655 | 300,000 |
| Common stock and warrants issued @ \$6.34 per unit | 508,343 | 5,083 | 3,217,813 | | | 3,222,896 |
| Common stock and warrants issued @ \$13.12 per unit | 659,299 | 6,593 | 3,692,078 | | | 3,698,671 |
| Common Stock issued to Calando stockholders in exchange for Calando s shares | 122,000 | 1,220 | (160,667) | | 159,447 | |
| Common Stock issued to Unidym stockholders in exchange for Unidym s shares | 15,318 | 153 | (1,435) | | 1,282 | |
| Stock-based compensation | | | 1,582,149 | | | 1,582,149 |
| Exercise of warrants | 225,189 | 2,250 | 1,063,600 | | 200 | 1,066,050 |
| Net loss for the year ended September 30, 2010 | | | | (5,774,048) | (1,182,990) | (6,957,038) |
| Balance at September 30, 2010 | 7,172,014 | 71,734 | 119,716,834 | (110,742,867) | (967,406) | 8,078,295 |
| Exercise of warrants | 8,656 | 87 | 43,192 | | | 43,279 |
| Exercise of stock options | 2,700 | 27 | 13,857 | | | 13,884 |
| Divestiture of Unidym | | | | | 254,275 | 254,275 |
| Issuance of preferred stock in subsidiary | | | 1,618,509 | | | 1,618,509 |

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|---|-------------------|-------------------|-----------------------|-----------------------|-------------------------|-----------------------|--|---------------------|
| Change in percentage of ownership in subsidiary | | | (849,707) | | | 849,707 | | |
| Stock-based compensation | | | 1,404,640 | | | | | 1,404,640 |
| Common stock issued @ \$3.80 per share | 1,458,917 | 14,574 | 4,629,110 | | | | | 4,643,684 |
| Issuance of Common Stock for Subscription | | | 900,000 | (900,000) | | | | |
| Net loss for the year ended September 30, 2011 | | | | | (3,128,885) | (363,514) | | (3,492,399) |
| Balance at September 30, 2011 | 8,642,286 | \$ 86,422 | \$ 127,476,435 | \$ (900,000) | \$ (113,871,752) | \$ (226,938) | | 12,564,167 |
| Exercise of stock options | 4,583 | 45 | 23,788 | | | | | 23,833 |
| Stock-based compensation | | | 1,241,404 | | | | | 1,241,404 |
| Common stock issued @ \$3.80 per share | 138,158 | 1,382 | 523,618 | (100,000) | | | | 425,000 |
| Common stock issued @ \$3.70 per share | 675,000 | 6,750 | 2,241,000 | | | | | 2,247,750 |
| Common stock issued @ \$4.00 per share | 100,000 | 1,000 | 399,000 | | | | | 400,000 |
| Common stock issued @ \$6.23 per share | 83,211 | 83 | 499,918 | | | | | 500,001 |
| Common stock issued @ \$5.11 per share | 97,831 | 98 | 499,904 | | | | | 500,002 |
| Common stock and warrants issued @ \$2.76 per unit | 2,260,869 | 2,261 | 5,809,979 | (16,000) | | | | 5,796,240 |
| Common stock issued under Committed Capital Agreement | 68,926 | 689 | (689) | | | | | |
| Common stock issued in acquisitions | 1,217,159 | 9,332 | 6,138,498 | | | | | 6,147,830 |
| Fractional shares redeemed in reverse stock split | (131) | | | | | | | |
| Preferred stock issued @ \$1,000 per share | | 1,015 | 1 | 1,014,999 | | | | 1,015,000 |
| Preferred stock converted to common stock | 275,782 | 276 | (1,015) | (1) | (275) | | | |
| Exercise of Calando stock options | | | | | | 8,000 | | 8,000 |
| Exercise of warrants | 15,511 | 16 | 50,390 | | | | | 50,406 |
| Net loss for the year ended September 30, 2012 | | | | | (21,125,928) | (984,795) | | (22,110,723) |
| Balance at September 30, 2012 | 13,579,185 | \$ 108,354 | \$ 145,917,968 | \$ (1,016,000) | \$ (134,997,680) | \$ (1,203,733) | | \$ 8,808,909 |
| Stock-based compensation | | | 750,782 | | | | | 750,782 |
| Subscription payment | | | | 16,000 | | | | 16,000 |
| Subscription reversal | (268,445) | (2,685) | (997,315) | 1,000,000 | | | | |
| Common stock and warrants issued @ \$2.26 per unit | 1,825,079 | 1,826 | 2,676,747 | | | | | 2,678,573 |
| Common stock and warrants issued @ \$2.12 per unit | 1,667,051 | 1,667 | 2,239,269 | | | | | 2,240,936 |
| Common stock issued @ \$4.49 per share to Roche | 239,894 | 240 | 985,809 | | | | | 986,049 |
| Net loss for the six months ended March 31, 2013 | | | | | (11,372,095) | (348,650) | | (11,720,745) |
| Balance at March 31, 2013 | 17,042,764 | \$ 109,402 | \$ 151,573,260 | \$ | \$ (146,369,775) | \$ (1,552,383) | | \$ 3,760,504 |

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

Table of Contents**Arrowhead Research Corporation and Subsidiaries****(A Development Stage Company)****Consolidated Statements of Cash Flows****(unaudited)**

| | Six Months Ended March 31, 2013 | Six Months Ended March 31, 2012 | May 7, 2003 (Date of inception) to March 31, 2013 |
|---|------------------------------------|------------------------------------|---|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | | |
| Net income (loss) | \$ (11,720,745) | \$ (8,270,913) | \$ (165,373,750) |
| Net (income) loss attributable to noncontrolling interests | 348,650 | 450,176 | 19,167,935 |
| Net income (loss) attributable to Arrowhead | (11,372,095) | (7,820,737) | (146,205,815) |
| (Income) loss from discontinued operations | 354 | 702 | 42,838,408 |
| Realized and unrealized (gain) loss on investments | | 58,091 | (762,954) |
| Charge for bad debt allowance | | | 2,497,300 |
| (Gain) loss from sale of subsidiary | | | (306,344) |
| (Gain) loss on purchase of Roche Madison | | (1,576,107) | (1,576,107) |
| (Gain) loss on disposal of fixed assets | 36,439 | 33,484 | 1,242,904 |
| Stock issued for professional services | | | 741,632 |
| Change in value of derivatives | (14,873) | 689,048 | (3,296,277) |
| Purchased in-process research and development | | | 15,851,555 |
| Stock-based compensation | 750,782 | 421,268 | 14,332,250 |
| Depreciation and amortization | 898,362 | 878,391 | 8,307,648 |
| Amortization (accretion) of note discounts, net | 36,931 | 6,285 | 38,383 |
| Gain on sale of stock in subsidiary | | | (2,292,800) |
| Write down of Note Receivable | 1,279,882 | | 2,922,657 |
| Equity in income (loss) of unconsolidated affiliates | 221,169 | 170,788 | 1,184,576 |
| Noncontrolling interest | (348,650) | (450,176) | (19,167,935) |
| Changes in operating assets and liabilities: | | | |
| Receivables | 9,375 | 149,570 | 109,415 |
| Other receivables | 1,080 | (698,224) | (2,542,062) |
| Prepaid expenses | 191,733 | (185,341) | (289,366) |
| Other current assets | (214,318) | | (378,073) |
| Accounts payable | (6,279) | 224,495 | 492,031 |
| Accrued expenses | 199,242 | 398,787 | 920,151 |
| Other liabilities | 26,516 | 837,234 | 1,156,677 |
| NET CASH USED IN OPERATING ACTIVITIES OF CONTINUING OPERATIONS | (8,304,350) | (6,862,442) | (84,182,146) |
| CASH FLOWS FROM INVESTING ACTIVITIES OF CONTINUING OPERATIONS: | | | |
| Purchase of property and equipment | (31,468) | (277,240) | (4,076,777) |
| Proceeds from sale of investments | 1,160,181 | 509,009 | 4,473,790 |
| Proceeds from sale of fixed assets | 129,454 | 6,528 | 562,141 |
| Cash transferred in acquisitions/divestitures | | 100,035 | (1,579,365) |
| Purchase of marketable securities - US Treasury Bills | | | (18,575,915) |
| Purchase of MASA Energy, LLC | | | (250,000) |
| Minority equity investment | | | (2,000,000) |

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| | | | |
|---|--|--|--------------|
| Cash paid for interest in Insert | | | (10,150,000) |
| Cash obtained from interest in Insert | | | 10,529,594 |
| Proceeds from sale of marketable securities - US Treasury Bills | | | 18,888,265 |
| Proceeds from sale of subsidiaries | | | 359,375 |
| Payment for patents | | | (303,440) |
| Restricted cash | | | 50,773 |

NET CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES OF CONTINUING OPERATIONS 1,258,167 338,332 (2,071,559)

CASH FLOWS FROM FINANCING ACTIVITIES OF CONTINUING OPERATIONS:

| | | | |
|--|-----------|-----------|-------------|
| Principal payments on capital leases | (106,595) | (91,598) | (303,201) |
| Proceeds from issuance of Calando debt | | | 2,516,467 |
| Proceeds from sale of stock in subsidiary | | 8,000 | 20,902,100 |
| Proceeds from issuance of common stock and warrants, net | 7,089,327 | 2,696,333 | 113,342,338 |

NET CASH PROVIDED BY FINANCING ACTIVITIES OF CONTINUING OPERATIONS 6,982,732 2,612,735 136,457,704

| | | | |
|--|-------|-------|--------------|
| Cash flows from discontinued operations: | | | |
| Operating cash flows | (354) | (902) | (46,004,141) |
| Investing cash flows | | | 790,625 |
| Financing cash flows | | | (1,677,000) |

Net cash provided by (used in) discontinued operations: (354) (902) (46,890,516)

NET INCREASE (DECREASE) IN CASH (63,805) (3,912,277) 3,313,483

CASH AT BEGINNING OF PERIOD 3,377,288 7,507,389

CASH AT END OF PERIOD \$ 3,313,483 \$ 3,595,112 \$ 3,313,483

| | | | |
|----------------------------|-----------|-----------|------------|
| Supplementary disclosures: | | | |
| Interest paid | \$ 21,828 | \$ 22,853 | \$ 302,516 |
| Taxes paid | \$ | \$ | \$ 742,500 |

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

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SUPPLEMENTAL NON-CASH TRANSACTIONS

On March 23, 2005, Arrowhead purchased 7,375,000 shares of Insert Therapeutics, Inc. common stock from two minority stockholders of Insert for 50,226 newly issued shares of Arrowhead Common Stock valued at \$2,000,000 based on the closing market price of Arrowhead Common Stock on NASDAQ on the date of the closing.

On March 31, 2006, Arrowhead purchased 964,000 shares of Calando Pharmaceuticals, Inc. common stock from minority stockholders of Calando for \$1,928,000 consisting of 20,838 newly issued shares of Arrowhead Common Stock valued at \$1,077,333 plus \$850,667 in cash. The 20,838 shares of Arrowhead Common Stock were valued based on the average closing price of Arrowhead's Common Stock on NASDAQ the ten trading days immediately prior to the date of the closing.

On April 20, 2007, Arrowhead purchased shares of Series E Preferred Stock of Carbon Nanotechnologies, Inc. in exchange for 143,122 shares of Arrowhead Common Stock with an estimated fair market value of \$5,400,000 based on the average closing price of Arrowhead's Common Stock on NASDAQ the ten trading days immediately prior to March 24, 2007, as set forth in the Agreement and Plan of Merger among Unidym, Carbon Nanotechnologies, Inc., Arrowhead, and others.

On April 23, 2008, Arrowhead purchased 200,000 shares of the Common Stock of Unidym Inc., in exchange for 7,054 shares of Arrowhead Common Stock with an estimated fair market value of \$200,000 based on the average closing price of Arrowhead's Common Stock on NASDAQ the ten trading days immediately prior to the date of the closing.

On April 29, 2008, Arrowhead purchased all of the membership units of MASA Energy, LLC for \$560,000. The purchase price consisted of 10,504 shares of Arrowhead Common Stock with an estimated fair market value of \$310,000 based on the average closing price of Arrowhead's Common Stock on NASDAQ the ten trading days immediately prior to the date of the closing, plus \$250,000 in cash.

On August 8, 2008, Unidym acquired all of the outstanding stock of Nanoconduction, Inc. in exchange for 11,411 shares of Arrowhead stock with an estimated fair market value of \$250,000.

On June 11, 2009, Arrowhead issued 132,462 shares of Common Stock with an estimated fair market value of \$688,802 in exchange for an equal number of Series A Preferred Stock of Unidym, with minority stockholders of Unidym.

On June 25, 2009, Arrowhead issued 194,444 shares of Common Stock with an estimated fair market value of \$972,222 in exchange for an equal number of Series C Preferred Stock of Unidym, with a minority stockholder of Unidym.

On September 22, 2009, Arrowhead issued 9,149 shares of Common Stock with an estimated fair market value of \$46,662 in exchange for an equal number of Series A Preferred Stock of Unidym with a minority stockholder of Unidym.

On September 28, 2009, Arrowhead issued 64,227 shares of Common Stock with an estimated fair market value of \$398,209 in exchange for 5,574 shares of Series A Preferred Stock and 636,699 shares of Series C Preferred Stock of Unidym, with several minority stockholders of Unidym.

On September 30, 2009, Arrowhead issued 27,777 shares of Common Stock with an estimated fair market value of \$186,111 in exchange for an equal number of Series C-1 Preferred Stock of Unidym, with a minority stockholder of Unidym.

In October and November 2009, Arrowhead issued 15,317 shares of Common Stock with an estimated fair market value of \$47,485 in exchange for an equal number of shares of Series C Preferred Stock of Unidym, with several minority stockholders of Unidym.

In October and November 2009, Arrowhead issued 114,000 shares of Common Stock with an estimated fair market value of \$706,800 in exchange for 2,850,000 shares of Calando's common stock, with several minority stockholders of Calando. In conjunction with the exchange, Arrowhead also issued 24,000 Warrants to purchase Arrowhead Common Stock in exchange for 600,000 Warrants to purchase Calando common stock.

In February 2010, Arrowhead issued 8,000 shares of Common Stock and 2,400 warrants to purchase Arrowhead Common Stock, at an exercise price of \$5.00, to several Calando shareholders, in exchange for 200,000 shares of Calando common stock and 60,000 warrants to purchase Calando common stock.

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In March 2010, a warrant holder exercised 24,788 warrants to purchase Arrowhead Common Stock, in a cashless exercise, whereby Arrowhead issued to the warrant holder 12,870 shares of Arrowhead Common Stock.

In September 2010, Arrowhead issued warrants to purchase 390,625 shares of Arrowhead Common Stock, at an exercise price of \$5.00, to two Calando shareholders, in exchange for 1,562.5 shares of Series A Preferred Stock of Calando Pharmaceuticals, Inc.

On October 21, 2011, Arrowhead entered into a Stock and Asset Purchase Agreement whereby in acquired all of the outstanding common stock of Roche Madison Inc. and certain intellectual property rights in exchange for 1,288,158 shares of Arrowhead Common Stock, a promissory note of \$50,000, and potential contingent consideration based on the achievement of certain regulatory milestones, and sales milestones and royalty payments after drug approval.

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On April 5, 2012, Arrowhead entered into a Stock Purchase Agreement whereby it acquired all of the outstanding common stock of Alvos Therapeutics, Inc. for 315,457 shares of Arrowhead Common Stock and potential contingent consideration based on the achievement of certain clinical, regulatory and sales milestones.

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

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Arrowhead Research Corporation

Notes to Consolidated Financial Statements

(unaudited)

Unless otherwise noted, (1) the term *Arrowhead* refers to Arrowhead Research Corporation, a Delaware corporation, (2) the terms *the Company*, *we*, *us*, and *our*, refer to the ongoing business operations of Arrowhead and its Subsidiaries, whether conducted through Arrowhead or a subsidiary of Arrowhead, (3) the term *Subsidiaries* refers collectively to Arrowhead Madison Inc. (*Madison*), Alvos Therapeutics, Inc. (*Alvos*), Calando Pharmaceuticals, Inc. (*Calando*), Ablaris Therapeutics, Inc. (*Ablaris*), Agonn Systems, Inc. (*Agonn*), and Tego Biosciences Corporation (*Tego*) as well as, where applicable, our former subsidiary, Unidym, Inc. (*Unidym*), which was divested in January 2011, (4) the term *Minority Investment* refers to Leonardo Biosystems, Inc. (*Leonardo*) in which the company holds a less than majority ownership position, and (5) the term *Common Stock* refers to Arrowhead's Common Stock and the term *stockholder(s)* refers to the holders of Arrowhead Common Stock.

NOTE 1. ORGANIZATION AND BASIS OF PRESENTATION

Nature of Business

Arrowhead Research Corporation is a clinical stage targeted therapeutics company with development programs in oncology, obesity, and chronic hepatitis B virus infection. Our novel delivery technologies have the potential to enable revolutionary new classes of drugs, such as RNAi interference and peptide drug conjugates, for a broad range of unmet medical needs. Our pipeline of targeted therapeutics are designed to have increased effectiveness through guided delivery and decreased toxicity through reduction of side effects associated with unwanted exposure in healthy cells and tissues.

Financing and Liquidity

The Company has historically financed its operations through the sale of equity securities of Arrowhead or its Subsidiaries. Development activities have required significant capital investment since the Company's inception and we expect our current operations to continue to require cash investment in fiscal 2013 and beyond to continue development.

At March 31, 2013, the Company had \$3.3 million in cash to fund operations. During the six months ended March 31, 2013, the Company's cash position remained relatively constant. During the six months ended March 31, 2013, the Company received \$7.2 million from the issuance of equity, net of fees. Other cash collections were \$1.6 million. The company had cash outflow of \$8.8 million related to its continuing operating activities.

In September 2011, the Company entered into an equity line facility whereby it has the ability to draw capital up to \$15 million, subject to certain provisions, including maintaining a minimum stock price of \$2.00 per share. During fiscal 2012, the Company drew \$1 million from this facility. During fiscal 2013, the Company has not made any draws on this facility.

In December 2012, the Company sold 1.8 million units at a price of \$2.26 per unit in a public offering. Each unit consisted of one share of Common Stock and a warrant to purchase 0.5 share of Common Stock. The exercise price of these warrants was \$2.12 as of March 31, 2013, subsequently adjusted to \$1.83. Proceeds net of expenses from the offering were \$3.9 million.

In January 2013, the Company sold 1.7 million units at a price of \$2.12 per unit in a public offering. Each unit consisted of one share of Common Stock and a warrant to purchase 0.5 share of Common Stock. The exercise price of these warrants was \$2.14 as of March 31, 2013, subsequently adjusted to \$1.83. Proceeds net of expenses from the offering were \$3.3 million.

In May 2013, the Company sold 14.3 million shares of Arrowhead common stock at a price of \$1.83 per share, and 9,900 shares of Arrowhead series B convertible preferred stock at a price of \$1,000 per share. The series B preferred stock is convertible into common stock at a conversion price of \$1.83. Gross proceeds were \$36 million.

Basis of Presentation and Principles of Consolidation

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The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information and in accordance with the instructions to Form 10-Q and Article 8 of Regulation S-X. Accordingly, the financial statements do not include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, all adjustments, including normal recurring accruals, considered necessary for a fair presentation have been included. Interim results are not necessarily indicative of results for a full year. The September 30, 2012 balance sheet was derived from audited financial statements, but does not include all disclosures required by GAAP. This financial information should be read in conjunction with the consolidated financial statements and notes included in the Company s Annual Report on Form 10-K for the year ended September 30, 2012.

The consolidated financial statements of the Company include the accounts of Arrowhead and its wholly-owned and majority-owned Subsidiaries. Prior to April 2008, Arrowhead s Subsidiaries included Insert Therapeutics, Inc. (Insert), which was merged with Calando in April 2008. The merged entity is majority-owned by Arrowhead and continues to operate under the name of Calando. Arrowhead sold its interests in Unidym and Tego in 2011 and 2009, respectively. Unidym and Tego results are included in the Income

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(Loss) from Discontinued Operations. Income (Loss) from Discontinued Operations also includes Aonex Technologies, Inc. (Aonex), sold in 2008 and Nanotechnica, Inc. (Nanotechnica), dissolved in 2005. All significant intercompany accounts and transactions are eliminated in consolidation, and noncontrolling interests are accounted for in the Company's financial statements. Certain reclassifications have been made to prior period financial statements to conform to the current period presentation.

Use of Estimates

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

Reverse Stock Split

As of November 17, 2011, the Company effected a 1 for 10 reverse stock split. As a result of the reverse stock split, each ten shares of the Company's Common Stock issued and outstanding immediately prior to the reverse stock split were combined into one share of Common Stock. Also, as a result of the reverse stock split, the per share exercise price, and the number of shares of Common Stock underlying Company stock options, warrants, and any Common Stock based equity grants outstanding immediately prior to the reverse stock split was proportionally adjusted, based on the one-for-ten split ratio, in accordance with the terms of such options, warrants or other Common Stock based equity grants as the case may be. No fractional shares of Common Stock were issued in connection with the reverse split. Stockholders received a cash payment in lieu of any fractional shares. All share and per share amounts in these financial statements have been retrospectively adjusted to reflect the reverse stock split. Unless otherwise noted, all impacted information has been retroactively adjusted to reflect this reverse stock split.

Recently Issued Accounting Standards

In July 2012, the FASB issued ASU 2012-02, *Testing Indefinite-Lived Intangible Assets for Impairment*, which amended the guidance in ASU 2011-08 to simplify the testing of indefinite-lived intangible assets other than goodwill for impairment. ASU 2012-02 becomes effective for annual and interim impairment tests performed for fiscal years beginning on or after September 15, 2012 and earlier adoption is permitted. We adopted this standard in the third quarter of fiscal year 2012. We believe adoption did not have a material effect on our financial statements.

In September 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2011-08, *Intangibles Goodwill and Other (Topic 350) Testing Goodwill for Impairment (ASU 2011-08)*, to allow entities to use a qualitative approach to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying value. If after performing the qualitative assessment an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step goodwill impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform the first step of the two-step goodwill impairment test. ASU 2011-08 is effective for us in fiscal 2013 and earlier adoption is permitted. The adoption of ASU 2011-08 is not anticipated to have any impact on our financial position, results of operations or cash flows.

In May 2011, the Financial Accounting Standards Board (FASB) issued ASU 2011-04, *Fair Value Measurement (ASU 2011- 04)*, which amended ASC 820, *Fair Value Measurements (ASC 820)*, providing a consistent definition and measurement of fair value, as well as similar disclosure requirements between U.S. GAAP and International Financial Reporting Standards. ASU 2011-04 changes certain fair value measurement principles, clarifies the application of existing fair value measurement and expands the disclosure requirements. ASU 2011-04 was effective for us beginning January 1, 2012. The adoption of ASU 2011-04 did not have a material effect on our consolidated financial statements or disclosures.

NOTE 2. NOTE RECEIVABLE

As part of the proceeds from the sale of Unidym in January 2011, Arrowhead received a Note Receivable from Wisepower (the Wisepower Note) in the face amount of \$2.5 million. On January 24, 2013, the Company entered into an agreement to sell the Wisepower Note. As consideration for selling the Wisepower Note the Company received 1,570,000 shares of Wisepower stock, (the First Tranche). Per the terms of the agreement, the Company was entitled to receive additional consideration (the Second Tranche) based on the proceeds realized from the First Tranche, at which time the Company would deliver the Wisepower Note to the Purchaser.

During the three months ended March 31, 2013, the Company sold 1,170,000 shares of Wisepower from the First Tranche, and realized approximately \$1.2 million in proceeds prior to a trading halt of Wisepower stock on March 22, 2013. As of May 6, 2013 the trading of Wisepower stock had not resumed. It is unclear whether trading will resume and whether the Company will receive any further proceeds from the sale of Wisepower stock, and whether the Company will receive the Second Tranche. Accordingly, the remaining 400,000 shares of Wisepower stock have been recorded at no value. The Company recorded the \$1.2 million proceeds realized from sales of shares from the First

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Tranche against the \$2.5 million value of the Wisepower Note, and has recorded a reserve for the balance of the Wisepower Note in the amount of approximately \$1.3 million. The Company is pursuing its rights under the applicable agreements.

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On October 21, 2011, the Company entered into a Stock and Asset Purchase Agreement (the "RNAi Purchase Agreement") with Hoffmann-La Roche Inc. and F. Hoffmann-La Roche Ltd (collectively, "Roche"), pursuant to which the Company purchased from Roche (i) all of the outstanding common stock of Roche Madison Inc. ("Roche Madison") and (ii) the intellectual property rights then held by Roche related to its RNAi business and identified in the RNAi Purchase Agreement (the "Transaction"). In consideration for the purchase of Roche Madison and the Roche RNAi assets, the Company issued to Roche a promissory note with a principal value of \$50,000 and 901,702 shares of Common Stock. Subsequently, pursuant to the RNAi Purchase Agreement, the Company issued an additional 239,894 shares of Common Stock. The acquisition provided additional technology, particularly related to RNAi delivery, and provided a state-of-the-art lab facility.

Pursuant to the RNAi Purchase Agreement, Roche has a right of first negotiation on certain product candidates developed by the Company and its affiliates relating to the purchased assets. If the Company proposes to out-license or enters into substantive negotiations to out-license, any Clinical Candidate or Existing Candidate (as such terms are defined in the RNAi Purchase Agreement), the Company must give notice of the Candidate it proposes to out-license and negotiate exclusively and in good faith with Roche for 90 days regarding the applicable out-license. This right of first negotiation applies to all Existing Candidates (as defined in the RNAi Purchase Agreement) and the first five Clinical Candidates for which the Company delivers notice to Roche and subsequently enters into an out-license.

In addition to the consideration paid by the Company as per the closing terms, the Company is obligated to make certain royalty and milestone payments to Roche upon the occurrence of certain events. For certain product candidates that are developed by the Company or its affiliates and that are covered by a valid claim by the patent rights transferred in the Transaction for which the Company and Roche do not enter into a licensing arrangement, the Company will be obligated to pay a 3% royalty on Net Sales (as defined in the RNAi Purchase Agreement), provided that the royalty rate may be reduced or offset in certain circumstances. The obligation to pay royalties on such candidates will last until the later of (i) the expiration of the last to expire patent right related to such product candidate that was transferred in the Transaction and (ii) ten years after the first commercial sale of such product candidate.

The Company will also be obligated to make cash payments to Roche upon the achievement of various milestones, including the first regulatory approval of an Existing Candidate in certain jurisdictions and upon certain annual sales milestones for Existing Candidates that may receive regulatory approval. The potential payments range from \$2,500,000 to \$6,000,000 per milestone. Based on the Company's estimate of future payments, a net present value of \$84,935 was calculated as contingent consideration, and is recorded as a part of other noncurrent liabilities.

The following table summarizes the estimated fair values at the date of acquisition:

| | |
|----------------------------------|------------------|
| Current assets | \$ 432,709 |
| Property and equipment | 7,215,206 |
| Intangible assets | 1,174,935 |
| Other noncurrent assets | 6,264 |
| Current liabilities | (414,122) |
| Noncurrent liabilities | (1,570,072) |
| Gain on purchase | (1,576,106) |
| Total purchase consideration | \$ 5,268,814 |

The purchase consideration was composed of the following:

| | |
|----------------------------------|------------------|
| Promissory note due Roche | \$ 50,000 |
| Contingent consideration | 84,935 |
| Shares issued to Roche | 5,133,879 |
| Total purchase consideration | \$ 5,268,814 |

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We estimated the fair value of the assets and liabilities acquired through various valuation techniques including a market approach and an income approach. Because the net identifiable tangible and intangible assets and liabilities were in excess of the purchase price, a gain on the purchase of \$1.6 million was recorded. The most significant assets capitalized were research equipment

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and certain in-process research and development. We believe that we were able to acquire these assets at a reasonable purchase price and generate a gain on the transaction due in part from the seller's desire to exit the relatively early stage of the RNAi business, as compared to the seller's other business operations, as well as the seller's desire to dispose of certain on-going costs associated with the facility, primarily lease costs and personnel costs, which were synergistic to the Company's strategy to establish a research facility to advance development efforts for its drug product candidates.

Alvos Therapeutics

On April 5, 2012, the Company entered into a Stock Purchase Agreement to purchase all of the outstanding shares of Alvos Therapeutics, Inc., (Alvos), a privately held company that licensed a large platform of proprietary human-derived Homing Peptides, and the method for their discovery, from MD Anderson Cancer Center. In conjunction with the acquisition, Arrowhead hired one employee from Alvos, and retained one employee on a consulting basis. In exchange for all of the outstanding shares of Alvos, Arrowhead issued an upfront payment of 315,457 shares of Common Stock. The former Alvos stockholders are also eligible to receive additional issuances of stock valued at up to \$23.5 million at the time of issuance based on the future achievement of clinical, regulatory and sales milestones. Based on the Company's estimate of future payments, a net present value of \$88,686 was calculated as contingent consideration, and is recorded as a part of other noncurrent liabilities. The Alvos acquisition provided key technology in targeted therapeutics.

The following table summarizes the estimated fair values at the date of acquisition:

| | |
|----------------------------------|------------------|
| Current assets | \$ 29,332 |
| In-process R&D | 2,172,387 |
| Current liabilities | (113,033) |
| Total purchase consideration | \$ 2,088,686 |

The purchase consideration was comprised of shares of Arrowhead Common Stock issued to the former shareholders of Alvos Therapeutics, Inc.

| | |
|----------------------------------|------------------|
| Shares issued | 315,457 |
| Price per share | \$ 6.34 |
| Share consideration | \$ 2,000,000 |
| Contingent consideration | 88,686 |
| Total purchase consideration | \$ 2,088,686 |

NOTE 4. INTANGIBLE ASSETS

Intangible assets consist of in-process research and development (IPR&D) not subject to amortization, and patents and other intangible assets subject to amortization, which were capitalized as a part of a business combination.

IPR&D represents projects that have not yet received regulatory approval and are required to be classified as indefinite assets until the successful completion or the abandonment of the associated R&D efforts. Accordingly, during the development period after the date of acquisition, these assets will not be amortized until approval is obtained in one or more jurisdictions which, individually or combined, are expected to generate a significant portion of the total revenue expected to be earned by an IPR&D project. At that time, we will determine the useful life of the asset, reclassify the asset out of IPR&D and begin amortization. If the associated R&D effort is abandoned the related IPR&D assets will likely be written off and we would record an impairment loss.

Intangible assets subject to amortization include license agreements and patents capitalized as part of a business combination.

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The license agreements are being amortized over the estimated life remaining at the time of acquisition which was 4 years. Patents are amortized over a period of three years to twenty years. The weighted average original amortization period is twelve years. Amortization of license agreements and patents is expected to be approximately \$148,000 for the balance of fiscal year 2013, and \$300,000 for fiscal years 2014, and 2015, \$250,000 in 2016, \$240,000 in 2017 and \$280,000 thereafter.

We review amounts capitalized as in-process research and development for impairment at least annually in the fourth quarter, and whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. In the event the carrying value of the assets is not expected to be recovered, the assets are written down to their estimated fair values. We continue to test our indefinite-lived IPR&D assets for potential impairment until the projects are completed or abandoned.

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The below table provides details on our intangible asset balances:

| | Intangible assets not subject to amortization | Intangible assets subject to amortization | Total Intangible assets |
|---------------------------------|---|---|----------------------------|
| Balance at September 30, 2011 | \$ 0 | \$ 1,731,211 | \$ 1,731,211 |
| Additions - Madison acquisition | 944,935 | 230,000 | 1,174,935 |
| Additions - Alvos acquisition | 2,172,387 | 0 | 2,172,387 |
| Amortization | 0 | (293,964) | (293,964) |
| | | | |
| Balance at September 30, 2012 | \$ 3,117,322 | \$ 1,667,247 | \$ 4,784,569 |
| Amortization | 0 | (148,230) | (148,230) |
| | | | |
| Balance at March 31, 2013 | \$ 3,117,322 | \$ 1,519,017 | \$ 4,636,339 |

NOTE 5. INVESTMENT IN SUBSIDIARIES

In addition to 100% ownership interest in Arrowhead Madison, Inc. and Alvos Therapeutics, Inc., Arrowhead also maintains majority ownership in Calando Pharmaceuticals, Ablaris Therapeutics, Inc., and a minority investment in Leonardo Biosystems, Inc.

Calando Pharmaceuticals, Inc.

Calando is a clinical stage RNAi therapeutics company. On April 17, 2008, Calando merged with and into Insert, with Insert as the surviving company.

In January 2011, Arrowhead invested \$9.1 million, through a cash investment of \$1.0 million and the conversion of \$8.1 million intercompany debt, acquiring newly issued Calando Series B and Series C preferred stock.

As of March 31, 2013, Calando owed to Arrowhead \$3.9 million under a series of 8% simple interest notes and advances. It is expected that these loans will either be repaid or converted to equity in the future. The balance of the notes and advances is eliminated in consolidation.

As of March 31, 2013, Arrowhead owned 79% of the outstanding shares of Calando and 76% on a fully diluted basis.

Ablaris Therapeutics, Inc.

Ablaris was formed and began operations in the first quarter of fiscal 2011, based on the license of certain anti-obesity technology developed at the MD Anderson Cancer Center at the University of Texas. During the year ended September 30, 2011, Ablaris raised \$2.9 million in cash, of which \$1.3 million was invested by Arrowhead and \$1.6 million was invested by outside investors, through the issuance of Ablaris Series A Preferred stock.

As of March 31, 2013, Arrowhead owned 64% of the outstanding shares of Ablaris and 64% on a fully diluted basis.

Nanotope, Inc.

Nanotope has ceased all operations and will be dissolved.

Leonardo Biosystems, Inc.

Leonardo is developing a drug-delivery platform technology based on novel methods of designing porous silicon microparticles that selectively accumulate in tumor vasculature. Arrowhead accounts for its investment in Leonardo using the cost method of accounting. As of March 31, 2013, Leonardo owed to Arrowhead \$698,000, included in other receivables. The Company has provided a full reserve against the receivable from Leonardo. As of March 31, 2013, Arrowhead's ownership interest in Leonardo was 3%.

NOTE 6. NOTES PAYABLE

On November 26, 2008, Calando entered into Unsecured Convertible Promissory Note Agreements (Notes) for \$2.5 million with accredited investors and Arrowhead, which invested \$200,000 in the Notes offering. Arrowhead subsequently invested an additional \$600,000 in the same offering. Except for one Note in the principal amount of \$500,000, all Notes and accrued interest were converted into a total of 2,950 shares of Calando Series A Preferred Stock on June 23, 2009. The remaining Note was renegotiated and extended until November 26, 2013. The terms of the new note include a 10% interest rate and require two times principal payment upon certain events as defined in the note and at maturity. At March 31, 2013, the Note is reflected on the balance sheet at the maturity amount of \$1,000,000 less a discount of \$119,761.

Also, as part of the acquisition of Roche Madison, Inc. in October 2011, the Company recorded a note payable of \$50,000, which is due October 17, 2014 and is reflected in long-term liabilities on the Company's balance sheet.

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At March 31, 2013, the Company had a total of 150,000,000 shares of capital stock authorized for issuance, consisting of 145,000,000 shares of Common Stock, par value \$0.001, and 5,000,000 shares of Preferred Stock, par value \$0.001.

At March 31, 2013, 17,042,764 shares of Common Stock were outstanding; no shares of Preferred Stock were outstanding. At March 31, 2013, 3,369,960 shares were reserved for issuance upon exercise of options granted or available to grant under Arrowhead's 2000 Stock Option Plan and 2004 Equity Incentive Plan.

On September 30, 2011, the Company sold 1,458,917 shares of Common Stock at a price of \$3.80 per share. Cash proceeds received in fiscal 2011 were \$4.5 million; the balance of \$1 million was recorded as subscription receivable. As of March 31, 2013, the subscription receivable had not been received, and it is not expected to be received. During the quarter ended March 31, 2013, the Company reversed the subscription receivable. On October 4, 2011, the Company completed a second closing of the offering in which the Company sold 138,158 shares of Common Stock at a price of \$3.80 per share. Cash proceeds were \$525,000.

On October 20, 2011, the Company and Lincoln Park Capital Fund, LLC, an Illinois limited liability company (LPC) entered into a \$15 million purchase agreement (the Purchase Agreement), together with a registration rights agreement, whereby LPC agreed to purchase up to \$15 million of Common Stock, subject to certain limitations, from time to time during the three-year term of the Purchase Agreement. Additionally, the Company filed a registration statement with the U.S. Securities & Exchange Commission covering the resale of the shares that may be issued to LPC under the Purchase Agreement. On January 30, 2012, the SEC declared the registration statement effective for the resale of such shares. The Company has the right, in its sole discretion, over a 36-month period to sell up to \$15 million of Common Stock (subject to certain limitations) to LPC, depending on certain conditions as set forth in the Purchase Agreement. As of March 31, 2013, the Company had drawn \$1 million from the facility.

On October 21, 2011 and October 24, 2011, the Company entered into Subscription Agreements with certain accredited investors (the Series A Purchasers), pursuant to which the Company issued and sold an aggregate of 1,015 shares of Series A Preferred Convertible Stock, \$0.001 par value per share, at a purchase price of \$1,000 per share. The aggregate purchase price paid for the shares of Series A Preferred was \$1,015,000. On February 16, 2012, upon approval by the Company's shareholders, 1,015 shares of Arrowhead Series A Preferred Convertible Stock, \$0.001 par value per share, were converted to 275,782 shares of Common Stock.

On October 21, 2011, the Company entered into a Subscription Agreement with an accredited investor, pursuant to which the Company issued and sold an aggregate of 675,000 shares of Common Stock, \$0.001 par value per share, at a purchase price of \$3.70 per share. The aggregate purchase price paid by the purchaser for the shares of Common Stock was \$2,497,500.

On August 10, 2012, the Company sold 2,260,869 units at a price of \$2.76 per unit. Each unit consisted of one share of common stock and a warrant to purchase 0.75 shares of common stock at an exercise price of \$3.25. Gross proceeds from the offering were \$6.2 million excluding offering fees and expenses.

In December 2012, the Company sold 1,825,079 units at a price of \$2.26 per unit. Each unit consisted of one share of common stock and a warrant to purchase 0.5 shares of common stock. Gross proceeds from the offering were \$4.1 million excluding offering fees and expenses. The exercise price of these warrants was \$2.12 as of March 31, 2013.

In January 2013, the Company sold 1,667,051 units at a price of \$2.12 per unit. Each unit consisted of one share of common stock and a warrant to purchase 0.5 shares of common stock. Gross proceeds from the offering were \$3.5 million excluding offering fees and expenses. The exercise price of these warrants was \$2.14 as of March 31, 2013.

In May 2013, the Company sold 14.3 million shares of Arrowhead common stock at a price of \$1.83 per share and 9,900 shares of Arrowhead series B convertible preferred stock at a price of \$1,000 per share. The series B preferred stock is convertible into common stock at a conversion price of \$1.83. Gross proceeds were \$36 million. No warrants were issued in the May 2013 financing.

The following table summarizes information about warrants outstanding at March 31, 2013:

Exercise prices

Number of Warrants

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| | | Remaining Life in Years |
|--------------------------------|---------------|--|
| \$70.60 | 94,897 | 4.1 |
| \$20.00 | 386,400 | 0.4 |
| \$5.00 | 1,155,023 | 1.7 |
| \$5.09 | 461,024 | 1.7 |
| \$1.38 | 322,150 | 2.7 |
| \$4.16 | 1,000 | 3.7 |
| \$3.25 | 1,695,654 | 3.4 |
| \$2.12 | 987,543 | 4.7 |
| \$2.83 | 79,013 | 3.4 |
| \$2.14 | 833,530 | 4.8 |
| \$2.65 | 39,301 | 3.4 |
| Total warrants outstanding | 6,055,535 | |

Table of Contents**NOTE 8. LEASES**

The Company's research facility in Madison, Wisconsin is leased through February 28, 2019. Monthly rental expense is approximately \$22,000. Other monthly rental expenses include common area maintenance and real estate taxes totaling approximately \$13,000 per month. Utilities costs are approximately \$16,000 per month. Including monthly payments recorded under a capital lease of approximately \$21,000, total monthly costs are approximately \$72,000 per month. The Company's corporate headquarters are located in Pasadena, California; Rental expense is approximately \$13,000 per month.

Facility and equipment rent expense, related to continuing operations, for the six months ended March 31, 2013 and 2012 was \$281,000 and \$214,000, respectively. From inception to date, rent expense was \$4,407,000.

As of March 31, 2013, future minimum lease payments due in fiscal years under capitalized leases are as follows:

| | |
|----------------------|--------------|
| 2013 | \$ 128,423 |
| 2014 | 256,846 |
| 2015 | 256,846 |
| 2016 | 256,846 |
| 2017 | 256,846 |
| 2018 | 256,846 |
| 2019 and thereafter | 107,020 |
| Less interest | (129,006) |
| | |
| Principal | 1,390,665 |
| Less current portion | (218,048) |
| | |
| Noncurrent portion | \$ 1,172,616 |

As of March 31, 2013, future minimum lease payments due in fiscal years under operating leases are as follows:

| | |
|---------------------|--------------|
| 2013 | \$ 182,899 |
| 2014 | 434,229 |
| 2015 | 445,921 |
| 2016 | 457,961 |
| 2017 | 470,154 |
| 2018 | 359,370 |
| 2019 and thereafter | 125,415 |
| | |
| Total | \$ 2,475,949 |

NOTE 9. STOCK-BASED COMPENSATION

Arrowhead has two plans that provide for equity-based compensation. Under the 2000 Stock Option Plan, 153,200 shares of Arrowhead's Common Stock are reserved for issuance upon exercise of non-qualified stock options. No further grants can be made under the 2000 Stock Option Plan. Under the 2004 Equity Incentive Plan, 1,965,860 shares of Common Stock are reserved for the grant of stock options, stock appreciation rights, restricted stock awards and performance unit/share awards by the Board of Directors to employees, consultants and others. As of March 31, 2013, there were options granted and outstanding to purchase 152,900 and 1,585,694 shares of Common Stock under the 2000 Stock Option Plan and the 2004 Equity Incentive Plan, respectively, and 251,200 options outstanding that were issued outside of equity incentive plans, as inducement options to new employees hired in conjunction with the Company acquisition of its Madison research facility in October 2011.

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During the six months ended March 31, 2013, 79,000 options were granted under the 2004 Equity Incentive Plan. The following tables summarize information about stock options:

| | Number of Options Outstanding | Weighted- Average Exercise Price Per Share | Weighted- Average Remaining Contractual Term | Aggregate Intrinsic Value |
|-------------------------------|-------------------------------------|--|--|---------------------------------|
| Balance At September 30, 2011 | 729,096 | 9.03 | | |
| Granted | 1,229,500 | 4.40 | | |
| Cancelled | (42,919) | 11.77 | | |
| Exercised | (4,883) | 5.20 | | |
| Balance At September 30, 2012 | 1,910,794 | \$ 6.01 | | |
| Granted | 79,000 | 2.20 | | |
| Cancelled | 0 | 0 | | |
| Exercised | 0 | 0 | | |
| Balance At March 31, 2013 | 1,989,794 | \$ 5.86 | 7.8 years | \$ 800 |
| Exercisable At March 31, 2013 | 1,037,989 | \$ 7.24 | 6.7 years | \$ |

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Stock-based compensation expense for the six months ended March 31, 2013 and 2012 was \$750,782 and \$486,152, respectively. There is no income tax benefit as the company is currently operating at a loss and an actual income tax benefit may not be realized. The loss creates a timing difference, resulting in a deferred tax asset, which is fully reserved by a valuation allowance.

The fair value of the options granted by Arrowhead during the six months ended March 31, 2013 and 2012 is estimated at \$103,293 and \$3,505,912, respectively. The aggregate fair value of options granted by Calando during the six months ended March 31, 2013 and 2011 is estimated at \$0 and \$33,690, respectively.

The intrinsic value of the options exercised during the six months ended March 31, 2012 was \$0, there were no options exercised during the six months ended March 31, 2013.

As of March 31, 2013, the pre-tax compensation expense for all unvested stock options at Arrowhead in the amount of approximately \$3,108,499 will be recognized in our results of operations over a weighted average period of 2.7 years. As of March 31, 2013, the pre-tax compensation expense for all unvested stock options at Calando in the amount of approximately \$45,478 will be recognized in our results of operations over a weighted average period of 2.4 years.

The fair value of each stock option award is estimated on the date of grant using the Black-Scholes option pricing model. The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options, which do not have vesting restrictions and are fully transferable. The determination of the fair value of each stock option is affected by our stock price on the date of grant, as well as assumptions regarding a number of highly complex and subjective variables. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options. The assumptions used to value stock options are as follows:

| | Six months ended March 31, | |
|---|-----------------------------------|--------------|
| | 2013 | 2012 |
| Dividend yield | | |
| Risk-free interest rate | 0.7% to 1.25% | 0.9% to 1.7% |
| Volatility | 69% | 90% to 100% |
| Expected life (in years) | 5.5 to 6.25 | 5.5 to 6.25 |
| Weighted average grant date fair value per share of options granted | \$1.31 | \$3.79 |

The dividend yield is zero as the Company currently does not pay a dividend.

The risk-free interest rate is based on the U.S. Treasury bond.

Volatility is estimated based on volatility average of the Company's Common Stock price.

NOTE 10. FAIR VALUE MEASUREMENTS & DERIVATIVE INSTRUMENTS

The Company measures its financial assets and liabilities at fair value. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability (i.e., exit price) in an orderly transaction between market participants at the measurement date. Additionally, the Company is required to provide disclosure and categorize assets and liabilities measured at fair value into one of three different levels depending on the assumptions (i.e., inputs) used in the valuation. Level 1 provides the most reliable measure of fair value while Level 3 generally requires significant management judgment. Financial assets and liabilities are classified in their entirety based on the lowest level of input significant to the fair value measurement. The fair value hierarchy is defined as follows:

Level 1 Valuations are based on unadjusted quoted prices in active markets for identical assets or liabilities.

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Level 2 Valuations are based on quoted prices for similar assets or liabilities in active markets, or quoted prices in markets that are not active for which significant inputs are observable, either directly or indirectly.

Level 3 Valuations are based on prices or valuation techniques that require inputs that are both unobservable and significant to the overall fair value measurement. Inputs reflect management's best estimate of what market participants would use in valuing the asset or liability at the measurement date.

The following table summarizes fair value measurements at March 31, 2013 and September 30, 2012 for assets and liabilities measured at fair value on a recurring basis:

March 31, 2013:

| | Level 1 | Level 2 | Level 3 | Total |
|---------------------------|--------------|---------|--------------|--------------|
| Cash and cash equivalents | \$ 3,313,310 | \$ | \$ | \$ 3,313,310 |
| Marketable securities | \$ | \$ | \$ | \$ |
| Derivative assets | \$ | \$ | \$ | \$ |
| Derivative liabilities | \$ | \$ | \$ 2,535,910 | \$ 2,535,910 |
| Contingent consideration | \$ | \$ | \$ 173,621 | \$ 173,621 |

September 30, 2012:

| | Level 1 | Level 2 | Level 3 | Total |
|---------------------------|--------------|---------|------------|--------------|
| Cash and cash equivalents | \$ 3,377,288 | \$ | \$ | \$ 3,377,288 |
| Marketable securities | \$ 106,500 | \$ | \$ | \$ 106,500 |
| Derivative assets | \$ | \$ | \$ 250,250 | \$ 250,250 |
| Derivative liabilities | \$ | \$ | \$ 647,213 | \$ 647,213 |
| Contingent consideration | \$ | \$ | \$ 173,621 | \$ 173,621 |

As part of the proceeds from the sale of Unidym in January 2011, Arrowhead received a bond from Wisepower in the face amount of \$2.5 million. The bond is convertible to Wisepower common stock at a price of \$2.00 per share. The conversion feature is subject to derivative accounting as prescribed under ASC 815. Accordingly, the fair value of the conversion feature on the date of issuance was estimated using an option pricing model and recorded on the Company's consolidated balance sheet as a derivative asset. The fair value of the conversion feature is estimated at the end of each reporting period and the change in the fair value of the conversion feature is recorded as a nonoperating gain/loss as change in value of derivatives in Company's Consolidated Statement of Operations. During the quarter ended March 31, 2013, the trading of Wisepower stock was halted. The Company determined that the probability of realizing value from the conversion feature was remote, and the derivative asset value has been reduced to zero.

During the six months ended March 31, 2013, the Company recorded a loss from the change in fair value of the derivative asset of \$250,250. The assumptions used in valuing the derivative asset were as follows:

| | March 31, 2013 | September 30, 2012 |
|-------------------------|----------------|--------------------|
| Risk free interest rate | NA | 0.23% |
| Expected life | 0 Years | 1.3 Years |
| Dividend yield | none | none |
| Volatility | 72% | 72% |

The following is a reconciliation of the derivative asset:

| | |
|-----------------------------|---------|
| Value at September 30, 2011 | 161,125 |
| Receipt of instruments | |

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| | |
|-----------------------------|-----------|
| Increase in value | 89,125 |
| Net settlements | |
| Value at September 30, 2012 | 250,250 |
| Receipt of instruments | |
| Change in value | (250,250) |
| Net settlements | |
| Value at March 31, 2013 | \$ |

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As part of the equity financing on June 17, 2010, Arrowhead issued warrants to acquire up to 329,649 shares of Common Stock (the 2010 Warrants), of which 322,150 warrants were outstanding at March 31, 2013, which contain a mechanism to adjust the strike price upon the issuance of certain dilutive equity securities. If during the term of the 2010 Warrants, the Company issues Common Stock at a price lower than the exercise price of the 2010 Warrants, the exercise price of the 2010 Warrants would be reduced to the amount equal to the issuance price of the Common Stock. Similarly, as part of a financing on December 12, 2012, Arrowhead issued warrants to acquire up to 912,543 shares of Common Stock (the 2012 Warrants) which contain a mechanism to adjust the strike price upon the issuance of certain dilutive equity securities. If during the term of the 2012 Warrants, the Company issues Common Stock at a price lower than the exercise price of the 2012 Warrants, the exercise price of the 2012 Warrants would be reduced to the amount equal to the issuance price of the Common Stock. Further, as part of a financing on January 25, 2013, Arrowhead issued warrants to acquire up to 833,530 shares of Common Stock (the 2013 Warrants) which contain a mechanism to adjust the strike price upon the issuance of certain dilutive equity securities. If during the term of the 2013 Warrants, the Company issues Common Stock at a price lower than the exercise price of the 2013 Warrants, the exercise price of the 2013 Warrants would be reduced to the amount equal to the issuance price of the Common Stock.

As a result of these features, the 2010 Warrants, the 2012 Warrants, and the 2013 Warrants are subject to derivative accounting as prescribed under ASC 815. Accordingly, the fair value of the Warrants on the date of issuance was estimated using an option pricing model and recorded on the Company's consolidated balance sheet as a derivative liability. The fair value of the Warrants is estimated at the end of each reporting period and the change in the fair value of the Warrants is recorded as a nonoperating gain or loss in the Company's consolidated statement of operations. During the six months ended March 31, 2013, the Company recorded a non-cash gain from the change in fair value of the derivative liability of \$244,801. The assumptions used in valuing the derivative liabilities were as follows:

| 2010 Warrants | March 31, 2013 | September 30, 2012 |
|-------------------------|----------------|--------------------|
| Risk free interest rate | 0.36% | 0.31% |
| Expected life | 2.7 Years | 3.2 Years |
| Dividend yield | none | none |
| Volatility | 69% | 100% |

| 2012 Warrants | March 31, 2013 | September 30, 2012 |
|-------------------------|----------------|--------------------|
| Risk free interest rate | 0.77% | N/A |
| Expected life | 4.7 Years | N/A |
| Dividend yield | none | N/A |
| Volatility | 69% | N/A |

| 2013 Warrants | March 31, 2013 | September 30, 2012 |
|-------------------------|----------------|--------------------|
| Risk free interest rate | 0.77% | N/A |
| Expected life | 4.8 Years | N/A |
| Dividend yield | none | N/A |
| Volatility | 69% | N/A |

The following is a reconciliation of the derivative liability related to these warrants:

| | |
|-----------------------------|------------|
| Value at September 30, 2011 | \$ 907,233 |
| Issuance of instruments | |
| Change in value | (281,038) |
| Net settlements | |
| Value at September 30, 2012 | \$ 626,195 |
| Issuance of instruments | 1,137,896 |
| Issuance of instruments | 1,015,923 |
| Change in value | (244,801) |
| Net settlements | |

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Value at March 31, 2013

\$ 2,535,213

In conjunction with the financing of Ablaris during the year ended September 30, 2011, Arrowhead sold exchange rights to certain investors whereby the investors have the right to exchange their shares of Ablaris for a prescribed number of shares of Arrowhead Common Stock based upon a predefined ratio. The exchange rights have a seven-year term. During the first year, the

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exchange right allows the holder to exchange one Ablaris share for 0.06 Arrowhead shares. This ratio declines to 0.04 in the second year, 0.03 in the third year and 0.02 in the fourth year. In the fifth year and beyond the exchange ratio is 0.01. Exchange rights for 675,000 Ablaris shares were sold during the year ended September 30, 2011, and remain outstanding. The exchange rights are subject to derivative accounting as prescribed under ASC 815. Accordingly, the fair value of the exchange rights on the date of issuance was estimated using an option pricing model and recorded on the Company's consolidated balance sheet as a derivative liability. The fair value of the exchange rights is estimated at the end of each reporting period and the change in the fair value of the exchange rights is recorded as a nonoperating gain or loss in the Company's Consolidated Statement of Operations. During the six months ended March 31, 2013, the Company recorded a non-cash gain from the change in fair value of the derivative liability of \$9,675. The assumptions used in valuing the derivative liability were as follows:

| | March 31, 2013 | September 30, 2012 |
|-------------------------|----------------|--------------------|
| Risk free interest rate | 0.72% | 0.62% |
| Expected life | 4.8 Years | 5.3 Years |
| Dividend yield | none | none |
| Volatility | 69% | 100% |

The following is a reconciliation of the derivative liability related to these exchange rights:

| | |
|-----------------------------|-----------|
| Value at September 30, 2010 | \$ |
| Issuance of instruments | 100,650 |
| Change in value | (69,758) |
| Value at September 30, 2011 | \$ 30,892 |
| Issuance of instruments | |
| Change in value | (20,520) |
| Net settlements | |
| Value at September 30, 2012 | \$ 10,372 |
| Issuance of instruments | |
| Change in value | (9,675) |
| Net settlements | |
| Value at March 31, 2013 | \$ 697 |

During the year ended September 30, 2012, contingent consideration was recorded upon the acquisitions of Roche Madison, Inc. and Alvos Therapeutics, Inc., totaling \$173,621. The fair value measurement of the contingent consideration obligations is determined using Level 3 inputs. The fair value of contingent consideration obligations is based on a discounted cash flow model using a probability-weighted income approach. The measurement is based upon unobservable inputs supported by little or no market activity based on our own assumptions and experience. Estimating timing to complete the development, and obtain approval of products is difficult, and there are inherent uncertainties in developing a product candidate, such as obtaining U.S. Food and Drug Administration (FDA) and other regulatory approvals. In determining the probability of regulatory approval and commercial success, we utilize data regarding similar milestone events from several sources, including industry studies and our own experience. These fair value measurements represent Level 3 measurements as they are based on significant inputs not observable in the market. Significant judgment is employed in determining the appropriateness of these assumptions as of the acquisition date and for each subsequent period. Accordingly, changes in assumptions could have a material impact on the amount of contingent consideration expense we record in any given period. Changes in the fair value of the contingent consideration obligations are recorded in our consolidated statement of operations. There were no changes in contingent consideration fair value.

| | |
|--|---------|
| Value at September 30, 2011 | \$ |
| Purchase price contingent consideration | 173,621 |
| Contingent consideration payments | |
| Change in fair value of contingent consideration | |

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| | |
|--|------------|
| Value at September 30, 2012 | \$ 173,621 |
| Purchase price contingent consideration | |
| Contingent consideration payments | |
| Change in fair value of contingent consideration | |
| Value at March 31, 2013 | \$ 173,621 |

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The carrying amounts of the Company's other financial instruments, which include accounts receivable, accounts payable, and accrued expenses approximate their respective fair values due to the relatively short-term nature of these instruments. The carrying value of the Company's debt obligations approximates fair value based on market interest rates.

NOTE 11. SUBSEQUENT EVENTS

On April 29, 2013, the Company entered into a Securities Purchase Agreement (the "SPA") with certain institutional investors (the "Purchasers"), pursuant to which the Company agreed to issue and sell an aggregate of 14,262,553 shares of common stock, \$0.001 par value per share (the "Shares"), at a purchase price of \$1.83 per share, and 9,900 shares of Series B Convertible Preferred Stock (the "Preferred Shares"), at a purchase price of \$1,000 per share. The Preferred Shares are convertible into shares of common stock at a conversion price of \$1.83 per share of common stock. The aggregate purchase price paid by the Purchasers for the Shares and Preferred Shares was \$36,000,472 and the Company received net proceeds of approximately \$35,350,000, after advisory fees and offering expenses. The closing of the offering occurred on May 3, 2013.

The Securities Purchase Agreement requires the Company to register the resale of the Shares and the Common Stock underlying the Preferred Shares (the "Conversion Shares"). The Company is required to prepare and file a registration statement with the Securities and Exchange Commission within 30 days of the closing of the offering, and to use commercially reasonable efforts to have the registration statement declared effective within 90 days of the closing date if there is no review by the Securities and Exchange Commission, and within 120 days of the closing date in the event of such review. Should the Company fail to file the registration statement as required by the SPA, fail to obtain effectiveness of such registration statement as required by the SPA, or fail to maintain such effectiveness as required by the SPA, the Company is subject to cash penalties during the time period of such failures up to 10% of the aggregate purchase price.

The Preferred Shares are convertible at the option of the stockholder into the number of shares of common stock determined by dividing the value of the Preferred Shares being converted by the conversion price of \$1.83, subject to adjustment for stock splits, reverse stock splits and similar recapitalization events. The Company will not effect any conversion of the Preferred Shares, and a stockholder shall not have the right to convert any portion of the Preferred Shares, to the extent that, after giving effect to the conversion such stockholder would beneficially own in excess of the Beneficial Ownership Limitation. The Beneficial Ownership Limitation is 9.99% of the number of shares of the common stock outstanding immediately after giving effect to the issuance of shares of common stock issuable upon conversion of Preferred Shares held by the applicable stockholder. The Preferred Shares are eligible to vote with the common stock of the Company on an as-converted basis, but only to the extent that the Preferred Shares are eligible for conversion without exceeding the Beneficial Ownership Limitation. The Preferred Shares are entitled to receive dividends on a pari passu basis with the common stock, when, and if declared. In any liquidation or dissolution of the Company, the Preferred Shares are entitled to participate in the distribution of assets, to the extent legally available for distribution, on a pari passu basis with the common stock.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This Quarterly Report on Form 10-Q contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, and we intend that such forward-looking statements be subject to the safe harbors created thereby. For this purpose, any statements contained in this Quarterly Report on Form 10-Q except for historical information may be deemed to be forward-looking statements. Without limiting the generality of the foregoing, words such as may, will, expect, believe, anticipate, intend, could, estimate, or continue or the negative or other variations thereof or comparable terminology are intended to identify forward-looking statements. In addition, any statements that refer to projections of our future financial performance, trends in our businesses, or other characterizations of future events or circumstances are forward-looking statements.

The forward-looking statements included herein are based on current expectations of our management based on available information and involve a number of risks and uncertainties, all of which are difficult or impossible to predict accurately and many of which are beyond our control. As such, our actual results may differ significantly from those expressed in any forward-looking statements. Readers should carefully review the factors identified in this report under the caption Risk Factors as well as the additional risks described in other documents we file from time to time with the Securities and Exchange Commission (SEC), including our most recent Annual Report on Form 10-K. In light of the significant risks and uncertainties inherent in the forward-looking information included herein, the inclusion of such information should not be regarded as a representation by us or any other person that such results will be achieved, and readers are cautioned not to place undue reliance on such forward-looking information. Except as may be required by law, we disclaim any intent to revise the forward-looking statements contained herein to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

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Overview

Arrowhead Research Corporation is a nanomedicine company developing innovative therapies at the interface of biology and nanoengineering to cure disease and improve human health. Arrowhead has one of the most advanced and broadest technology platforms for therapeutics based on RNA interference (RNAi), including access to several different RNAi delivery systems and small interfering RNA (siRNA) structures in commercial development for RNAi therapeutics. This broad technology platform enables optimization of siRNA therapeutic candidates for delivery based on siRNA chemistry, tissue type, disease state, target gene and siRNA type and chemistry on a target-by-target basis. Through its acquisition of Alvos Therapeutics, Arrowhead has access to a large platform of proprietary human-derived homing peptides and the method for their discovery. These targeting peptide sequences can be linked to our siRNA delivery vehicles as well as to traditional small molecule drugs to preferentially shuttle them into target cells. Arrowhead is leveraging its in-house R&D expertise and capabilities, as well as a broad intellectual property portfolio for RNAi therapeutics, and RNAi and peptide delivery vehicles and targeting methods to seek development partnerships with other pharmaceutical and biotech companies committed to bringing RNAi therapeutics to market, as well as continuing the preclinical and clinical development of its own clinical candidates. Arrowhead's non-RNAi development programs include a therapeutic candidate for the potential treatment of obesity.

Arrowhead's wholly-owned subsidiary, Arrowhead Madison Inc., operates a lab facility in Madison, Wisconsin, supporting the company's initiatives including the development of RNAi therapeutics. In addition to its wholly owned subsidiaries, Arrowhead Madison and Alvos Therapeutics, Arrowhead operates two majority owned subsidiaries, Calando, a leader in delivering small interfering RNAs for gene silencing, and Ablaris, an anti-obesity therapeutics company, and has minority investments in Nanotope, a regenerative medicine company and Leonardo, a multistage drug delivery company.

The Company's principal executive offices are located at 225 South Lake Avenue, Suite 1050, Pasadena, California 91101, and its telephone number is (626) 304-3400.

Liquidity and Capital Resources

As a development stage company, Arrowhead has historically financed its operations through the sale of securities of Arrowhead and its subsidiaries. Research and development activities have required significant capital investment since the Company's inception, and are expected to continue to require significant cash investment for the foreseeable future.

At March 31, 2013, the Company had \$3.3 million in cash to fund operations. During the six months ended March 31, 2013, the Company's cash position remained relatively constant. The Company received \$7.1 million from the issuance of equity, net of fees. Other cash collections were \$1.5 million. The company had cash outflow of \$8.7 million related to its continuing operating activities.

During the six months ended March 31, 2013, cash used in operating activities was \$8.3 million, which represents the on-going expenses for research and development activities, business development, and corporate overhead. Cash expenses were partially offset by cash received from revenues and other inflows of \$0.4 million.

Cash provided by investing activities was \$1.3 million, primarily related to proceeds from the sales of investments.

Cash provided by financing activities was \$7.0 million, primarily related to cash received from the sale of Common Stock.

Recent Financing Activity:

In May 2013, the Company sold 14.3 million shares of Arrowhead common stock at a price of \$1.83 per share, and 9,900 shares of Arrowhead series B convertible preferred stock at a price of \$1,000 per share. The series B preferred stock is convertible into common stock at a conversion price of \$1.83. Gross proceeds were \$36 million.

On January 25, 2013, the Company sold 1.7 million units at a price of \$2.12 per unit in a public offering. Each unit consisted of one share of Common Stock and a warrant to purchase 0.5 share of Common Stock. The exercise price of these warrants was \$2.14 as of March 31, 2013. Gross proceeds from the offering were \$3.5 million; net proceeds were \$3.3 million after deducting commissions and other offering expenses.

On December 6, 2012, the Company sold 1.8 million units at a price of \$2.26 per unit in a public offering. Each unit consisted of one share of Common Stock and a warrant to purchase 0.5 share of Common Stock. The exercise price of these warrants was \$2.12 as of March 31, 2013. Gross proceeds from the offering were \$4.1 million; net proceeds were \$3.9 million after deducting commissions and other offering expenses.

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On August 10, 2012, the Company sold 2.3 million units at a price of \$2.76 per unit in a registered offering to institutional and individual investors. Each unit consisted of one share of Common Stock and a warrant to purchase 0.75 share of Common Stock exercisable at \$3.25 per share. Gross proceeds from the offering were approximately \$6.2 million, with net proceeds of \$5.8 million after deducting commissions and other offering expenses.

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On October 20, 2011, the Company and Lincoln Park Capital Fund, LLC, an Illinois limited liability company (LPC) entered into a \$15 million purchase agreement, together with a registration rights agreement, whereby LPC agreed to purchase up to \$15 million of Common Stock, subject to certain limitations, from time to time during the three-year term of the agreement. Additionally, the Company filed a registration statement with the U.S. Securities & Exchange Commission covering the resale of the shares that may be issued to LPC under the agreement. On January 30, 2012, the SEC declared the registration statement effective for the resale of such shares. The Company has the right, in its sole discretion, over a 36-month period to sell up to \$15 million of Common Stock (subject to certain limitations) to LPC, depending on certain conditions as set forth in the agreement. As of March 31, 2013, the Company had drawn \$1 million from the facility. The use of this facility requires a minimum share price of \$2.00, as defined in the agreement.

Although the Company has sources of liquidity, as described above, the Company anticipates that further equity financings, and/or license agreements, or other sources of revenue, will be necessary to continue to fund operations in the future.

Critical Accounting Policies and Estimates

Management makes certain judgments and uses certain estimates and assumptions when applying accounting principles generally accepted in the United States in the preparation of our Consolidated Financial Statements. We evaluate our estimates and judgments on an ongoing basis and base our estimates on historical experience and on assumptions that we believe to be reasonable under the circumstances. Our experience and assumptions form the basis for our judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results may vary from what we anticipate and different assumptions or estimates about the future could change our reported results. We believe the following accounting policies are the most critical to us, in that they are important to the portrayal of our consolidated financial statements and require our most difficult, subjective or complex judgments in the preparation of our consolidated financial statements. For further information, see *Note 1, Organization and Basis of Presentation*, to our Consolidated Financial Statements which outlines our application of significant accounting policies and new accounting standards.

Stock Compensation Expense

We recognize stock-based compensation expense based on the grant date fair value using the Black-Scholes options pricing model, which requires us to make assumptions regarding certain variables including the risk-free interest rate, expected stock price volatility, and the expected life of the award. The assumptions used in calculating stock-based compensation expense represent management's best estimates, but these estimates involve inherent uncertainties, and if factors change or the Company used different assumptions, its stock-based compensation expense could be materially different in the future.

Derivative Financial Instruments

During the normal course of business, and associated with certain equity financings, the Company may issue warrants or become party to other agreements which require the use of derivative accounting treatment under GAAP. The company does not enter into derivative contracts for speculative purposes. We account for derivatives under the provisions of ASC Topic 815, which generally requires that derivative assets and liabilities be measured at fair value each reporting period with changes in fair value reflected as a current period income or loss, unless the derivatives qualify for hedge accounting treatment. The valuation of such derivatives are made using option pricing models which require various assumptions, some of which may be subjective, including but not limited to the Company's stock price, the expected life of the instrument, a risk-free interest rate, and expected stock price volatility. Subjective assumptions are estimated by management, but other reasonable assumptions could provide differing results.

Revenue Recognition

Revenue from product sales are recorded when persuasive evidence of an arrangement exists, title has passed and delivery has occurred, a price is fixed and determinable, and collection is reasonably assured.

We may generate revenue from technology licenses, collaborative research and development arrangements, research grants and product sales. Revenue under technology licenses and collaborative agreements typically consists of nonrefundable and/or guaranteed technology license fees, collaborative research funding, and various milestone and future product royalty or profit-sharing payments.

Revenue associated with research and development funding payments under collaborative agreements is recognized ratably over the relevant periods specified in the agreement, generally the research and development period. Revenue from up-front license fees, milestones and product royalties are recognized as earned based on the completion of the milestones and product sales, as defined in the respective agreements. Payments received in advance of recognition as revenue are recorded as deferred revenue.

Table of Contents**Overview for the six months ended March 31, 2013**

During the six months ended March 31, 2013, the Company continued its research and development efforts, in particular, its focus on advancing ARC-520, its next clinical candidate for treatment of chronic hepatitis B virus (HBV). The Company has completed internal preclinical requirements and final IND-enabling steps, including GMP manufacturing and GLP toxicology, are in process.

Results of Operations

The Company had consolidated loss attributable to Arrowhead of \$11,372,095 for the six months ended March 31, 2013, compared to a consolidated loss attributable to Arrowhead of \$7,820,737 for the six months ended March 31, 2012. Details of the results of operations are presented below.

Revenue

The Company recorded revenue of \$202,766 during the six months ended March 31, 2013, as compared to \$55,208 during the six months ended March 31, 2012. The revenue in fiscal 2013 was related to three license agreements related to technology acquired through the acquisition of Roche Madison, Inc., totaling \$87,500, as well as \$115,266 in non-recurring services revenue. The revenue in fiscal 2012 was related to the two license agreements acquired through the acquisition of Roche Madison, Inc.

Operating Expenses

The analysis below details the operating expenses and discusses the expenditures of the Company within the major expense categories. The following tables provide details of operating expenses for the three and six months ended March 31, 2013 and 2012.

Salaries Three and six months ended March 31, 2013 compared to the three and six months ended March 31, 2012

The Company employs management, administrative, and scientific and technical staff at its corporate offices and its research facility. Salaries expense consists of salary and related benefits. Salary and benefits include two major categories: general and administrative compensation expense, and research and development compensation expense, depending on the primary activities of each employee. Arrowhead also manages certain general and administrative functions Leonardo and charges fees for those services. The following tables provide detail of salary and wage expenses for the three and six months ended March 31, 2013 as compared to the three and six months ended March 31, 2012.

(in thousands)

| | Three months Ended March 31, 2013 | % of Expense Category | Three months Ended March 31, 2012 | % of Expense Category | Increase (Decrease) | |
|----------------------------|---|-----------------------------|---|-----------------------------|---------------------|-------------|
| | | | | | \$ | % |
| G&A - compensation-related | \$ 785 | 46% | \$ 1,124 | 56% | \$ (339) | -30% |
| R&D - compensation-related | 940 | 54% | 893 | 44% | 47 | 5% |
| Total | \$ 1,725 | 100% | \$ 2,017 | 100% | \$ (292) | -14% |

| | Six months Ended March 31, 2013 | % of Expense Category | Six months Ended March 31, 2012 | % of Expense Category | Increase (Decrease) | |
|----------------------------|---------------------------------------|-----------------------------|---------------------------------------|-----------------------------|---------------------|-----------|
| | | | | | \$ | % |
| G&A - compensation-related | \$ 1,503 | 45% | \$ 1,717 | 51% | \$ (214) | -12% |
| R&D - compensation-related | 1,852 | 55% | 1,621 | 49% | 231 | 14% |
| Total | \$ 3,355 | 100% | \$ 3,338 | 100% | \$ 17 | 1% |

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G&A compensation expense was \$785,000 during the three months ended March 31, 2013, compared to \$1,124,000 in the comparable prior period. During the three months ended March 31, 2012, the Company recorded bonus expense of \$518,000, which was not repeated in 2013. This was somewhat offset by higher salaries on higher headcount, and lower salary allocation to non-consolidated entities. R&D compensation expense was relatively constant during the quarter ended March 31, 2013 as compared to the comparable prior period.

During the six months ended March 31, 2013, G&A compensation expense was \$1,503,000 compared to \$1,717,000 in the comparable prior period. During the six months ended March 31, 2012, the Company made bonus payments of \$350,000 and recorded a bonus accrual of \$274,000. During the first half of fiscal 2013, the Company did not pay performance bonuses, and no further bonus accrual was recorded. The decrease in bonus expense was somewhat offset by higher salary costs driven by increased headcount and salary increases, and lower salary allocation to non-consolidated entities during the six months ended March 31, 2013. The Company added two management positions in 2012, a Vice President of Program Management and a Director of Finance/Investor Relations, and the Company added one management position in 2013. R&D compensation expense increased from \$1,621,000 to \$1,852,000 due to higher R&D headcount in 2013 versus 2012.

Table of Contents**General & Administrative Expenses Three and six months ended March 31, 2013 compared to the three and six months ended March 31, 2012**

The following tables provide detail of G&A expenses for the three and six months ended March 31, 2013 as compared to the three and six months ended March 31, 2012.

(in thousands)

| | Three months | % of | Three months | % of | Increase (Decrease) | |
|-------------------------------|----------------|-------------|----------------|-------------|---------------------|-------------|
| | Ended | Expense | Ended | Expense | \$ | % |
| | March 31, 2013 | Category | March 31, 2012 | Category | | |
| Professional/outside services | \$ 322 | 41% | \$ 378 | 41% | \$ (56) | -15% |
| Patent expense | 180 | 23% | 290 | 31% | (110) | -38% |
| Facilities and related | 44 | 6% | 26 | 3% | 18 | 69% |
| Travel | 93 | 12% | 86 | 9% | 7 | 8% |
| Business insurance | 50 | 6% | 50 | 5% | | 0% |
| Communication and Technology | 51 | 7% | 57 | 6% | (6) | -11% |
| Office expenses | 19 | 2% | 20 | 2% | (1) | -5% |
| Other | 21 | 3% | 24 | 3% | (3) | -13% |
| Total | \$ 780 | 100% | \$ 931 | 100% | \$ (151) | -16% |

| | Six months | % of | Six months | % of | Increase (Decrease) | |
|-------------------------------|-----------------|-------------|-----------------|-------------|---------------------|-------------|
| | Ended | Expense | Ended | Expense | \$ | % |
| | March 31, 2013 | Category | March 31, 2012 | Category | | |
| Professional/outside services | \$ 689 | 41% | \$ 1,180 | 54% | \$ (491) | -42% |
| Patent expense | 430 | 25% | 511 | 23% | (81) | -16% |
| Facilities and related | 86 | 5% | 52 | 2% | 34 | 65% |
| Travel | 191 | 11% | 149 | 7% | 42 | 28% |
| Business insurance | 99 | 6% | 100 | 5% | (1) | -1% |
| Communication and Technology | 87 | 5% | 102 | 5% | (15) | -15% |
| Office expenses | 60 | 4% | 52 | 2% | 8 | 15% |
| Other | 56 | 3% | 52 | 2% | 4 | 8% |
| Total | \$ 1,698 | 100% | \$ 2,198 | 100% | \$ (500) | -23% |

Professional/outside services include legal, accounting, consulting and other outside services retained by the Company. All periods include normally recurring legal and audit expenses related to SEC compliance and other corporate matters. Professional/outside services expense was \$322,000 during the three months ended March 31, 2013, compared to \$378,000 in the comparable prior period. During the six months ended March 31, 2013, professional/outside services expense was \$689,000 compared to \$1,180,000 in the comparable prior period. The decrease in professional services for the six month ended March 31, 2013 primarily relates to certain fees and expenses associated with the acquisition of Roche Madison, Inc. incurred in the first quarter of fiscal 2012 which were not repeated in the current quarter.

Patent expense was \$180,000 during the three months ended March 31, 2013, compared to \$290,000 in the comparable prior period. During the six months ended March 31, 2013, patent expense was \$430,000 compared to \$511,000 in the comparable prior period. The decrease in patent-related expenses was primarily due to the nonrecurring legal costs in the prior period associated with the due diligence services on the patent portfolio of Roche Madison Inc. in association with its acquisition. The Company expects to continue to invest in patent protection as the Company extends and maintains protection for its current portfolios and files new patent applications as its product applications are improved. The cost will vary depending on the needs of the Company.

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Facilities-related expense was \$44,000 during the three months ended March 31, 2013, compared to \$26,000 in the comparable prior period. During the six months ended March 31, 2013, facilities-related expense was \$86,000 compared to \$52,000 in the comparable prior period. Facilities expense increased due to the increase of lease costs as the Company moved from a temporary lower cost location to a new corporate office in August of 2012.

Travel expense was \$93,000 during the three months ended March 31, 2013, compared to \$86,000 in the comparable prior period. During the six months ended March 31, 2013, travel expense was \$191,000 compared to \$149,000 in the comparable prior period. Travel expense increased due to travel related to fund raising efforts, investor relations meetings and business development by Company personnel. Travel expense includes expenses related to travel by Company personnel for operational business meetings at other company locations for other business initiatives and collaborations with other companies, and for marketing, investor relations, fund raising and public relations purposes. Travel expenses can fluctuate from quarter to quarter and from year to year depending on current projects and activities.

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Business insurance expense was \$50,000 during the three months ended March 31, 2013, compared to \$50,000 in the comparable prior period. During the six months ended March 31, 2013, business insurance expense was \$99,000 compared to \$100,000 in the comparable prior period.

Communication and technology expense was \$51,000 during the three months ended March 31, 2013 compared to \$57,000 in the comparable prior period. During the six months ended March 31, 2013, communication and technology expense was \$87,000 compared to \$102,000 in the comparable prior period. The decrease was related to lower software maintenance costs at our Madison facility, primarily end-user software and software maintenance on laboratory computer software.

Office expense was \$19,000 during the three months ended March 31, 2013 compared to \$20,000 in the comparable prior period. During the six months ended March 31, 2013, office expense was \$60,000 compared to \$52,000 in the comparable prior period. The increase was related to higher costs associated with the new corporate headquarters, as well as increased costs at the Madison facility.

Research and Development Expenses Three and six months ended March 31, 2013 compared to the three and six months ended March 31, 2012

R&D expenses are related to the Company's on-going research and development efforts, primarily related to its laboratory research facility in Madison, Wisconsin, and also include outsourced R&D services. The following tables provide detail of research and development expenses for the three and six months ended March 31, 2013, as compared to the three and six months ended March 31, 2012.

(in thousands)

| | Three months Ended | % of Expense Category | Three months Ended | % of Expense Category | Increase (Decrease) | |
|----------------------------------|--------------------|-----------------------|--------------------|-----------------------|---------------------|------|
| | March 31, 2013 | | March 31, 2012 | | \$ | % |
| Outside labs & contract services | \$ 345 | 16% | \$ 267 | 20% | \$ 78 | 29% |
| In vivo studies | 446 | 21% | 94 | 7% | 352 | 374% |
| Drug Manufacturing | 486 | 23% | 390 | 29% | 96 | 25% |
| Consulting | 130 | 6% | 133 | 10% | (3) | -2% |
| License, royalty & milestones | 134 | 6% | 22 | 2% | 112 | 509% |
| Laboratory supplies & services | 301 | 14% | 221 | 15% | 80 | 36% |
| Facilities and related | 173 | 8% | 198 | 15% | (25) | -13% |
| Sponsored research | 84 | 4% | 28 | 2% | 56 | 200% |
| Other research expenses | 26 | 2% | 6 | 0% | 20 | 333% |
| Total | \$ 2,125 | 100% | \$ 1,359 | 100% | \$ 766 | 56% |

| | Six months Ended | % of Expense Category | Six months Ended | % of Expense Category | Increase (Decrease) | |
|----------------------------------|------------------|-----------------------|------------------|-----------------------|---------------------|------|
| | March 31, 2013 | | March 31, 2012 | | \$ | % |
| Outside labs & contract services | \$ 628 | 17% | \$ 512 | 24% | \$ 116 | 23% |
| In vivo studies | 808 | 22% | 107 | 5% | 701 | 655% |
| Drug Manufacturing | 703 | 19% | 470 | 22% | 233 | 50% |
| Consulting | 308 | 8% | 287 | 13% | 21 | 7% |
| License, royalty & milestones | 162 | 4% | 37 | 2% | 125 | 338% |
| Laboratory supplies & services | 536 | 15% | 303 | 15% | 233 | 77% |
| Facilities and related | 364 | 10% | 330 | 16% | 34 | 10% |
| Sponsored research | 156 | 4% | 73 | 3% | 83 | 114% |
| Other research expenses | 37 | 1% | 9 | 0% | 28 | 311% |
| Total | \$ 3,702 | 100% | \$ 2,128 | 100% | \$ 1,574 | 74% |

Outside labs and contract services expense was \$345,000 during the three months ended March 31, 2013, compared to \$267,000 in the comparable prior period. During the six months ended March 31, 2013, outside labs and contract services expense was \$628,000 compared to \$512,000 in the comparable prior period. The increase was primarily related to study and analytic development costs for ARC-520, our HBV candidate.

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In vivo studies expense was \$446,000 during the three months ended March 31, 2013, compared to \$94,000 in the comparable prior year period. During the six months ended March 31, 2013, in vivo studies expense was \$808,000 compared to \$107,000 in the comparable prior period. The current period expense relates to preclinical GLP toxicology program costs related to our HBV program.

Drug manufacturing expense was \$486,000 during the three months ended March 31, 2013, compared to \$390,000 in the comparable prior year period. During the six months ended March 31, 2013, drug manufacturing expense was \$703,000 compared to \$470,000 in the comparable prior period. Drug manufacturing costs during the current quarter related to manufacturing costs for clinical supplies for the HBV program. Drug manufacturing costs in 2012 related to costs to manufacture polymer components for RONDEL. Drug manufacture costs for the HBV program will continue until the Company completes its manufacturing campaign related to supplies for the HBV clinical trial expected to begin in the summer of 2013. Additional manufacturing costs will be incurred for the HBV program as the candidate progresses to further stages of the clinical trial, and for future clinical trials based on timing of new drug candidates.

Consulting expense was \$130,000 during the three months ended March 31, 2013, compared to \$133,000 in the comparable prior period. During the six months ended March 31, 2013, consulting expense was \$308,000 compared to \$287,000 in the comparable prior period. The majority of consulting expense during the current quarter relates to clinical and regulatory consulting related to the Company's HBV program. The costs in the prior period related to clinical consulting for our cancer candidate, CALAA-01. The Company expects consulting costs related to the HBV program to accelerate over the next several quarters.

Licensing fees, royalty and milestones expense was \$134,000 during the three months ended March 31, 2013, compared to \$22,000 in the comparable prior period. During the six months ended March 31, 2013, licensing fees, royalty and milestones expense was \$162,000 compared to \$37,000 in the comparable prior period. Licensing fees, royalty and milestones expenses increased due to a nonrecurring payment of \$120,000, related to access to certain targeting technology, during the three months ended March 31, 2013.

Laboratory supplies and services expense was \$301,000 during the three months ended March 31, 2013, compared to \$221,000 in the comparable prior period. During the six months ended March 31, 2013, laboratory supplies and services expense was \$536,000 during compared to \$303,000 in the comparable prior period. Laboratory supplies are used at our Madison research facility which was acquired on October 21, 2011. During the three months ended December 31, 2011, the Madison research facility was acquired and did not include a full three months of activity, and the facility was utilizing laboratory supplies on-hand at the time of the acquisition. In addition, the Company increased research on its targeting platform obtained as part of its acquisition of Alvos in 2012.

Facilities expense was \$173,000 during the three months ended March 31, 2013, compared to \$198,000 in the comparable prior period. During the six months ended March 31, 2013, facilities expense was \$364,000 compared to \$330,000 in the comparable prior period. Facilities expenses were higher in the current quarter due to higher costs related to repairs and maintenance, while during the six months ended March 31, 2013, facilities expenses were lower due to a rent refund reflecting a favorable rent true up due to lower electricity costs incurred.

Sponsored research expense was \$84,000 during the three months ended March 31, 2013, compared to \$28,000 in the comparable prior period. During the six months ended March 31, 2013, sponsored research expense was \$156,000 during compared to \$73,000 in the comparable prior period. Sponsored research expense in both periods relates solely to work at the University of Cincinnati related to our obesity program. Such research expense is dependent upon studies undertaken, and vary based on needs of the program.

Other research expense was \$26,000 during the three months ended March 31, 2013, compared to \$6,000 in the comparable prior period. During the six months ended March 31, 2013, other research expense was \$37,000 during compared to \$9,000 in the comparable prior period. The increase primarily relates to the costs of other laboratory services.

Stock-based compensation expense

Stock-based compensation expense, a noncash expense, was \$751,000 during the six months ended March 31, 2013, compared to \$421,000 during the comparable prior period. Stock-based compensation expense is based upon the valuation of stock options granted to employees, directors, and certain consultants. Many variables affect the amount expensed, including the Company's stock price on the date of the grant, as well as other assumptions. Based on the completion of vesting of a number of stock options during the second half of fiscal 2012, compensation expense related to those awards ended. This was mostly offset by additional options granted to new and existing employees in fiscal 2012.

Depreciation and amortization expense

Depreciation and amortization expense, a noncash expense, was \$898,000 during the six months ended March 31, 2013, compared to \$878,000 during the comparable prior period. The majority of depreciation and amortization expense relates to depreciation on lab equipment and

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leasehold improvement in Madison. The increase in depreciation expense relates to newly acquired lab equipment in Madison facility with its normal depreciation.

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Other income (expense)

Other expense was \$1,520,000 during the six months ended March 31, 2013, compared to other income of \$638,000 in the comparable prior period. The primary component of other expense during the six months ended March 31, 2013 was a nonrecurring charge related to the write down of a note receivable in the amount of \$1.3 million. During the prior period, the Company recorded a gain from the acquisition of Roche Madison in the amount of \$1.6 million. Further, the loss related to change in the value of derivatives was \$689,000 in the prior period, compared to a gain of \$15,000 in the current period.

Off-Balance Sheet Arrangements

We do not have and have not had any off-balance sheet arrangements or relationships.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable.

ITEM 4. CONTROLS AND PROCEDURES

Our Chief Executive Officer and our Chief Financial Officer, after evaluating our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e)) of the Securities Exchange Act of 1934, as amended (the Exchange Act) as of the end of the period covered by this Quarterly Report on Form 10-Q (the Evaluation Date), have concluded that, as of the Evaluation Date, our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and to ensure that information required to be disclosed by us in such reports is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer where appropriate, to allow timely decisions regarding required disclosure.

No change in the Company's internal controls over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) occurred during the Company's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

From time to time, we may be involved in routine legal proceedings, as well as demands, claims and threatened litigation, which arise in the normal course of our business. We believe there is no litigation pending that could, individually or in the aggregate, have a material adverse effect on our results of operations or financial condition.

ITEM 1A. RISK FACTORS

There have been no material changes to the risk factors included in our Annual Report of Form 10-K for the year ended September 30, 2012. Please carefully consider the information set forth in this Quarterly Report on Form 10-Q and the risk factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended September 30, 2012, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K, as well as other risks and uncertainties, could materially and adversely affect our business, results of operations and financial condition, which in turn could materially and adversely affect the trading price of shares of our common stock. Additional risks not currently known or currently material to us may also harm our business.

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

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. MINE SAFETY DISCLOSURES

Not Applicable.

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ITEM 5. OTHER INFORMATION

On May 3, 2012, the Company's compensation committee approved cash bonuses to the Company's executive officers related to the prior fiscal year, including a cash bonus of \$75,000 to the Company's CEO, Chris Anzalone, a cash bonus of \$54,000 to the Company's COO, Bruce Given, and a cash bonus of \$27,500 to the Company's CFO, Ken Myszkowski.

ITEM 6. EXHIBITS

| Exhibit Number | Document Description |
|---------------------------|--|
| 31.1 | Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002* |
| 31.2 | Certification of Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002* |
| 32.1 | Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002** |
| 32.2 | Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002** |
| 101 | The following materials from Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2013, formatted in XBRL (Extensible Business Reporting Language): (1) Consolidated Balance Sheets, (2) Consolidated Statements of Operations, (3) Consolidated Statement of Stockholders' Equity, (4) Consolidated Statements of Cash Flows, and (5) Notes to Consolidated Financial Statements.** |

* Filed herewith

** Furnished herewith

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SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this Quarterly Report on Form 10-Q to be signed on its behalf by the undersigned, thereunto duly authorized.

Dated: May 9, 2013

ARROWHEAD RESEARCH CORPORATION

By: /s/ Kenneth A. Myszkowski
Kenneth A. Myszkowski
Chief Financial Officer