ALKERMES INC
Form 10-Q
November 09, 2006

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

Form 10-Q

(Mark One)

þ	**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** **For the quarterly period ended September 30, 2006**
o	**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** **For the transition period from to**

Commission file number 1-14131

ALKERMES, INC.
(Exact name of registrant as specified in its charter)

PENNSYLVANIA	**23-2472830**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*
88 Sidney Street, Cambridge, MA	**02139-4234**
(Address of principal executive offices)	*(Zip Code)*

Registrant s telephone number including area code:
(617) 494-0171

(Former name, former address, and former fiscal year, if changed since last report)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer þ Accelerated filer o Non-accelerated filer o

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

The number of shares outstanding of each of the issuer s classes of common stock was:

Class	As of November 2, 2006
Common Stock, $.01 par value	100,472,626
Non-Voting Common Stock, $.01 par value	382,632

ALKERMES, INC. AND SUBSIDIARIES

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PART 1. FINANCIAL INFORMATION

Item 1. ***Condensed Consolidated Financial Statements:***

ALKERMES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS
(unaudited)

	September 30, 2006	March 31, 2006
	(In thousands, except share and per share amounts)	
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 57,055	$ 33,578
Investments short-term	263,442	264,389
Receivables	64,284	39,802
Inventory, net	14,514	7,341
Prepaid expenses and other current assets	8,676	2,782
Total current assets	407,971	347,892
PROPERTY, PLANT AND EQUIPMENT:		
Land	301	301
Building and improvements	23,930	20,966
Furniture, fixtures and equipment	66,702	61,086
Equipment under capital lease	464	464
Leasehold improvements	46,370	45,842
Construction in progress	29,544	23,555
	167,311	152,214
Less: accumulated depreciation and amortization	(45,452)	(39,297)
Property, plant and equipment net	121,859	112,917
RESTRICTED INVESTMENTS long-term	5,144	5,145
OTHER ASSETS	9,133	11,209
TOTAL ASSETS	$ 544,107	$ 477,163
LIABILITIES, REDEEMABLE CONVERTIBLE PREFERRED STOCK AND SHAREHOLDERS EQUITY		
CURRENT LIABILITIES:		
Accounts payable and accrued expenses	$ 30,672	$ 36,141

Accrued interest	2,977	3,239
Accrued restructuring costs	858	852
Unearned milestone revenue current portion	59,861	83,338
Deferred revenue current portion	200	200
Convertible subordinated notes current portion	676	676
Long-term debt current portion	1,261	1,214
Total current liabilities	96,505	125,660
NON-RECOURSE RISPERDAL CONSTA SECURED 7% NOTES	155,218	153,653
CONVERTIBLE SUBORDINATED NOTES LONG-TERM PORTION		124,346
LONG-TERM DEBT	884	1,519
UNEARNED MILESTONE REVENUE LONG-TERM PORTION	102,751	16,198
DEFERRED REVENUE LONG-TERM PORTION	650	750
OTHER LONG-TERM LIABILITIES	6,606	6,821
TOTAL LIABILITIES	362,614	428,947
REDEEMABLE CONVERTIBLE PREFERRED STOCK, par value, $0.01 per share; authorized and issued, 1,500 shares at September 30, 2006 and March 31, 2006 (at liquidation preference)	15,000	15,000
COMMITMENTS AND CONTINGENCIES:		
SHAREHOLDERS EQUITY:		
Capital stock, par value, $0.01 per share; authorized, 4,550,000 shares (includes 2,997,000 shares of preferred stock); issued, none		
Common stock, par value, $0.01 per share; authorized, 160,000,000 shares; 101,229,825 and 91,744,680 shares issued, 100,406,148 and 91,744,680 shares outstanding at September 30, 2006 and March 31, 2006, respectively	1,012	917
Nonvoting common stock, par value, $0.01 per share; authorized 450,000 shares; issued and outstanding, 382,632 shares at September 30, 2006 and March 31, 2006	4	4
Treasury stock, at cost (823,677 and 0 shares at September 30, 2006 and March 31, 2006, respectively)	(12,492)	
Additional paid-in capital	806,432	664,596
Deferred compensation		(374)
Accumulated other comprehensive income	1,517	1,064
Accumulated deficit	(629,980)	(632,991)
TOTAL SHAREHOLDERS EQUITY	166,493	33,216
TOTAL LIABILITIES, REDEEMABLE CONVERTIBLE PREFERRED STOCK AND SHAREHOLDERS EQUITY	$ 544,107	$ 477,163

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

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ALKERMES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited)

	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Six Months Ended September 30, 2006	Six Months Ended September 30, 2005
	(In thousands, except per share amounts)			
REVENUES:				
Manufacturing revenues	$ 26,122	$ 13,526	$ 48,315	$ 27,509
Royalty revenues	5,813	4,035	10,952	7,639
Research and development revenue under collaborative arrangements	17,624	16,733	32,088	23,984
Net collaborative profit	11,611	12,394	21,353	12,394
Total revenues	61,170	46,688	112,708	71,526
EXPENSES:				
Cost of goods manufactured	11,822	4,360	21,160	8,877
Research and development	29,817	19,370	55,680	40,992
Selling, general and administrative	15,677	9,109	32,207	18,061
Total expenses	57,316	32,839	109,047	67,930
OPERATING INCOME	3,854	13,849	3,661	3,596
OTHER INCOME (EXPENSE):				
Interest income	4,734	3,019	9,069	4,650
Interest expense	(4,034)	(5,212)	(9,507)	(10,381)
Derivative loss related to convertible subordinated notes		(503)		(769)
Other (expense) income, net	(664)	599	123	919
Total other income (expense)	36	(2,097)	(315)	(5,581)
INCOME (LOSS) BEFORE INCOME TAXES	3,890	11,752	3,346	(1,985)
INCOME TAXES	164		335	
NET INCOME (LOSS)	$ 3,726	$ 11,752	$ 3,011	$ (1,985)
EARNINGS (LOSS) PER COMMON SHARE:				
BASIC	$ 0.04	$ 0.13	$ 0.03	$ (0.02)
DILUTED	$ 0.04	$ 0.12	$ 0.03	$ (0.02)
WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING:				

BASIC	101,331	90,558	97,581	90,475
DILUTED	105,543	96,599	102,536	90,475

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

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ALKERMES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)

	Six Months Ended September 30, 2006	Six Months Ended September 30, 2005
	(In thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	$ 3,011	$ (1,985)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Share-based compensation	14,718	115
Depreciation and amortization	5,767	5,183
Other non-cash charges	2,228	2,585
Derivative loss related to convertible subordinated notes		769
Gain on investments	(153)	(868)
Gain on sale of equipment	(9)	
Changes in assets and liabilities:		
Receivables	(24,482)	(5,036)
Inventory, prepaid expenses and other current assets	(12,483)	(5,095)
Accounts payable, accrued expenses and accrued interest	(5,683)	1,623
Accrued restructuring costs	(280)	(671)
Unearned milestone revenue	63,076	146,412
Deferred revenue	(100)	
Other long-term liabilities	71	214
Net cash provided by operating activities	45,681	143,246
CASH FLOWS FROM INVESTING ACTIVITIES:		
Additions to property, plant and equipment	(14,715)	(10,910)
Proceeds from the sale of equipment	15	92
Purchases of short and long-term investments	(189,668)	(514,080)
Sales and maturities of short and long-term investments	190,922	376,703
Decrease in other assets	18	53
Net cash used in investing activities	(13,428)	(148,142)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of common stock	4,304	1,796
Payment of debt	(588)	(552)
Purchase of treasury stock	(12,492)	
Net cash (used in) provided by financing activities	(8,776)	1,244

NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS		23,477		(3,652)
CASH AND CASH EQUIVALENTS Beginning of period		33,578		47,485
CASH AND CASH EQUIVALENTS End of period	$	57,055	$	43,833
SUPPLEMENTARY INFORMATION:				
Cash paid for interest	$	4,569	$	7,333
Cash paid for taxes		270		
Noncash activities:				
Conversion of 2.5% convertible subordinated notes into common stock	$	125,000	$	

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

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ALKERMES, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying condensed consolidated financial statements of Alkermes, Inc. (the Company or Alkermes) for the three and six months ended September 30, 2006 and 2005 are unaudited and have been prepared on a basis substantially consistent with the audited financial statements for the year ended March 31, 2006. In the opinion of management, the condensed consolidated financial statements include all adjustments that are necessary to present fairly the results of operations for the reported periods. The Company s condensed consolidated financial statements are prepared in conformity with accounting principles generally accepted in the United States of America (commonly referred to as GAAP).

These financial statements should be read in conjunction with the Company s audited consolidated financial statements and notes thereto which are contained in the Company s Annual Report on Form 10-K/A for the year ended March 31, 2006, filed with the Securities and Exchange Commission (SEC).

The results of the Company s operations for any interim period are not necessarily indicative of the results of the Company s operations for any other interim period or for a full fiscal year.

Principles of Consolidation The unaudited condensed consolidated financial statements include the accounts of Alkermes, Inc. and its wholly-owned subsidiaries: Alkermes Controlled Therapeutics, Inc. (ACT I); Alkermes Acquisition Corp.; Alkermes Europe, Ltd.; Advanced Inhalation Research, Inc. (AIR); and RC Royalty Sub LLC (Royalty Sub). The assets of Royalty Sub are not available to satisfy obligations of Alkermes and its subsidiaries, other than the obligations of Royalty Sub including Royalty Sub s non-recourse RISPERDAL® CONSTA® secured 7% notes (the Non-Recourse 7% Notes). Alkermes Controlled Therapeutics Inc. II (ACT II) was dissolved on July 31, 2006. Intercompany accounts and transactions have been eliminated.

Use of Estimates The preparation of the Company s unaudited condensed consolidated financial statements in conformity with GAAP necessarily requires management to make estimates and assumptions that affect the following: (1) reported amounts of assets and liabilities; (2) disclosure of contingent assets and liabilities at the date of the unaudited condensed consolidated financial statements; and (3) the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

New Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements* , which establishes a framework for measuring fair value in GAAP and expands disclosures about the use of fair value to measure assets and liabilities in interim and annual reporting periods subsequent to initial recognition. Prior to SFAS No. 157, which emphasizes that fair value is a market-based measurement and not an entity-specific measurement, there were different definitions of fair value and limited guidance for applying those definitions in GAAP. SFAS No. 157 is effective for the Company on a prospective basis for the reporting period beginning April 1, 2008. The Company is in the process of evaluating the impact of the adoption of SFAS No. 157 on its financial statements and related disclosures.

In June 2006, the FASB issued FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes* an interpretation of SFAS No. 109, *Accounting for Income Taxes* . FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in a company s financial statements and prescribes a recognition threshold and measurement process for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN No. 48 also provides guidance on derecognition,

ALKERMES, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

classification, interest and penalties, accounting in interim periods, disclosure and transition and will become effective for the Company on April 1, 2007. The Company is in the process of evaluating the impact of the adoption of FIN No. 48 on its financial statements and related disclosures.

2. COLLABORATIVE ARRANGEMENTS

In September 2006, the Company and Rensselaer Polytechnic Institute (RPI) entered into a license agreement granting the Company exclusive rights to a family of opioid receptor compounds discovered at RPI. These compounds represent an opportunity for the Company to develop therapeutics for a broad range of diseases and medical conditions, including addiction, pain and other central nervous system disorders. The Company will screen this library of compounds and plans to pursue preclinical work of an undisclosed, lead oral compound that has already been identified.

Under the terms of the agreement, RPI granted the Company an exclusive worldwide license to certain patents and patent applications relating to its compounds designed to modulate opioid receptors. The Company will be responsible for the continued research and development of any resulting product candidates. The Company paid RPI a nonrefundable upfront payment and will pay certain milestones relating to clinical development activities and royalties on products resulting from the agreement. All amounts paid to RPI under this license agreement have been expensed and are included in research and development expenses.

3. COMPREHENSIVE INCOME (LOSS)

Comprehensive income (loss) for the three and six months ended September 30, 2006 and 2005 is as follows:

	Three Months Ended September 30,		Six Months Ended September 30,	
(In thousands)	**2006**	**2005**	**2006**	**2005**
Net income (loss)	$ 3,726	$ 11,752	$ 3,011	$ (1,985)
Unrealized gain (loss) on available-for-sale investments	119	(2)	453	134
Comprehensive income (loss)	$ 3,845	$ 11,750	$ 3,464	$ (1,851)

4. EARNINGS (LOSS) PER COMMON SHARE

Basic earnings (loss) per common share is calculated based upon net income (loss) available to holders of common shares divided by the weighted average number of shares outstanding. For the calculation of diluted earnings per common share, the Company uses the weighted average number of shares outstanding, as adjusted for the effect of potential outstanding shares, including stock options, stock awards, convertible preferred stock and convertible debt. For periods during which the Company reports a net loss from operations, basic and diluted net loss per common share are equal since the impact of potential common shares would have an anti-dilutive effect.

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ALKERMES, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Basic and diluted earnings (loss) per common share are calculated as follows:

(In thousands)	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Six Months Ended September 30, 2006	Six Months Ended September 30, 2005
Numerator:				
Net income (loss)	$ 3,726	$ 11,752	$ 3,011	$ (1,985)
Denominator:				
Weighted average number of common shares outstanding	101,331	90,558	97,581	90,475
Effect of dilutive securities:				
Stock options	3,086	3,674	4,105	
Restricted stock awards	312	81	220	
Redeemable convertible preferred stock	814	2,286	630	
Dilutive common share equivalents	4,212	6,041	4,955	
Shares used in calculating diluted earnings (loss) per common share	105,543	96,599	102,536	90,475

The following amounts were not included in the calculation of net income (loss) per common share because their effects were anti-dilutive:

(In thousands)	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Six Months Ended September 30, 2006	Six Months Ended September 30, 2005
Numerator:				
Adjustment for interest	$ 4	$ 787	$ 1,235	$ 1,574
Adjustment for derivative loss		503		769
Total	$ 4	$ 1,290	$ 1,235	$ 2,343
Denominator:				
Stock options				17,610
Restricted stock awards				81
Redeemable convertible preferred stock				2,835

2.5% convertible subordinated notes		9,025	3,699	9,025
3.75% convertible subordinated notes	10	10	10	10
Total	10	9,035	3,709	29,561

ALKERMES, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. INVENTORY, NET

Inventory, net was stated at the lower of cost or market value. Cost was determined using the first-in, first-out method. Inventory, net consisted of the following:

(In thousands)	September 30, 2006	March 31, 2006
Raw materials	$ 4,317	$ 3,757
Work in process	5,728	2,083
Finished goods	4,469	1,501
Total(1)	$ 14,514	$ 7,341

(1) Net of allowances for inventory losses of $1.0 million and $0.8 million as of September 30, 2006 and March 31, 2006, respectively.

6. CONVERTIBLE SUBORDINATED NOTES

2.5% Convertible Subordinated Notes On June 15, 2006, the Company converted all of the outstanding $125.0 million principal amount of the 2.5% convertible subordinated notes due 2023 (the 2.5% Subordinated Notes) into 9,025,271 shares of the Company s common stock. In connection with the conversion, the Company paid approximately $0.6 million in cash to satisfy a three-year interest make-whole provision in the note indenture. None of the 2.5% Subordinated Notes were outstanding as of September 30, 2006, and no gain or loss was recorded on the conversion of the 2.5% Subordinated Notes, which was executed in accordance with the underlying indenture.

7. RESTRUCTURING

In connection with the 2004 restructuring program, in which the Company and Genentech, Inc. announced the decision to discontinue commercialization of NUTROPIN DEPOT® (the 2004 Restructuring), the Company recorded net restructuring charges of approximately $11.5 million in the year ended March 31, 2005. As of September 30, 2006, the Company had paid in cash or written off an aggregate of approximately $9.3 million in facility closure costs and $0.1 million in employee separation costs in connection with the 2004 Restructuring. The amounts remaining in the restructuring accrual as of September 30, 2006 are expected to be paid out through fiscal 2009 and relate primarily to estimates of lease costs associated with the exited facility.

The following table displays the restructuring activity during the six months ended September 30, 2006:

	Balance March 31,		Balance September 30,

(In thousands)	2006	Payments	2006
Employee separation	$ 9	$	$ 9
Facility closure	2,359	(280)	2,079
Total	$ 2,368	$ (280)	$ 2,088

8. REDEEMABLE CONVERTIBLE PREFERRED STOCK

In December 2002, the Company and Lilly expanded the collaboration for the development of inhaled formulations of insulin and hGH based on the Company s AIR® pulmonary drug delivery technology. In connection with the expansion, Lilly purchased $30.0 million of the Company s newly issued 2002 redeemable convertible preferred stock, $0.01 par value per share (the Preferred Stock), in accordance with a stock purchase agreement dated December 13, 2002 (the Stock Purchase Agreement). The Preferred Stock has a

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

liquidation preference of $10,000 per share and no dividends are payable by the Company on these securities. Lilly has the right to return the Preferred Stock in exchange for a reduction in the royalties payable to the Company on sales of the AIR insulin product, if approved. The Preferred Stock is convertible into the Company s common stock at market price under certain conditions at the Company s option, and automatically upon the filing of a NDA with the Food and Drug Administration (FDA) for an AIR insulin product.

Under the expanded collaboration, the royalties payable to the Company on sales of the AIR insulin product were increased. The Company agreed to use the proceeds from the issuance of the Preferred Stock primarily to fund the AIR insulin development program and to use a portion of the proceeds to fund the AIR hGH development program. The Company did not record research and development revenue on these programs while the proceeds from the Preferred Stock funded this development. The $30.0 million of research and development expended by the Company was recognized as research and development expense as incurred. All of the proceeds from the sale of the Preferred Stock had been spent through fiscal year 2005.

The Preferred Stock is carried on the condensed consolidated balance sheets at its estimated fair value in the amount of $15.0 million as of September 30, 2006 and March 31, 2006. In October 2005, the Company converted 1,500 shares of the Preferred Stock with a carrying value of $15.0 million into 823,677 shares of Company common stock. The conversion secured a proportionate increase in the minimum royalty rate payable to the Company on sales by Lilly of the AIR insulin product, if approved.

Because Lilly has a put right and the Preferred Stock can be returned in circumstances outside of the Company s control, the Company accounted for the initial issuance of the Preferred Stock as an equity instrument in temporary equity at its initial issuance and conversion value. The Preferred Stock remains in temporary equity until such time as the put right is exercised, no longer has economic effect or becomes unexercisable as a result of a conversion or redemption. The Company re-evaluates the carrying value of the Preferred Stock on a quarterly basis to determine if the fair value is different than its current carrying value. As of September 30, 2006, the Company has determined that the fair value of the Preferred Stock has not changed from its initial issuance amount, other than the change due to the exercise of its conversion right in October 2005, which converted $15.0 million of the Preferred Stock into an equivalent amount of Company common stock.

The Company considers its agreements with Lilly for the development of inhaled formulations of insulin and the Stock Purchase Agreement a single arrangement (the Arrangement). As the Arrangement contains elements of funded research and development activities, the Company determined that the Arrangement should be accounted for as a financing arrangement under SFAS No. 68, *Research and Development Arrangements.*

Under the Arrangement, the Company reserves the right to call, subject to Lilly s approval, the Preferred Stock and Lilly reserves the right to put the Preferred Stock. In both instances, the Preferred Stock would be returned to the Company and Lilly s rights would be limited to the services required to be performed by the Company under the Arrangement. Accordingly, if and when either the call or put are exercised and the Preferred Stock is returned to the Company, or Lilly s put rights expire in December 2008, at that time the Preferred Stock will be reclassified to shareholders equity at its carrying value.

9. SHAREHOLDERS EQUITY

In June 2006, the Company converted all of its outstanding 2.5% Subordinated Notes into 9,025,271 shares of the Company s common stock (see Note 6).

In September 2005, the Company s Board of Directors authorized a share repurchase program up to $15.0 million of common stock to be repurchased in the open market or through privately negotiated transactions. The repurchase program has no set expiration date and may be suspended or discontinued at any

ALKERMES, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

time. During the six months ended September 30, 2006 and since September 2005, the Company had repurchased 823,677 shares at a cost of approximately $12.5 million under the program.

10. SHARE-BASED COMPENSATION

Effective April 1, 2006, the Company adopted the provisions of SFAS No. 123(R), *Share-Based Payment* (SFAS No. 123(R)) which is a revision of SFAS No. 123 *Accounting for Stock-Based Compensation* and supersedes accounting principles board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees* (APB No. 25). Under the provisions of SFAS No. 123(R), share-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as an expense over the employee s requisite service period (generally the vesting period of the equity grant).

Prior to April 1, 2006, the Company accounted for share-based compensation to employees in accordance with APB No. 25 and related interpretations, and the Company also followed the disclosure requirements of SFAS No. 123.

The Company has elected to adopt the provisions of SFAS No. 123(R) using the modified prospective transition method, and recognizes share-based compensation cost on a straight-line basis over the requisite service periods of awards. Under the modified prospective transition method, share-based compensation expense is recognized for the portion of outstanding stock options and stock awards granted prior to the adoption of SFAS No. 123(R) for which service has not been rendered, and for any future grants of stock options and stock awards. The Company recognizes share-based compensation cost for awards that have graded vesting on a straight-line basis over the requisite service period of each separately vesting portion.

The following table presents share-based compensation expense for continuing operations included in the Company s unaudited condensed consolidated statements of operations:

(In thousands)	Three Months Ended September 30, 2006	Six Months Ended September 30, 2006
Cost of goods manufactured	$ 903	$ 1,163
Research and development	2,232	5,068
Selling, general and administrative	3,236	8,487
Total share-based compensation expense	$ 6,371	$ 14,718

As of September 30, 2006, $0.6 million of share-based compensation cost was capitalized and recorded under the caption, Inventory, net in the unaudited condensed consolidated balance sheet.

The Company estimates the fair value of stock options on the grant date using the Black-Scholes option-pricing model. Assumptions used to estimate the fair value of stock options are the expected option term, expected volatility of the Company s common stock over the option s expected term, the risk-free interest rate over the option s expected term and the Company s expected annual dividend yield. The Company believes that the valuation technique and the approach utilized to develop the underlying assumptions are appropriate in calculating the fair values of the Company s stock options granted in the three and six months ended September 30, 2006. Estimates of fair value may not represent actual future events or the value to be ultimately realized by persons who receive equity awards.

The Company used historical data as the basis for estimating option terms and forfeitures. Separate groups of employees that have similar historical stock option exercise and forfeiture behavior were considered separately for valuation purposes. The ranges of expected terms disclosed below reflect different expected behavior among certain groups of employees. Expected stock volatility factors were based on a weighted average of implied volatilities from traded options on the Company s common stock and historical stock price

ALKERMES, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

volatility of the Company s common stock, which was determined based on a review of the weighted average of historical weekly price changes of the Company s common stock. The risk-free interest rate for periods commensurate with the expected term of the share option was based on the United States (U.S.) treasury yield curve in effect at the time of grant. The dividend yield on the Company s common stock was estimated to be zero as the Company does not issue dividends. The exercise price of option grants equals the average of the high and low of the Company s common stock traded on the NASDAQ National Market on the date of grant.

During the three and six months ended September 30, 2006, the fair value of each stock option grant was estimated on the grant date with the following assumptions:

	Three Months Ended September 30, 2006	Six Months Ended September 30, 2006
Expected option term	4 -5 years	4 -5 years
Expected stock volatility	50%	50%
Risk-free interest rate	4.75% - 5.07%	4.75% - 5.07%
Expected annual dividend yield		

Upon adoption of SFAS No. 123(R), the Company recognized a benefit of approximately $0.02 million as a cumulative effect of a change in accounting principle resulting from the requirement to estimate forfeitures on the Company s restricted stock awards at the date of grant under SFAS No. 123(R) rather than recognizing forfeitures as incurred under APB No. 25. An estimated forfeiture rate was applied to previously recorded compensation expense for the Company s unvested restricted stock awards to determine the cumulative effect of a change in accounting principle. The cumulative benefit, net of tax, was immaterial for separate presentation in the unaudited condensed consolidated statement of operations and was included in operating income in the quarter ended June 30, 2006.

The Company had previously adopted the provisions of SFAS No. 123, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure* through disclosure only. The following table illustrates the effects on net income (loss) and earnings (loss) per common share, basic and diluted, for the three and six months ended September 30, 2005 as if the Company had applied the fair value recognition provisions of SFAS No. 123 to share-based employee awards.

(In thousands, except per share amounts)	**Three Months Ended September 30, 2005**	**Six Months Ended September 30, 2005**
Net income (loss) as reported	$ 11,752	$ (1,985)
	57	115

Add: employee share-based compensation expense as reported in the unaudited condensed consolidated statement of operations				
Deduct: employee share-based compensation expense determined under the fair-value method for all options and awards		(5,298)		(11,111)
Net income (loss) pro-forma	$	6,511	$	(12,981)
Reported earnings (loss) per common share:				
Basic	$	0.13	$	(0.02)
Diluted	$	0.12	$	(0.02)
Pro-forma earnings (loss) per common share:				
Basic	$	0.07	$	(0.14)
Diluted	$	0.07	$	(0.14)

ALKERMES, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The fair value of each option grant was estimated on the grant date using the Black-Scholes option pricing model with the following assumptions:

	Three Months Ended September 30, 2005	Six Months Ended September 30, 2005
Expected option term	4 years	4 years
Expected stock volatility	52%	53%
Risk-free interest rate	4.18%	3.95%
Expected annual dividend yield		

Stock Options and Award Plans

The Company s stock option plans (the Plans) provide for issuance of nonqualified and incentive stock options to employees, officers and directors of, and consultants to, the Company. Stock options generally expire ten years from the grant date and generally vest ratably over a four-year period, except for grants to the non-employee directors and part-time employee directors, which vest over six months. The exercise price of stock options granted under the Plans may not be less than 100% of the fair market value of the common stock on the date of grant. The measurement date for accounting purposes is the date that all elements of the grant are fixed and notification of the grant is made to recipients within a reasonable time. Under the terms of one plan, the option exercise price may be below the fair market value, but not below par value, of the underlying stock at the time the option is granted.

The Compensation Committee of the Board of Directors is responsible for administering the Company s equity plans other than the non-employee director stock plans. The Limited Compensation Sub-Committee has the authority to make individual grants of options under certain of the Company s stock option plans to purchase shares of common stock to employees of the Company who are not subject to the reporting requirements of the Securities Exchange Act. The Limited Compensation Sub-Committee has generally approved new hire employee stock option grants of up to the limit of its authority. Until July 2006, such authority was limited to 5,000 shares per individual grant. In July 2006, this limit was raised by the Compensation Committee to 25,000 shares per individual grant and limited to employees who are not subject to the reporting requirements of the Securities Exchange Act and below the level of Vice President of the Company.

The Compensation Committee has established procedures for the grant of options to new employees. The Limited Compensation