NovaBay Pharmaceuticals, Inc.
Form 10-Q
August 07, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2018

OR

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

For the transition period from ______________ to ______________

Commission File Number: 001-33678

NOVABAY PHARMACEUTICALS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**68-0454536**

(State or other jurisdiction of incorporation or organization) **(I.R.S. Employer Identification No.)**

2000 Powell Street, Suite 1150, Emeryville, CA 94608

(Address of principal executive offices) (Zip Code)

Registrant's Telephone Number, Including Area Code: (510) 899-8800

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 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, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer	Accelerated filer	Emerging growth company
Non-accelerated filer (Do not check if a smaller reporting company)	Smaller reporting company	

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

As of August 3, 2018, there were 17,089,304 shares of the registrant's common stock outstanding.

NOVABAY PHARMACEUTICALS, INC.

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Unless the context requires otherwise, all references in this report to “we,” “our,” “us,” the “Company” and “NovaBay” refer to NovaBay Pharmaceuticals, Inc.

NovaBay®, NovaBay Pharma®, Avenova®, NeutroPhase®, CelleRx®, intelli-Case™, AgaNase®, Aganocide®, AgaDerm®, Neutrox® and Going Beyond Antibiotics® are trademarks of NovaBay Pharmaceuticals, Inc. All other trademarks and trade names are the property of their respective owners.

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PART I

FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

NOVABAY PHARMACEUTICALS, INC.

CONSOLIDATED BALANCE SHEETS

(In thousands, except par value amounts)

	June 30, 2018 (Unaudited)	**December 31, 2017** See Note 2
ASSETS		
Current assets:		
Cash and cash equivalents	$ 6,833	$ 3,199
Accounts receivable, net of allowance for doubtful accounts ($11 and $13 at June 30, 2018 and December 31, 2017, respectively)	2,024	3,629
Inventory, net of allowance for excess and obsolete inventory and lower of cost or estimated net realizable value adjustments of $138 and $140 at June 30, 2018 and December 31, 2017, respectively	317	504
Prepaid expenses and other current assets	1,598	1,663
Total current assets	10,772	8,995
Property and equipment, net	351	471
Other assets	582	613
TOTAL ASSETS	$ 11,705	$ 10,079
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Current liabilities:		
Accounts payable	$ 329	$ 466
Accrued liabilities	2,665	1,672
Deferred revenue	62	2,841
Total current liabilities	3,056	4,979

Deferred revenues - non-current	-	534
Deferred rent	237	286
Warrant liability	785	1,489
Other liabilities	198	197
Total liabilities	4,276	7,485
Stockholders' equity:		
Preferred stock: 5,000 shares authorized; none outstanding at June 30, 2018 and December 31, 2017	—	—
Common stock, $0.01 par value; 50,000 and 240,000 shares authorized at June 30, 2018 and December 31, 2017, respectively; 17,089 and 15,385 shares issued and outstanding at June 30, 2018 and December 31, 2017, respectively	171	154
Additional paid-in capital	119,433	113,514
Accumulated deficit	(112,175)	(111,074)
Total stockholders' equity	7,429	2,594
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 11,705	$ 10,079

As the Company adopted the requirements of Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606) as of January 1, 2018,* using the modified retrospective method, there is a lack of comparability to the prior periods presented. See Note 8.

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

NOVABAY PHARMACEUTICALS, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS

(Unaudited)

(In thousands, except per share data)

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2018	2017	2018	2017
Sales:				
Product revenue, net	$2,794	$4,094	$5,728	$7,788
Other revenue, net	-	28	13	35
Total net sales	2,794	4,122	5,741	7,823
Product cost of goods sold	479	698	730	1,286
Gross profit	2,315	3,424	5,011	6,537
Research and development	61	70	107	132
Sales and marketing	2,977	3,376	6,373	7,116
General and administrative	1,360	1,735	2,982	4,823
Total operating expenses	4,398	5,181	9,462	12,071
Operating Loss	(2,083)	(1,757)	(4,451)	(5,534)
Non-cash gain (loss) on changes in fair value of warrant liability	490	15	704	(220)
Other income (expense), net	5	4	9	6
Loss before provision for income taxes	(1,588)	(1,738)	(3,738)	(5,748)
Provision for income tax	(1)	-	(1)	(1)
Net loss and comprehensive loss	$(1,589)	$(1,738)	$(3,739)	$(5,749)
Net loss per share attributable to common stockholders, basic	$(0.09)	$(0.11)	$(0.22)	$(0.38)
Net loss per share attributable to common stockholders, diluted	$(0.12)	$(0.11)	$(0.26)	$(0.38)
Weighted-average shares of common stock outstanding used in computing net loss per share of common stock				
Basic	17,089	15,308	16,750	15,296
Diluted	17,292	15,308	16,985	15,296

As the Company adopted the requirements of Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606) as of January 1, 2018,* using the modified retrospective method, there is a lack of comparability to the prior periods presented. See Note 8.

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

NOVABAY PHARMACEUTICALS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(In thousands)

	Six Months Ended June 30,	
	2018	**2017**
Operating activities:		
Net loss	$(3,739)	$(5,749)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	127	36
Stock-based compensation expense for options and stock issued to employees and directors	250	1,600
Stock-based compensation expense for options and stock issued to non-employees	13	89
Stock option modification expense	77	-
Non-cash (gain) loss on change in fair value of warrant liability	(704)	220
Changes in operating assets and liabilities:		
Decrease (Increase) in Accounts receivable	2,134	(1,480)
Decrease in Inventory	160	200
Decrease in Prepaid expenses and other assets	64	1,004
Decrease (Increase) in Other assets long-term	33	(101)
(Decrease) Increase in Accounts payable and accrued liabilities	(327)	390
(Decrease) Increase in Deferred rent	(32)	48
Increase (Decrease) in Deferred revenue	(13)	118
Net cash used in operating activities	(1,957)	(3,625)
Investing activities:		
Purchases of property and equipment	(5)	(155)
Net cash used in investing activities	(5)	(155)
Financing activities:		
Proceeds from common stock issuances, net	5,585	-
Proceeds from exercise of options, net	11	-
Proceeds from stock options & RSUs for taxes	1	-
Settlement of restricted stock for tax withholding	-	(48)
Exercise of warrants, net	-	38
Net cash provided by (used in) financing activities	**5,597**	(10)
Net increase (decrease) in cash and cash equivalents	**3,635**	**(3,790)**
Cash, cash equivalents and restricted cash, beginning of period	3,673	9,986
Cash, cash equivalents and restricted cash, end of period	**7,308**	**6,196**

	Six Months Ended June 30,	
	2018	2017
Supplemental disclosure of non cash information		
Cumulative effect of adoption of new accounting standard	$2,638	$-
Stock issued to consultants for services, included in accounts payable and accrued liabilities	$-	$1
Fixed asset purchases, included in accounts payable and accrued liabilities	$1	$(28)
Severance paid in RSUs to non-employee	$-	$69
Equity transferred to warrant liability	$-	$58
Proceeds from stock options and restricted stock for taxes, in accounts payable and accrued liabilities	$1	$-

As the Company adopted the requirements of Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606) as of January 1, 2018,* using the modified retrospective method, there is a lack of comparability to the prior periods presented. See Note 8.

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

NOTE 1. ORGANIZATION

NovaBay Pharmaceuticals, Inc. is a biopharmaceutical company focusing on commercializing and developing its non-antibiotic anti-infective products to address the unmet therapeutic needs of the global, topical anti-infective market with its two distinct product categories: the NEUTROX® family of products and the AGANOCIDE® compounds. The Neutrox family of products includes AVENOVA® for the eye care market, NEUTROPHASE® for wound care market, and CELLERX® for the aesthetic dermatology market. The Aganocide compounds, still under development, have target applications in the dermatology and urology markets.

The Company was incorporated under the laws of the State of California on January 19, 2000, as NovaCal Pharmaceuticals, Inc. It had no operations until July 1, 2002, on which date it acquired all of the operating assets of NovaCal Pharmaceuticals, LLC, a California limited liability company. In February 2007, it changed its name from NovaCal Pharmaceuticals, Inc. to NovaBay Pharmaceuticals, Inc. In June 2010, the Company changed the state in which it is incorporated (the “Reincorporation”) and is now incorporated under the laws of the State of Delaware. All references to “the Company” herein refer to the California corporation prior to the date of the Reincorporation and to the Delaware corporation on and after the date of the Reincorporation. The Company has minimized research and development and is now focused primarily on commercializing prescription Avenova for the domestic eyecare market.

Effective December 18, 2015, the Company effected a 1-for-25 reverse split of its outstanding common stock (the “Reverse Stock Split”) (See Note 11). The accompanying financial statements and related notes give retroactive effect to the Reverse Stock Split.

Liquidity

Based primarily on the funds available at June 30, 2018, the Company believes these resources will be sufficient to fund its operations into April 2019. The Company has sustained operating losses for the majority of its corporate history and expects that its 2018 expenses will exceed its 2018 revenues, as the Company continues to re-invest in its Avenova commercialization efforts. The Company expects to continue incurring operating losses and negative cash flows until revenues reach a level sufficient to support ongoing growth and operations. Accordingly, the Company’s planned operations raise substantial doubt about its ability to continue as a going concern. The Company’s liquidity needs will be largely determined by the success of operations in regard to the commercialization of Avenova. The Company also may consider other plans to fund operations including: (1) out-licensing rights to certain of its products or product candidates, pursuant to which the Company would receive cash milestones or an upfront fee; (2) raising additional capital through debt and equity financings or from other sources; (3) reducing spending on one or more of its sales and marketing programs; and/or (4) restructuring operations to change its overhead structure. The Company may issue securities, including common stock and warrants through private placement transactions or registered

public offerings, which would require the filing of a Form S-1 or Form S-3 registration statement with the Securities and Exchange Commission ("SEC"). An extended delay or cessation of the Company's continuing product development efforts will have a material adverse effect on the Company's financial condition and results of operations. In the absence of the Company's completion of one or more of such transactions, there will be substantial doubt about the Company's ability to continue as a going concern within one year after the date these financial statements are issued, and the Company will be required to scale back or terminate operations and/or seek protection under applicable bankruptcy laws. The accompanying financial statements have been prepared assuming the Company will continue to operate as a going concern, which contemplates the realization of assets and the settlement of liabilities in the normal course of business. The consolidated financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts of liabilities that may result from uncertainty related to its ability to continue as a going concern.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States ("U.S. GAAP") and are expressed in U.S. dollars.

Reclassifications

Prior period amounts in the accompanying consolidated balance sheets have been reclassified to conform to current period presentation. Prior period amounts in the accompanying consolidated statements of operations and comprehensive loss have also been reclassified to conform to current period presentation. The reclassifications did not change the net loss or loss per share.

Additionally, prior period amounts in the accompanying consolidated statements of cash flow have also been reclassified to conform to current period presentation. The reclassifications did not change net cash used in operating activities, net cash used in investing activities, or net cash provided by financing activities.

Use of Estimates

The preparation of financial statements in accordance with U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. These estimates include useful lives for property and equipment and related depreciation calculations, estimated amortization periods for payments received from product development and license agreements as they relate to revenue recognition, assumptions for valuing options and warrants, and income taxes. Actual results could differ from those estimates.

Unaudited Interim Financial Information

The accompanying interim condensed consolidated financial statements and related disclosures are unaudited, have been prepared on the same basis as the annual consolidated financial statements and, in the opinion of management, reflect all adjustments, which include only normal recurring adjustments, necessary for a fair statement of the results of operations for the periods presented.

The year-end condensed consolidated balance sheet data was derived from audited financial statements but does not include all disclosures required by U.S. GAAP. The condensed consolidated results of operations for any interim period are not necessarily indicative of the results to be expected for the full year or for any other future year or interim period.

Cash, Cash Equivalents, and Restricted Cash

The Company considers all highly-liquid instruments with a stated maturity of three months or less at the date of purchase to be cash equivalents. Cash and cash equivalents are stated at cost, which approximates fair value. As of June 30, 2018, and December 31, 2017, the Company’s cash and cash equivalents were held in two highly-rated, major financial institutions in the United States.

Beginning fiscal 2018, the Company adopted Accounting Standards Update ("ASU") No. 2016-18, *Statement of Cash Flows (Topic 230): Restricted Cash*, which requires the statement of cash flows to explain the change during the period relating to total cash, cash equivalents, and restricted cash. The Company adopted this standard using the retrospective transition method by restating its consolidated statements of cash flows to include restricted cash of $474 thousand in beginning and ending cash, cash equivalents, and restricted cash for the period ended December 31, 2017, and $475 thousand in the beginning and ending cash, cash equivalents, and restricted cash balances for the period ended June 30, 2018. Net cash flows for the six months ended June 30, 2018 and 2017, did not change as a result of including restricted cash with cash and cash equivalents when reconciling the beginning-of-period and end-of-period amounts presented on the statements of cash flows.

The following table provides a reconciliation of the cash, cash equivalents, and restricted cash reported in the consolidated balance sheet that sum to the total of the same reported in the consolidated statement of cash flows:

	June 30,	**December 31,**
	2018	**2017**
Cash and cash equivalents	$6,833	$ 3,199
Restricted cash included in Other assets	475	474
Total cash, cash equivalents, and restricted cash in the statement of cash flows	$7,308	$ 3,673

The restricted cash amount included in Other assets on the consolidated balance sheet represents amounts held as certificate of deposit for long-term financing and lease arrangements as contractually required by our financial institution and landlord.

Concentrations of Credit Risk and Major Partners

Financial instruments that potentially subject us to significant concentrations of credit risk consist primarily of cash and cash equivalents. The Company maintains deposits of cash and cash equivalents with two highly-rated, major financial institutions in the United States.

Deposits in these banks may exceed the amount of federal insurance provided on such deposits. The Company does not believe it is exposed to significant credit risk due to the financial position of the financial institutions in which these deposits are held.

During the six months ended June 30, 2018 and 2017, revenues were derived primarily from sales of Avenova directly to doctors through the Company's webstore and to three major distribution partners.

During the six months ended June 30, 2018 and 2017, revenues from our major distribution partners greater than 10% were as follows:

Major distribution or collaboration partner	Three Months Ended June 30, 2018	Three Months Ended June 30, 2017	Six Months Ended June 30, 2018	Six Months Ended June 30, 2017
Distributor A	21%	23 %	21%	23 %
Distributor B	23%	25 %	24%	25 %
Distributor C	24%	18 %	25%	20 %
Collaborator D	10%	*	10%	*

***Not greater than 10%**

As of June 30, 2018 and December 31, 2017, accounts receivable from our major distribution or collaboration partners greater than 10% were as follows:

Major distribution or collaboration partner	June 30, 2018	December 31, 2017
Distributor A	26 %	25 %
Distributor B	33 %	23 %
Distributor C	24 %	22 %
Collaborator D	*	20 %

***Not greater than 10%**

The Company relies on two contract sole source manufacturers to produce its finished goods. The Company does not have any manufacturing facilities and intends to continue to rely on third parties for the supply of finished goods. Third party manufacturers may not be able to meet the Company's needs with respect to timing, quantity or quality.

Fair Value of Financial Assets and Liabilities

Financial instruments, including cash, cash equivalents and restricted cash, accounts receivable, accounts payable and accrued liabilities are carried at cost, which management believes approximates fair value due to the short-term nature of these instruments. Our warrant liability is carried at fair value.

The Company measures the fair value of financial assets and liabilities based on U.S. GAAP guidance, which defines fair value, establishes a framework for measuring fair value, and requires disclosures about fair value measurements.

Under U.S. GAAP, fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. A fair value hierarchy is also established, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. There are three levels of inputs that may be used to measure fair value:

Level 1 – quoted prices in active markets for identical assets or liabilities;

Level 2 – quoted prices for similar assets and liabilities in active markets or inputs that are observable; and

Level 3 – inputs that are unobservable (for example, cash flow modeling inputs based on assumptions).

Allowance for Doubtful Accounts

The Company charges bad debt expense and records an allowance for doubtful accounts when management believes it to be unlikely that specific invoices will be collected. Management identifies amounts due that are in dispute and it believes are unlikely to be collected. As of June 30, 2018 and December 31, 2017, management reserved $11 thousand and $13 thousand, respectively, primarily based on specific amounts that were in dispute or were over 120 days past due.

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Inventory

Inventory is comprised of (1) raw materials and supplies, such as bottles, packaging materials, labels, boxes, and pumps; (2) goods in progress, which are normally unlabeled bottles; and (3) finished goods. We utilize contract manufacturers to produce our products and the cost associated with manufacturing is included in inventory. At June 30, 2018 and December 31, 2017, management had recorded an allowance for excess and obsolete inventory and lower of cost or estimated net realizable value adjustments of $138 thousand and $140 thousand, respectively.

Inventory is stated at the lower of cost or estimated net realizable value determined by the first-in, first-out method.

Property and Equipment

Property and equipment are stated at cost, less accumulated depreciation and amortization. Depreciation is calculated using the straight-line method over the estimated useful lives of the related assets of five to seven years for office and laboratory equipment, three years for computer equipment and software and seven years for furniture and fixtures. Leasehold improvements are amortized over the shorter of seven years or the lease term.

The costs of normal maintenance, repairs, and minor replacements are charged to operations when incurred.

Impairment of Long-Lived Assets

The Company accounts for long-lived assets in accordance with U.S. GAAP, which requires that companies consider whether events or changes in facts and circumstances, both internally and externally, may indicate that an impairment of long-lived assets held for use are present. Management periodically evaluates the carrying value of long-lived assets. There were no impairment charges during the six months ended June 30, 2018 and June 30, 2017. Determination of recoverability is based on an estimate of undiscounted future cash flows resulting from the use of the asset and its eventual disposition. In the event that such cash flows are not expected to be sufficient to recover the carrying amount of the asset, the assets are written down to their estimated fair values and the loss is recognized in the statements of operations.

Comprehensive Income (Loss)

Accounting Standards Codification ("ASC") 220, *Comprehensive Income* requires that an entity's change in equity or net assets during a period from transactions and other events from non-owner sources be reported. The Company reports unrealized gains and losses on its available-for-sale securities as other comprehensive income (loss).

Revenue Recognition

Beginning January 1, 2018, the Company has followed the provisions of ASC Topic 606, *Revenue from Contracts with Customers*. The guidance provides a unified model to determine how revenue is recognized.

The Company generates product revenue through product sales to its major distribution partners, a limited number of other distributors and via its webstore. Product supply is the only performance obligation contained in these arrangements, and the Company recognizes product revenue upon transfer of control to its major distribution partners at the amount of consideration that the Company expects to be entitled to, generally upon shipment to the distributor on a "sell-in" basis.

Other revenue is primarily generated through commercial partner agreements with strategic partners for the development and commercialization of the Company's product candidates. The terms of the agreements typically include more than one performance obligation and generally contain non-refundable upfront fees, payments based upon achievement of certain milestones and royalties on net product sales.

In determining the appropriate amount of revenue to be recognized as it fulfills its obligations under its agreements, the Company performs the following steps: (i) identification of the promised goods or services in the contract; (ii) determination of whether the promised goods or services are performance obligations including whether they are distinct in the context of the contract; (iii) measurement of the transaction price, including the constraint on variable consideration; (iv) allocation of the transaction price to the performance obligations based on estimated selling prices; and (v) recognition of revenue when (or as) the Company satisfies each performance obligation.

Performance Obligations

A performance obligation is a promise in a contract to transfer a distinct good or service to the customer and is the unit of account in ASC Topic 606. The Company's performance obligations include:

- Product supply
- Exclusive distribution rights in the product territory
- Regulatory submission and approval services
- Development services
- Sample supply
- Incremental discounts and product supply prepayments considered material rights to the customer

The Company has optional additional items in contracts, which are considered marketing offers and are accounted for as separate contracts when the customer elects such options. Arrangements that include a promise for future commercial product supply and optional research and development services at the customer's or the Company's discretion are generally considered options. The Company assesses if these options provide a material right to the licensee and if so, such material rights are accounted for as separate performance obligations.

Transaction Price

The Company has both fixed and variable consideration. Under the Company's license arrangements, non-refundable upfront fees are considered fixed, while milestone payments are identified as variable consideration when determining the transaction price. Product supply selling prices are identified as variable consideration subject to the constraint on variable consideration for estimated discounts, rebates, chargebacks and product returns. Funding of research and development activities are considered variable payments until such costs are reimbursed, at which point they are considered fixed. The Company allocates the total transaction price to each performance obligation based on the relative estimated standalone selling prices of the promised goods or services for each performance obligation.

For product supply under the Company's distribution arrangements, contract liabilities are recorded for invoiced amounts that are subject to significant reversal, including product revenue allowances for cash consideration paid to customers for services, discounts, rebate programs, chargebacks, and product returns. Because the Company doesn't have sufficient historical data to compute its own return rate, the return rate used to estimate the constraint on variable consideration for product returns is based on an average of peer and competitor company historical return rates. The Company updates the return rate assumption quarterly and applies it to the inventory balance that is held at the distributor and has not yet been sold through to the end customer. Payment for product supply is typically due 30 days after control transfers to the customer. At any point in time there is generally one month of inventory in the sales

channel, therefore uncertainty surrounding constraints on variable consideration is generally resolved one month from when control is transferred.

At the inception of each arrangement that includes milestone payments, the Company evaluates whether the milestones are considered probable of being achieved and estimates the amount to be included in the transaction price using the most likely amount method. If it is probable that a significant revenue reversal would not occur, and achievement is in the control of the Company (such as a regulatory submission by the Company), the value of the associated milestone is included in the transaction price. Milestone payments that are not within the control of the Company, such as approvals from regulators, are not considered probable of being achieved until those approvals are received.

For arrangements that include sales-based royalties and the license is deemed to be the predominant item to which the royalties relate, the Company recognizes revenue at the later of (a) when the related sales occur, or (b) when the performance obligation to which some or all of the royalty has been allocated has been satisfied (or partially satisfied).

Allocation of Consideration

As part of the accounting for arrangements that contain multiple performance obligations, the Company must develop assumptions that require judgment to determine the stand-alone selling price of each performance obligation identified in the contract. When a contract contains more than one performance obligation, the Company uses key assumptions to determine the stand-alone selling price of each performance obligation. The estimated stand-alone selling prices for distribution rights and material rights for incremental discounts on product supply are calculated using an income approach discounted cash flow model and can include the following key assumptions: forecasted commercial partner sales, product life cycle estimates, costs of product sales, commercialization expenses, annual growth rates and margins, discount rates and probabilities of technical and regulatory success. For all other performance obligations, the Company uses a cost-plus margin approach. The Company allocates the total transaction price to each performance obligation based on the estimated relative stand-alone selling prices of the promised goods or services underlying each performance obligation.

Timing of Recognition

Significant management judgment is required to determine the level of effort required under an arrangement and the period over which the Company expects to complete its performance obligations under the arrangement. If the Company cannot reasonably estimate when its performance obligations either are completed or become inconsequential, then revenue recognition is deferred until the Company can reasonably make such estimates. Revenue is then recognized over the remaining estimated period of performance using the cumulative catch-up method. Revenue is recognized for products at a point in time and for licenses of functional intellectual property at the point in time the customer can use and benefit from the license. For performance obligations that are services, revenue is recognized over time proportionate to the costs that the Company has incurred to perform the services using the cost-to-cost input method.

The Company's intellectual property in the form of distribution rights are determined to be distinct from the other performance obligations identified in the arrangements and considered "right to use" licenses which the customer can benefit from at a point in time. The Company recognizes revenues from non-refundable, up-front fees allocated to the license when the license is transferred to the customer, and the customer can use and benefit from the license.

Cost of Goods Sold

Cost of goods sold includes third party manufacturing costs, shipping costs, and other costs of goods sold. Cost of goods sold also includes any necessary allowance for excess and obsolete inventory along with lower of cost and estimated net realizable value.

Research and Development Costs

The Company charges research and development costs to expense as incurred. These costs include salaries and benefits for research and development personnel, costs associated with clinical trials managed by contract research organizations, and other costs associated with research, development and regulatory activities. Research and development costs may vary depending on the type of item or service incurred, location of performance or production, level of availability of the item or service, and specificity required in production for certain compounds. The Company uses external service providers to conduct clinical trials, to manufacture supplies of product candidates and to provide various other research and development-related products and services. The Company's research, clinical and development activities are often performed under agreements it enters into with external service providers. The Company estimates and accrues the costs incurred under these agreements based on factors such as milestones achieved, patient enrollment, estimates of work performed, and historical data for similar arrangements. As actual costs are incurred, the Company adjusts its accruals. Historically, the Company's accruals have been consistent with

management's estimates and no material adjustments to research and development expenses have been recognized. Subsequent changes in estimates may result in a material change in the Company's expenses, which could also materially affect its results of operations.

Patent Costs

Patent costs, including legal expenses, are expensed in the period in which they are incurred. Patent expenses are included in general and administrative expenses in the consolidated statements of operations and comprehensive loss.

Stock-Based Compensation

The Company accounts for stock-based compensation under the provisions of ASU No. 2014-12, *Compensation-Stock Compensation (Topic 718)*. Under the fair value recognition provisions, stock-based compensation expense is measured at the grant date for all stock-based awards to employees and directors and is recognized as expense over the requisite service period, which is generally the vesting period. Non-employee stock-based compensation charges are amortized over the vesting period on a straight-line basis. For stock options granted, the fair value of the stock options is estimated using a Black-Scholes-Merton option pricing model. See Note 12 for further information regarding stock-based compensation expense and the assumptions used in estimating that expense. The Company accounts for restricted stock unit awards issued to employees and non-employees (consultants and advisory board members) based on the fair market value of the Company's common stock as of the date of issuance.

Income Taxes

The Company accounts for income taxes under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is recognized if it is more likely than not that some portion or the entire deferred tax asset will not be recognized.

Common Stock Warrant Liability

For warrants that are newly issued or modified and there is a deemed possibility that the Company may have to settle them in cash, or for warrants it issues or modifies that contain an exercise price adjustment feature, the Company records the fair value of the issued or modified warrants as a liability at each balance sheet date and records changes in the estimated fair value as a non-cash gain or loss in the consolidated statements of operations and comprehensive loss. The fair values of these warrants have been determined using the Binomial Lattice ("Lattice") valuation model. The Lattice model provides for assumptions regarding volatility, call and put features and risk-free interest rates within the total period to maturity. These values are subject to a significant degree of our judgment.

Net (Loss) per Share

The Company computes net (loss) per share by presenting both basic and diluted (loss) per share ("EPS").

Basic EPS is computed by dividing net (loss) available to common shareholders by the weighted average number of common shares outstanding during the period. Diluted EPS gives effect to all dilutive potential common shares outstanding during the period, including stock options and warrants, using the treasury stock method, using the if-converted method. In computing diluted EPS, the average stock price for the period is used in determining the number of shares assumed to be purchased from the exercise of stock options or warrants. Potentially dilutive common share equivalents are excluded from the diluted EPS computation in net loss periods since their effect would be anti-dilutive.

During the three and six months ended June 30, 2018, the basic EPS was a net loss of $0.09 and $0.22, respectively, per share and the diluted EPS was a net loss of $0.12 and $0.26, respectively, per share due to the gain on changes in fair value of warrant liability. During the three and six months ended June 30, 2017, there was no difference between basic and diluted EPS due to the Company's net losses.

The following table sets forth the calculation of basic EPS and diluted EPS:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2018	2017	2018	2017
Numerator				

Net loss	$(1,589)	$(1,738)	$(3,739)	$(5,749)
Less gain on changes in fair value of warrant liability	(490)	-	(704)	-
Net loss, diluted	$(2,079)	$(1,738)	$(4,443)	$(5,749)
Denominator				
Weighted average shares outstanding, basic	17,089	15,308	16,750	15,296
Net loss per share, basic	$(0.09)	$(0.11)	$(0.22)	$(0.38)
Weighted average shares outstanding, basic	17,089	15,308	16,750	15,296
Effect of dilutive warrants	203	-	235	-
Weighted average shares outstanding, diluted	17,292	15,308	16,985	15,296
Net loss per share, diluted	$(0.12)	$(0.11)	$(0.26)	$(0.38)

The following outstanding stock options and stock warrants were excluded from the diluted net loss per share computation, as their effect would have been anti-dilutive:

	As of June 30,	
(in thousands)	2018	2017
Period end stock options to purchase common stock	3,189	2,828
Period end common stock warrants	-	544
	3,189	3,372

Recent Accounting Pronouncements

In 2014, the Financial Accounting Standards Board ("FASB") issued ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. In 2015 and 2016, the FASB issued additional amendments to the new revenue guidance relating to reporting revenue on a gross versus net basis, identifying performance obligations, licensing arrangements, collectability, noncash consideration, presentation of sales tax, transition, and clarifying examples. Collectively, these are referred to as ASC Topic 606, which replaces all legacy U.S. GAAP guidance on revenue recognition and eliminates all industry-specific guidance. The new revenue recognition guidance provides a unified model to determine how revenue is recognized. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In applying Topic 606, companies need to use more judgment and make more estimates than under the legacy guidance. This includes identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price, allocating the transaction price to each distinct performance obligation, the level of effort required to satisfy performance obligations, and the period over which we expect to complete our performance obligations under the arrangement. As a result, the timing of recognition of revenue has more variability under the new revenue standard due to significant estimates involved in the new accounting. Topic 606, as amended, is effective for interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted one year earlier.

On January 1, 2018, the Company adopted Topic 606 using the modified retrospective method applied to those contracts which were not completed as of January 1, 2018. In addition, the Company has accounted for all contract modifications retrospectively for contracts in transition at the date of adoption by electing the contract modification practical expedient. Contract consideration has not been adjusted for the effects of a significant financing component if the time between the transfer of the good or service and payment timing is one year or less. Results for reporting periods beginning after January 1, 2018 are presented under Topic 606, while prior period amounts are not adjusted and continue to be reported in accordance with the Company's historical accounting under Topic 605. See Note 8 for further information.

In November 2016, the FASB issued ASU 2016-18, *Statement of Cash Flows (Topic 230): Restricted Cash*, to address the diversity in the classification and presentation of changes in restricted cash in the statement of cash flows by requiring entities to combine the changes in cash and cash equivalents and restricted cash in one line. As a result, entities will no longer present transfers between cash and cash equivalents and restricted cash in the statement of cash flows. Additionally, if more than one-line item is recorded on the balance sheet for cash and cash equivalents and restricted cash, a reconciliation between the statement of cash flows and balance sheet is required. The Company adopted the standard effective January 1, 2018 using the retrospective transition method. The impact of the adoption was not material to the consolidated statement of cash flows.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*, which supersedes the lease accounting requirements in *Leases (Topic 840)*. ASU 2016-02 requires a dual approach for lessee accounting under which a lessee would account for leases as finance leases or operating leases. Both finance leases and operating leases will result in

the lessee recognizing a right-of-use asset and a corresponding lease liability. For finance leases, the lessee would recognize interest expense and amortization of the right-of-use asset, and for operating leases, the lessee would recognize a straight-line total lease expense. The guidance also requires qualitative and specific quantitative disclosures to supplement the amounts recorded in the financial statements so that users can understand more about the nature of an entity's leasing activities, including significant judgments and changes in judgments. This guidance is effective beginning in the first quarter of fiscal year 2019. While the Company is currently evaluating the impact of the adoption of this standard on its financial statements, the Company anticipates the recognition of additional assets and corresponding liabilities on its condensed consolidated balance sheet related to leases.

In July 2017, the FASB issued ASU 2017-11, *Earnings Per Share (Topic 260), Distinguishing Liabilities from Equity (Topic 480), Derivatives and Hedging (Topic 815): I. Accounting for Certain Financial Instruments with Down Round Features and II. Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests with a Scope Exception.* Part I applies to entities that issue financial instruments such as warrants, convertible debt or convertible preferred stock that contain down round features. Part II simply replaces the indefinite deferral for certain mandatorily redeemable noncontrolling interests and mandatorily redeemable financial instruments of nonpublic entities contained within Accounting Standards Codification (ASC) Topic 480 with a scope exception and does not impact the accounting for these mandatorily redeemable instruments. This ASU is effective for public companies for the annual reporting periods beginning after December 15, 2018, and interim periods within those annual periods. Early adoption is permitted. The Company is currently evaluating the effects of the adoption of ASU 2017-11 to its consolidated financial statements.

In June 2018, the FASB issued ASU 2018-07, *Improvements to Nonemployee Share-Based Payment Accounting (Topic 718),* that expands the scope of Topic 718 to include share-based payment transactions for acquiring goods and services from nonemployees. An entity should apply the requirements of Topic 718 to nonemployee awards except for certain specified exemptions. The guidance is effective for fiscal years beginning after December 15, 2018, including interim reporting periods within that fiscal year. Early adoption is permitted, but no earlier than an entity's adoption date of Topic 606. The Company is currently evaluating the effects of the adoption of ASU 2018-07 to its consolidated financial statements.

NOTE 3. FAIR VALUE MEASUREMENTS

The Company measures the fair value of financial assets and liabilities based on authoritative guidance which defines fair value, establishes a framework consisting of three levels for measuring fair value, and requires disclosures about fair value measurements. Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date.

The Company's warrant liability is classified within Level 3 of the fair value hierarchy because the value is calculated using significant judgment based on the Company's own assumptions in the valuation of this liability.

The following table presents the Company's assets and liabilities measured at fair value on a recurring basis as of June 30, 2018:

		Fair Value Measurements Using		
(in thousands)	**Balance at June 30, 2018**	**Quoted Prices in Active Markets for Identical Items (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Assets				
Cash equivalents	$ 102	$ 102	$ —	$ —
Restricted cash held as a certificate of deposit	324	324	—	—
Deposit held as a certificate of deposit	151	151	—	—
Total assets	$ 577	$ 577	$ —	$ —
Liabilities				

Warrant liability	$ 785	$—	$ —	$ 785
Total liabilities	$ 785	$—	$ —	$ 785

The following table presents the Company's assets and liabilities measured at fair value on a recurring basis as of December 31, 2017:

(in thousands)	Balance at December 31, 2017	Fair Value Measurements Using Quoted Prices in Active Markets for Identical Items (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
Cash equivalents	$ 101	$101	$ —	$ —
Restricted cash held as a certificate of deposit	324	324	—	—
Deposit held as a certificate of deposit	150	150	—	—
Total assets	$ 575	$575	$ —	$ —
Liabilities				
Warrant liability	$ 1,489	$—	$ —	$ 1,489
Total liabilities	$ 1,489	$—	$ —	$ 1,489

As a result of the fair value adjustment of the warrant liability, the Company recorded a non-cash gain of $490 thousand for the three-month period ended June 30, 2018 on a decrease in the fair value of the warrants. See Note 10 for further discussion of the calculation of the fair value of the warrant liability.

(in thousands)	**Warrant liability**
Fair value of warrant liability at December 31, 2017	$ 1,489
Decrease in fair value at March 31, 2018	(214)
Fair value of warrant liability at March 31, 2018	1,275
Decrease in fair value at June 30, 2018	(490)
Fair value of warrant liability at June 30, 2018	$ 785

NOTE 4. PREPAID EXPENSES AND OTHER CURRENT ASSETS

Prepaid expenses and other current assets consisted of the following:

(in thousands)	**June 30, 2018**	**December 31, 2017**
Prepaid employees' benefits	$112	$ 112
Prepaid sales rebate	945	923
Prepaid rent	-	123
Rent receivable	101	86
Prepaid insurance	57	27
Prepaid fleet leasing costs	75	61
Prepaid dues and subscriptions	93	117
Other	215	214
Total prepaid expenses and other current assets	$1,598	$ 1,663

NOTE 5. INVENTORY

Inventory consisted of the following:

(in thousands)	June 30, 2018	December 31, 2017
Raw materials and supplies	$270	$ 298
Finished goods	185	346
Less allowance for excess and obsolete inventory and lower of cost or estimated net realizable value adjustments	(138)	(140)
Total inventory, net	$317	$ 504

NOTE 6. PROPERTY AND EQUIPMENT

Property and equipment consisted of the following:

(in thousands)	June 30, 2018	December 31, 2017
Office and laboratory equipment	$24	$ 24
Furniture and fixtures	157	157
Computer equipment and software	359	354
Production equipment	105	105
Leasehold improvements	76	74
Total property and equipment, at cost	721	714
Less: accumulated depreciation and amortization	(370)	(243)
Total property and equipment, net	$351	$ 471

Depreciation and amortization expense was $86 thousand and $18 thousand for the three months ended June 30, 2018 and 2017, respectively, and $127 thousand and $36 thousand for the six months ended June 30, 2018 and 2017, respectively.

NOTE 7. ACCRUED LIABILITIES

Accrued liabilities consisted of the following:

(in thousands)	**June 30, 2018**	**December 31, 2017**
Employee payroll and benefits	$781	$ 761
Severance/retirement pay	171	347
Distributor fees and discounts	-	185
Sales rebates	-	106
Avenova contract liabilities (see Note 8)	1,487	-
Deferred rent	85	69
Other	141	204
Total accrued liabilities	$2,665	$ 1,672

NOTE 8. ADOPTION OF ASC TOPIC 606, "REVENUE FROM CONTRACTS WITH CUSTOMERS"

On January 1, 2018, the Company adopted Topic 606 using the modified retrospective method applied to those contracts which were not completed as of January 1, 2018. In addition, the Company has accounted for all contract modifications retrospectively for contracts in transition at the date of adoption by electing the contract modification practical expedient. Contract consideration has not been adjusted for the effects of a significant financing component if the time between the transfer of the good or service and payment timing is one year or less. Results for reporting periods beginning after January 1, 2018 are presented under Topic 606, while prior period amounts are not adjusted

and continue to be reported in accordance with the Company's historical accounting under Topic 605.

Transactions under the Company's major distribution agreements, which under prior guidance were recognized upon shipment from its distributors to the final customers, are now recognized upon transfer of control to its major distribution partners at the amount of consideration that the Company expects to be entitled to. As a result, the Company now records contract liabilities for the invoiced amounts that are estimated to be subject to significant reversal, including product revenue allowances for cash consideration paid to customers for services, discounts, rebate programs, chargebacks, and product returns. The constraint on variable consideration for product returns is a new estimation resulting from the earlier recognition under the new guidance. Based on this change, the entire deferred revenue and deferred cost of goods sold balances related to its distribution agreements were allocated to either contract liabilities and other liabilities associated with invoicing in periods prior to adoption or included in the cumulative adjustment to retained earnings upon adoption.

Milestone payments, which under the prior milestone recognition methodology were not recognized until they are substantively achieved, are included in the estimated transaction price when they are considered probable of being achieved. This may result in earlier recognition of revenue for the portion of milestone payments deemed probable which are allocated to performance obligations that are satisfied before the milestones are achieved. For license and collaboration revenue for which contract deliverables were previously accounted for as a combined unit of accounting because products or services were not separable, the Company has identified that under the new guidance the separate performance obligations are capable of being distinct. As a result, the transaction price under these arrangements, including upfront fees and milestone payments, are allocated differently to each performance obligation and may be recognized at earlier points in time or with a different pattern of performance over time.

The following table shows the reconciliation of assets and liabilities disclosed in the Form 10-K for the year ended December 31, 2017, as adjusted, due to the modified retrospective adoption of Topic 606 on January 1, 2018 (in thousands):

	As Reported Under Topic 605	Effect of Change	As Adjusted Under Topic 606
Accounts receivable	$3,629	$530	$4,159
Inventory	$504	$(25)	$479
Accrued liabilities	$1,672	$1,166	$2,838
Deferred revenue	$2,841	$(2,766)	$75
Deferred revenue, non-current	$534	$(534)	$-
Accumulated deficit	$(111,074)	$2,639	$(108,435)

As a result of adopting Topic 606 using the modified retrospective approach, the following table shows the financial statement line items for the six months ended June 30, 2018, as if revenue from contracts with customers had been accounted for under Topic 605 (in thousands, except per share data):

	As Reported Under Topic 606	Effect of Change	As Revised Under Topic 605
Consolidated Balance Sheet:			
Accounts receivable	$ 2,024	$ (315	