

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 June 30, 2006.

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

Commission file number 000-21898

ARROWHEAD RESEARCH CORPORATION

(Name of small business issuer in its charter)

Delaware
(State of incorporation)

46-0408024
(I.R.S. Employer Identification No.)

201 South Lake Avenue, Suite 703
Pasadena, California 91101
(626) 304-3400
(Address and telephone number of principal executive offices)

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

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: 33,860,690 as of August 9, 2006.

Transitional Small Business Disclosure Format (Check one): Yes No

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Arrowhead Research Corporation and Subsidiaries
(A Development Stage Company)
Consolidated Balance Sheets
As of June 30, 2006 and September 30, 2005

	(Unaudited) June 30, 2006	September 30, 2005
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	\$ 16,688,051	\$ 22,467,016
Marketable securities at fair market value - US Treasury Bills	13,945,260	76,880
Grant receivable, net of allowance for doubtful account of \$0	34,377	25,748
Other receivables	2,200	7,700
Prepaid sponsored research, <i>Note 6</i> .	138,135	10,000
Other prepaid research	223,288	81,666
Other prepaid expenses	310,711	144,985
TOTAL CURRENT ASSETS	31,342,022	22,813,995
PROPERTY AND EQUIPMENT		
Computers, office equipment and furniture	502,912	392,164
Research equipment	1,125,794	860,759
Software	52,023	52,023
Leasehold improvement	369,699	324,690
	2,050,428	1,629,636
Less: Accumulated depreciation and amortization	(972,260)	(551,514)
NET PROPERTY AND EQUIPMENT	1,078,168	1,078,122
INTANGIBLE AND OTHER ASSETS		
Rent deposit	164,425	110,379
Patents, <i>Note 1</i> .	3,490,730	3,276,075
Goodwill	4,507,427	1,762,150
TOTAL OTHER ASSETS	8,162,582	5,148,604
TOTAL ASSETS	\$ 40,582,772	\$ 29,040,721
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Accounts payable, <i>Note 1</i> .	\$ 209,343	\$ 471,943
Accrued expenses	1,184,752	264,541
Payroll liabilities	334,543	181,330
Deferred revenue	—	106,250
TOTAL CURRENT LIABILITIES	1,728,638	1,024,064
Minority interests	1,229,462	1,889,190
Commitment and contingencies, <i>Note 6</i> .		
STOCKHOLDERS' EQUITY, <i>Note 4</i>.		
Common stock	33,829	27,997
Preferred stock	—	—
Deferred compensation	(4,971,396)	(1,976,353)
Additional paid-in capital	62,259,035	37,554,933
Accumulated deficit during the development stage	(19,696,796)	(9,479,110)
TOTAL STOCKHOLDERS' EQUITY	37,624,672	26,127,467
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 40,582,772	\$ 29,040,721

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

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

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005	Nine Months Ended June 30, 2006	Nine Months Ended June 30, 2005	Period from May 7, 2003 (Date of inception) to June 30, 2006
REVENUE	\$ 246,229	\$ 173,304	\$ 556,229	\$ 380,408	\$ 1,343,218
OPERATING EXPENSES					
Salaries	2,036,639	700,891	4,866,443	1,787,531	8,295,294
Consulting	171,375	136,482	439,727	536,509	1,787,009
General and administrative expenses	1,439,881	796,191	3,791,033	1,764,822	7,422,581
Research and development	1,081,332	1,344,781	3,939,906	2,431,724	8,530,012
TOTAL OPERATING EXPENSES	4,729,227	2,978,345	13,037,109	6,520,586	26,034,896
OPERATING LOSS	(4,482,998)	(2,805,041)	(12,480,880)	(6,140,178)	(24,691,678)
OTHER INCOME (EXPENSES)					
Gain on sale of stock in subsidiary	—	—		2,292,800	2,292,800
Realized and unrealized gain (loss) in marketable securities	124,549	(6,685)	261,010	67,969	327,658
Interest income	223,443	4,586	581,270	20,641	763,663
Other income				3,221	3,308
Minority interests	221,298	496,430	1,602,234	1,010,813	3,354,955
Patents - amortization	(60,440)	(393)	(181,320)	(2,551)	(329,600)
TOTAL OTHER INCOME (EXPENSES)	508,850	493,938	2,263,194	3,392,893	6,412,784
Loss from continuing operations	(3,974,148)	(2,311,103)	(10,217,686)	(2,747,285)	(18,278,894)
Loss from operation of discontinued Nanotechnica, Inc.		(654,598)		(1,234,233)	(1,342,505)
Loss on disposal of Nanotechnica, Inc. (July 2005 - September 2005)					(73,797)
Provision for income taxes	—		—		(1,600)
NET INCOME (LOSS)	\$ (3,974,148)	\$ (2,965,701)	\$ (10,217,686)	\$ (3,981,518)	\$ (19,696,796)
Income (loss) from continuing operations per share, undiluted	(0.12)	(0.12)	(0.33)	(0.18)	
Loss from discontinued operations	—	(0.04)	—	(0.08)	
Net income (loss) per share, undiluted	(0.12)	(0.16)	(0.33)	(0.26)	
Weighted average shares outstanding, undiluted	33,810,131	18,760,122	31,265,796	15,605,038	

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

Arrowhead Research Corporation and Subsidiaries
(A Development Stage Company)
Consolidated Statement of Stockholders Equity
from inception to June 30, 2006
(unaudited)
Common Stock

	Shares	Amount	Additional Paid-in- Capital	Deferred Compensation	Accumulated Deficit during the Development Stage	Totals
Initial Issuance of Stock:						
Common stock & warrants issued for cash @ \$0.001 per unit	3,000,000	\$ 3,000	\$ —	\$ —	\$ —	\$ 3,000
Common stock & warrants issued for cash @ \$1.00 per unit	1,680,000	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	4,680,000	4,680	1,510,320	—	(95,238)	1,419,762
Exercise of stock options @ \$0.20 per share	75,000	75	14,925	—	—	15,000
Common stock & warrants issued for cash @ \$1.00 per unit	475,000	475	474,525	—	—	475,000
Common stock & warrants issued for marketable securities @ \$1.00 per unit	500,000	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 @ \$1.50 per unit	6,608,788	6,609	9,906,573	—	—	9,913,182
Common stock issued in reverse acquisition	705,529	706	(151,175)	—	—	(150,469)
Common stock issued as a gift for \$1.09 per share	150,000	163	162,587	—	—	162,750
Common stock and warrants issued as stock issuance cost @ \$1.50 per unit	356,229	356	533,988	—	—	534,344
Stock issuance cost charged to additional paid-in capital	—	—	(991,318)	—	—	(991,318)
Exercise of stock option @ \$0.20 per share	75,000	75	14,925	—	—	15,000
Exercise of stock options @ \$1.00 per share	6,000	6	5,994	—	—	6,000
Issuance of stock options	—	—	612,507	(612,507)	—	—
Amortization of deferred compensation expense	—	—	—	175,653	—	175,653
Net loss for the year ended September 30, 2004	—	—	—	—	(2,530,023)	(2,530,023)
Balance at September 30, 2004	13,631,546	13,645	12,496,851	(436,854)	(2,625,261)	9,448,381
Exercise of warrants @ \$1.50 per share	13,812,888	13,813	20,705,522	—	—	20,719,335
Exercise of stock options @ \$1.00 per share	25,000	25	24,975	—	—	25,000
Purchase of Insert Therapeutics shares @ \$0.28/share	502,260	502	1,999,498	—	—	2,000,000
Common stock issued for services	12,500	12	49,988	—	—	50,000
Issuance of stock options	—	—	2,048,012	(2,048,012)	—	—
Amortization of deferred compensation expense	—	—	—	508,513	—	508,513
Change in percentage of ownership in subsidiary	—	—	230,087	—	—	230,087
Net loss for the year ended September 30, 2005	—	—	—	—	(6,853,849)	(6,853,849)
Balance at September 30, 2005	27,984,194	27,997	37,554,933	(1,976,353)	(9,479,110)	26,127,467
Exercise of stock options @ \$1.00 per share	4,000	4	3,996	—	—	4,000
Common stock issued @ \$3.84 per share to Dr. M. Moskovits as payment for application of patents	15,000	15	57,585	—	—	57,600
Issuance of stock options	—	—	1,510,173	(1,510,173)	—	—
Amortization of deferred compensation expense	—	—	—	278,777	—	278,777
Net loss for the three months ended December 31, 2005	—	—	—	—	(3,136,953)	(3,136,953)
Balance at December 31, 2005	28,003,194	28,016	39,126,687	(3,207,749)	(12,616,063)	23,330,891
Common stock issued @ \$3.50 per share	5,590,000	5,590	19,539,410	—	—	19,545,000
Purchase of Calando Pharmaceuticals, Inc. @ \$5.17/share	208,382	208	1,077,125	—	—	1,077,333
Issuance of stock options	—	—	218,987	(218,987)	—	—
Amortization of deferred compensation	—	—	—	352,986	—	352,986

expense						
Net loss for the three months ended						
March 31, 2006	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>(3,106,585)</u>	<u>(3,106,585)</u>
Balance at March 31, 2006	33,801,576	33,814	59,962,209	(3,073,750)	(15,722,648)	41,199,625
Exercise of stock options	15,500	15	33,465			33,480
Issuance of stock options	—	—	2,164,222	(2,164,222)	—	—
Amortization of deferred compensation						
expense				266,576		266,576
Accelerated stock options			99,139			99,139
Net loss for the three months ended June 30,						
2006					<u>(3,974,148)</u>	<u>(3,974,148)</u>
Balance at June 30, 2006	33,817,076	33,829	62,259,035	(4,971,396)	(19,696,796)	37,624,672

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

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Arrowhead Research Corporation and Subsidiaries
(A Development Stage Company)

Consolidated Statements of Cash Flows

For the six months ended June 30, 2006 and 2005 and from inception through June 30, 2006

	Nine Months Ended June 30, 2006	Nine Months Ended June 30, 2005	Period from May 7, 2003 (Date of inception) to June 30, 2006
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net Loss	\$(10,217,686)	\$ (3,981,518)	\$ (19,696,796)
Realized and unrealized (gain) loss on investment	(261,010)	(67,969)	(327,658)
Stock issued as gift to Caltech	—	—	162,750
Stock issued for professional services	—	50,000	50,000
Compensation expense related to stock option issuance	997,539	233,034	1,681,644
Depreciation and amortization	634,869	405,907	1,353,705
Gain on sale of stock in subsidiary	—	(2,292,800)	(2,292,800)
Minority interests	(1,602,234)	(1,010,814)	(3,373,996)
Decrease/increase in:			—
Receivables	(3,129)	(39,364)	(36,577)
Prepaid research expense	(269,757)	181,855	(361,424)
Other prepaid expenses	(165,726)	(167,061)	(310,711)
Restricted cash		50,773	—
Deposits	(54,046)	(77,061)	(154,467)
Accounts payable	(262,600)	(299,828)	9,453
Accrued expenses	920,211	247,209	1,151,649
Deferred revenue	153,213	143,750	259,463
Other liabilities	(106,250)	110,261	77,769
	—	—	—
NET CASH PROVIDED (USED) IN OPERATING ACTIVITIES	(10,236,666)	(6,513,626)	(21,807,996)
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchase of marketable securities - US Treasury Bills	(18,575,915)	—	(18,575,915)
Purchase of property and equipment	(420,792)	(709,492)	(1,761,133)
Cash paid for interest in Nanotechnica		—	(4,000,000)
Cash paid for interest in Aonex	(1,000,000)	(1,000,000)	(5,000,000)
Cash paid for interest in Insert		(1,000,000)	(5,000,000)
Cash paid for interest in Calando	(2,890,668)	(2,000,000)	(4,890,668)
Cash paid for interest in NanoPolaris	(3,000,000)	(1,000)	(3,001,000)
Cash obtained from interest in Nanotechnica		—	4,000,000
Cash obtained from interest in Aonex	1,000,000	1,000,000	5,001,250
Cash obtained from interest in Insert		1,000,000	5,379,594
Cash obtained from interest in Calando	2,000,000	2,000,000	4,000,000
Cash obtained from interest in NanoPolaris	3,000,000	1,000	3,001,000
Proceeds from sale of marketable securities - US Treasury Bills	4,888,399	—	4,888,399
Proceeds from sale of stock in subsidiary	—	2,640,000	2,424,924
Proceeds from sale of investments	80,146	489,768	569,914
Proceeds from sale of investments Payment for patents	(205,948)	(48,373)	(304,321)
Restricted cash		—	50,773
NET CASH USED IN INVESTING ACTIVITIES	(15,124,778)	2,371,903	(13,217,183)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from issuance of common stock and warrants, net	19,582,479	20,706,764	51,713,230
NET CASH PROVIDED BY FINANCING ACTIVITIES	19,582,479	20,706,764	51,713,230
NET INCREASE (DECREASE) IN CASH	(5,778,965)	16,565,041	16,688,051
CASH AT BEGINNING OF PERIOD	22,467,016	8,552,667	—
CASH AT END OF PERIOD	\$ 16,688,051	\$ 25,117,708	\$ 16,688,051
Supplementary disclosures:			
Interest paid	\$ —	\$ —	\$ —
Income tax paid	\$ —	\$ 2,400	\$ 11,100

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 502,260 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 \$850,668 and 208,382 newly issued shares of Arrowhead Common Stock valued at \$1,077,333. The 208,382 shares of Arrowhead common stock were valued based on the average closing price of Arrowhead's Common Stock on NASDAQ during the last ten days prior to the date of the closing.

On June 13, 2005, NanoPolaris, Inc. purchased the net assets and name of Unidym, Inc. for \$25,000 in cash, the assumption of certain liabilities not to exceed \$75,000 and 735,000 of newly issued shares of NanoPolaris Common Stock with a preliminary value, estimated by management, of \$154,350.

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

Arrowhead Research Corporation

Notes to Consolidated Financial Statements

June 30, 2006

Unless otherwise noted, (1) the term “Arrowhead Research” refers to Arrowhead Research Corporation, a Delaware corporation formerly known as InterActive Group, Inc., (2) the terms “Arrowhead,” the “Company,” “we,” “us,” and “our,” refer to the ongoing business operations of Arrowhead and its subsidiaries, whether conducted through Arrowhead Research or a subsidiary of the company, (3) the term “ARC” refers to Arrowhead Research Corporation, a privately-held California corporation, the shareholders of which Arrowhead Research consummated a stock exchange transaction in January 2004 (the “Share Exchange”), (4) the term “Common Stock” refers to Arrowhead Research’s common stock, (5) the term “Warrant” refers to warrants to purchase Company Common Stock, and the term “stockholder(s)” refers to the holders of Common Stock, Warrants, and any other security convertible into Common Stock.

NOTE 1: ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

Nature of Business

Arrowhead is a development stage nanotechnology company commercializing products and technologies through majority-owned subsidiaries and partnerships with universities and government labs. Currently, operations conducted by Arrowhead and its subsidiaries consist primarily of technological research and development.

Nanotechnology generally refers to the investigation, design, and manipulation of matter at the atomic, molecular, or macromolecular levels. Due to their size and unique properties, nanoscale materials, devices, and systems are being used in a variety of commercial applications and are expected to have broad impact across many industries.

Arrowhead has three strategic components to its business model:

- **Outsourced R&D Program:** Arrowhead identifies patented or patent-pending technologies at universities or government labs and funds additional development of those technologies in exchange for the exclusive right to license and commercialize the resulting prototypes. Leveraging the resources and infrastructure of these institutions provides Arrowhead with a cost-effective development pipeline. At June 30, 2006, Arrowhead is supporting efforts in drug discovery tools, stem cell technology and, nanoelectronics, at the California Institute of Technology, Stanford University and, Duke University. On August 3, 2006, Arrowhead announced a collaboration with the University of Florida to further develop flexible thin film electronic devices.
- **Commercialization Program:** After prototypes have been sufficiently developed in the laboratories, Arrowhead forms or acquires majority-owned subsidiaries to commercialize the technology and provides the subsidiaries with strategic, managerial and operational support. By doing so, each research team is able to maintain focus on its specific technology and each management team can focus on specific markets, increasing the likelihood of successful technological development and commercialization. At June 30, 2006, Arrowhead owns majority interest in subsidiaries commercializing diverse technologies, including anti-cancer drugs, RNAi therapeutics, compound semiconductor materials and nanotube technology.
- **The Patent Toolbox:** Arrowhead has acquired or exclusively licensed patents and patent applications covering a broad range of nanotechnology. The Company actively adds to and manages its intellectual property portfolio.

Arrowhead is incorporated in Delaware and its principal executive offices are located in Pasadena, California.

The Company has had no revenue from product sales since its inception. The Company has generated some revenue from collaboration agreements, licensing and grants.

Summary of Significant Accounting Policies

Basis of Presentation—This report on Form 10-Q for the quarter ended June 30, 2006 should be read in conjunction with the Company’s Annual Report on Form 10-KSB for the year ended September 30, 2005 filed with the SEC on December 22, 2005. The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial statements and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all normal recurring adjustments considered necessary for a fair presentation have been included. Operating results for the three month and nine month periods ended June 30, 2006 are not necessarily indicative of the results that might be expected for the year ending September 30, 2006.

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Principles of Consolidation—The consolidated financial statements of the Company include the accounts of Arrowhead and its subsidiaries, Aonex Technologies, Inc. (“Aonex”), Calando Pharmaceuticals, Inc. (“Calando”), Insert Therapeutics, Inc. (“Insert”) and NanoPolaris, Inc. (“NanoPolaris”), which name has been changed to Unidym. Nanotechnica, Inc. (“Nanotechnica”), which the majority of its stockholders voted to dissolve on June 3, 2005, is included in the results for the three months and nine months ended June 30, 2005 only as Loss from Discontinued Operations of Nanotechnica, Inc. All significant intercompany accounts and transactions are eliminated in consolidation and minority interests were accounted for in the condensed consolidated statements of operations and the balance sheets.

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. Significant estimates made in preparing these financial statements include the allowance for doubtful accounts, deferred tax asset valuation allowance, patents, goodwill, minority- interest common stock and useful lives for depreciable and amortizable assets. Actual results could differ from those estimates.

Cash and Cash Equivalents—For purposes relating to the statement of cash flows, the Company considers all liquid debt instruments purchased with a maturity of three months or less to be cash equivalents.

Concentration of Credit Risk—The Company maintains checking accounts for Arrowhead and separate accounts for each subsidiary at one financial institution. These accounts are insured by the Federal Deposit Insurance Corporation (FDIC), up to \$100,000. The Company has a portion of its excess cash in two “Diversifier Accounts” at the same financial institution. The “Diversifier Accounts” invest in other bank issued CD’s in amounts of \$100,000, each of which are fully insured by FDIC. The Company has a Wealth Management Account at the same financial institution which invests in higher yield money market accounts and in government securities. At June 30, 2006, the Company had uninsured cash deposits totaling \$21,963,990, which includes \$14,320,488 invested in U.S. government securities. The Company has not experienced any losses in such accounts and management believes it has placed its cash on deposit with financial institutions that are financially stable.

Property and Equipment—Property and equipment are recorded at cost. Depreciation of property and equipment is recorded on the straight-line method over the respective useful lives of the assets ranging from 3 to 7 years. Leasehold improvements are amortized over the life of the lease.

Intellectual Property—At June 30, 2006, intellectual property consists of patents and patent applications licensed or purchased totaling \$570,983. The purchased patent applications are being amortized over three years. The Company’s additional capital investment in Insert has been recorded as an increase in the value of the patent held by Insert. The additional patent value is \$3,301,190 and is being amortized over the life of this patent. As of June 30, 2006, the patent has 147 months until its expiration. The accumulated amortization of patents totaled \$381,444 at June 30, 2006. The majority of the Nanotechnica patents were transferred from Nanotechnica to Arrowhead in June 2005. The transferred patents were returned to the California Institute of Technology in January 2006.

Goodwill—Goodwill represents the excess of cost over the value of net assets of businesses acquired pursuant to Statement of Financial Accounting Standards (“SFAS”) No. 141, “Business Combinations” and is carried at cost unless write-downs for impairment are required. The Company evaluates the carrying value of goodwill on an annual basis and whenever events and changes in circumstances indicate that the carrying amount may not be recoverable, an adjustment is then made. To date, no such impairment has been recorded. Goodwill at June 30, 2006 consisted of \$999,000 for Aonex and \$3,508,427 for Calando in accordance with the preliminary purchase accounting for the March 31, 2006 transaction described in Note 3: Investment in Subsidiaries.

Revenue Recognition—The Company recognizes license fee revenue on a straight-line basis over the term of the license. Development fees, milestone fees, collaboration fees and grant revenues are recognized upon the completion and payment of services or achievement of the mutually agreed upon milestones.

Research and Development—Costs and expenses that can be clearly identified as research and development are charged to expense as incurred in accordance with FASB statement No. 2, “Accounting for Research and Development Costs.”

Earnings (Loss) per Share—Basic earnings (loss) per share is computed using the weighted-average number of common shares outstanding during the period. Diluted earnings (loss) per share is computed using the weighted-average number of common shares and dilutive potential common shares outstanding during the period. Dilutive potential common shares

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primarily consist of stock options issued to employees and consultants and warrants of the Company. For three-month period ended June 30, 2006 and nine-month periods ended June 30, 2006 and 2005 respectively, their effect was anti-dilutive.

Accounting for Stock-Based Compensation. The Company has adopted the retrospective method of implementing SFAS 123R. Therefore, the financials for the three month and nine month periods ended June 30, 2006 have been adjusted to reflect the accounting and expensing of the fair value of the stock based awards.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections." This statement applies to all voluntary changes in accounting principle and requires retrospective application to prior periods' financial statements of changes in accounting principle, unless this would be impracticable. This statement also makes a distinction between "retrospective application" of an accounting principle and the "restatement" of financial statements to reflect the correction of an error. This statement is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company is evaluating the effect the adoption of this interpretation will have on its financial position, cash flows and results of operations.

NOTE 2: BASIS OF CONSOLIDATION

The consolidated financial statements for the three month and nine month periods ended June 30, 2006 and 2005 respectively include the accounts of Arrowhead and its subsidiaries, Aonex, Calando, Insert and NanoPolaris/Unidym. Nanotechnica (which a majority of its shareholders voted to dissolve on June 3, 2005) is included in the results for the three month and nine month periods ended June 30, 2005 only as Loss from Discontinued Operations of Nanotechnica, Inc. All significant intercompany accounts and transactions are eliminated in consolidation and minority interests were accounted for in the consolidated statements of operations and the balance sheets.

NOTE 3. INVESTMENT IN SUBSIDIARIES

Aonex Technologies, Inc.

On April 20, 2004, Arrowhead purchased 1,000,000 shares of Series A Preferred Stock in a newly-formed entity, Aonex, for \$2,000,000. The 1,000,000 shares of Series A Preferred stock represent 80% of the outstanding, voting shares of Aonex and allow Arrowhead to elect a majority of Aonex's Board of Directors. Since its initial investment on April 20, 2004, Arrowhead has provided \$3,000,000 of additional capital to Aonex, including \$1,000,000 provided in February 2006.

Insert Therapeutics, Inc.

On June 4, 2004, Arrowhead purchased 24,496,553 shares of Series B Preferred Stock of Insert, a Pasadena, California based company for \$1,000,000. The Series B Preferred Stock allows Arrowhead to elect a majority of Insert's Board of Directors. On March 29, 2005, Arrowhead exchanged 4,000,000 shares of its Series B Preferred Stock for 4,000,000 shares of Series C Preferred Stock. The Series C Preferred Stock has a liquidation preference senior to Series B Preferred Stock.

On March 23, 2005, Arrowhead purchased 7,375,000 shares of Insert common stock from two minority stockholders of Insert for 502,260 newly issued shares of Arrowhead Common Stock. The Arrowhead Common Stock was valued at \$2,000,000 based on the closing market price of Arrowhead Common Stock on NASDAQ on March 23, 2005.

On June 30, 2005, Arrowhead sold 2,640,000 shares of its Series C Preferred Stock to qualified investors for \$1.00 per share. Net proceeds of the sale were \$2,424,924.

As of June 30, 2006, Arrowhead owns 68.3% of the outstanding, voting securities of Insert. Since its initial investment on June 4, 2004, Arrowhead has provided \$4,000,000 of additional capital to Insert.

Calando Pharmaceuticals, Inc.

On February 22, 2005, Arrowhead purchased 4,000,000 shares of common stock in a newly-formed entity, Calando, for \$250,000. Calando and Insert have entered into a license agreement giving Calando exclusive rights to Insert's technology for the delivery and therapeutic use of RNAi in Calando's research, development and business efforts. A voting agreement between Arrowhead and certain shareholders in Calando gives the Company the right to designate a majority of Calando's Board of Directors. Arrowhead has provided \$3,750,000 in additional capital to Calando, including \$2,000,000 contributed in February 2006.

On March 31, 2006, Arrowhead purchased 5,000,000 shares of Calando's Series A Preferred Stock for \$3,000,000. The preferred shares are convertible to common stock on a one to one basis, are entitled to a non-cumulative dividend of eight percent (8%) and have a liquidation preference over the common stock. Concurrent with the Series A purchase, Arrowhead

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purchased 964,000 shares of common stock for \$2.00 per share from minority shareholders. The \$1,928,000 payment for the purchase of Calando common stock consisted of \$850,667 in cash and 208,382 in shares of Arrowhead common stock with an estimated value of \$1,077,333 or \$5.17 per share based on the average closing price of Arrowhead's common stock during the last ten days prior to the transaction closing. At March 31, 2006, the \$850,667 cash portion of the payment was included in accounts payable until payment was made on April 10, 2006.

As a result of the transactions described above, Arrowhead increased its ownership from 58.2% to 83.2% of the outstanding, voting stock of Calando. Arrowhead has direct ownership of 80.6% of the outstanding, voting stock of Calando and indirectly, through Insert, controls another 2.6% of the outstanding, voting stock. Two of Calando's founders have warrants for Calando common stock that, if exercised, would reduce Arrowhead's direct and indirect ownership from 83.2% to 68.3%.

On March 31, 2006, Arrowhead entered into an Agreement with Calando to provide up to \$7,000,000 of additional capital to Calando subject to the attainment of certain milestones in its preclinical testing, clinical testing and related approval processes. Should Arrowhead elect not to make the additional capital contributions, the preferred stock conversion right of one to one will be adjusted to approximately three to one.

NanoPolaris, Inc./ Unidym, Inc.

On April 4, 2005, Arrowhead founded NanoPolaris as a wholly owned subsidiary of Arrowhead. NanoPolaris was initially capitalized with \$1,000.

On June 13, 2006, NanoPolaris acquired substantially all of the net assets and the name of Unidym, a Los Angeles company that develops carbon nanotube-based electronics. The net assets acquired include Unidym's intellectual property, prototypes, and equipment, for a purchase price consisting of \$25,000 in cash and assumption of \$75,000 of liabilities and shares of NanoPolaris common stock, with an estimated value of \$154,350, equal to 11.9% (10% on a fully diluted basis) of NanoPolaris' outstanding voting stock, at closing. At the closing, Arrowhead Research invested \$3,000,000 in NanoPolaris and committed up to \$4 million of additional capital to NanoPolaris, with \$2 million to be paid on the first anniversary of closing and the remaining \$2,000,000 to be paid on the second anniversary of the closing. Subsequent to June 30, 2006, NanoPolaris has changed its name to Unidym, Inc.

Nanotechnica, Inc.—Discontinued Operations

In the third quarter of FY 2005, the Company determined that the progress being made by Nanotechnica in commercializing microfluidics technology was not progressing satisfactorily and the market potential was uncertain. Therefore, on June 3, 2005, a majority of the stockholders of Nanotechnica voted to dissolve the company. Because of Arrowhead's liquidation preference as Series A Preferred Stockholders, \$2.8 million in cash was remitted to Arrowhead along with \$213,000 of the other remaining assets. Arrowhead has discontinued development efforts related to microfluidics and returned the applicable patents to Caltech. The losses incurred by Nanotechnica are segregated on the Consolidated Statement of Operations as Loss from Operation of Discontinued Nanotechnica, Inc. Nanotechnica had no revenue in either FY 2004 or FY 2005.

NOTE 4: STOCKHOLDERS' EQUITY

On January 26, 2005, after stockholder approval, the Company's Certificate of Incorporation was amended to increase the number of authorized shares of the Company to a total of 75,000,000 shares, consisting of 70,000,000 authorized shares of common stock, par value \$0.001, and 5,000,000 shares of authorized preferred stock. The number of authorized shares of the Company, prior to this Amendment, was 60,000,000 shares, consisting of 50,000,000 shares of authorized common stock and 10,000,000 shares of authorized preferred stock.

At June 30, 2006, 33,817,076 shares of common stock were outstanding. At June 30, 2006, 1,748,500 shares and 5,000,000 shares were reserved for issuance upon exercise of options granted under Arrowhead's 2000 Stock Option Plan and 2004 Equity Incentive Plan, respectively. Through June 30, 2006, options to purchase 1,748,500 shares were outstanding under the 2000 Stock Option Plan and options to purchase 2,891,833 shares were outstanding under the 2004 Equity Incentive Plan.

In connection with the formation of the Company and two private placements, the Company issued approximately 13.8 million common stock purchase warrants, which were called on May 4, 2005. Substantially all of the outstanding warrants were exercised by June 2005, and the Company received approximately \$20.7 million in total exercise proceeds. The warrants not exercised were redeemed by the Company for \$0.001 per share.

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On January 24, 2006, the Company completed a private placement of 5,590,000 shares of restricted common stock at \$3.50 per share that generated \$19.6 million in total proceeds. The purchasers received warrants, exercisable after July 25, 2006, to purchase an additional 1,397,500 shares of restricted common stock at \$5.04 per share. The exercise price of the warrants at closing was at a premium to the closing market price of the common stock on January 24, 2006. The warrants may be called by the Company any time after July 25, 2006 if the closing price of the Company's Common stock is \$6.50 or above for the previous 30 trading days.

The following table summarizes information about warrants outstanding at June 30, 2006:

<u>Exercise prices</u>	<u>Number of Warrants</u>	<u>Weighted Average Remaining Life in Years</u>	<u>Weighted Average Exercise Price</u>
\$5.04	1,397,500	9.6	\$ 5.04

NOTE 5: LEASES

The Company leases the following facilities:

	<u>Lab/Office Space</u>	<u>Monthly Rent</u>	<u>Lease Commencement</u>	<u>Lease Term</u>
Arrowhead				
Pasadena (1)	7,388 sq ft	\$ 16,992	March 1, 2006	62 Months
Pasadena	3,653 sq ft	\$ 6,575	December 27, 2004	25 Months
New York (2)	130 sq ft	\$ 3,350	September 15, 2005	12 Months
Aonex	4,000 sq ft	\$ 7,211	July 1, 2004	48 Months
Calando (3)	2,755 sq ft	\$ 4,821	May 16, 2005	24 Months
Calando	7,000 sq ft	\$ 12,944	June 1, 2006	18 Months
Insert	4,354 sq ft	\$ 11,761	June 1, 2006	36 Months

- Arrowhead leased new corporate office space in Pasadena, which it occupied beginning March 1, 2006. The new lease agreement provides Arrowhead with two months free rent which was recorded as a deferred liability and is being amortized over the life of the lease. The lease for the prior corporate office space terminated on February 28, 2006.
- In September, Arrowhead opened an office in New York City and has one employee working out of that office. The rent for the first six months is \$1,675 per month. For the second six months, the rent is \$3,350 per month.
- Calando is in the process of moving into laboratory space previously occupied by Insert. Calando's previous landlord and agreed to accept a \$25,000 payment in exchange for early termination of this lease agreement.

The Company has no plans to own any real estate and expects all facility leases will be operating leases.

At June 30, 2006, the future minimum commitments by Fiscal Year remaining under leases are as follows:

	<u>Facilities Leases</u>	<u>Equipment Leases</u>
FY 2006 (3 months)	\$ 202,751	\$ 5,227
FY 2007	\$ 624,883	\$ 19,222
FY 2008	\$ 452,782	\$ 7,550
FY 2009	\$ 302,813	\$ 3,460
FY 2010 & Beyond	\$ 348,344	—

Facility and equipment rent expense for the three-month and nine-month periods ended June 30, 2006 was \$185,587 and 495,265, respectively. Facility and equipment rent expense for the three-month and nine-month periods ended June 30, 2005 was \$92,547 and \$248,089 respectively. From inception to date, rent expense totals \$947,190.

NOTE 6: COMMITMENTS AND CONTINGENCIES—SUBSIDIARIES AND SPONSORED RESEARCH

Subsidiaries

As of June 30, 2006, Arrowhead held a majority of the voting stock of the following four subsidiaries (the “Subsidiaries”):

<u>Subsidiary</u>	<u>%Ownership</u>	<u>Technology/Product Focus</u>
Aonex Technologies, Inc. <i>founded April 20, 2004</i>	80.0%	Semiconductor nanomaterial process with initial emphasis on high efficiency solar cells
Insert Therapeutics, Inc. <i>acquired June 4, 2004</i>	68.3%	Nano-engineered drug delivery system, beginning clinical trials with first anti-cancer compound
Calando Pharmaceuticals, Inc. <i>founded February 20, 2005</i>	83.2%*	Nano-engineered RNAi Therapeutics
NanoPolaris, Inc./Unidym, Inc. <i>founded April 4, 2005</i>	88.1%	Developing strategic opportunities for the commercialization of nanotube-based products.

* Arrowhead has direct ownership of 80.6% of the outstanding, voting stock of Calando and indirectly, through Insert, controls another 2.6% of the outstanding, voting stock.

Arrowhead holds a majority interest in each of Aonex, Insert, Calando and NanoPolaris/Unidym and provided capital to each company in exchange for Arrowhead’s ownership interest in each subsidiary, as well as the right to appoint a majority of each Subsidiary’s Board of Directors. Arrowhead has made all capital contributions pursuant to its original investments and capital contribution agreements with each subsidiary.

On March 31, 2006, Arrowhead and Calando entered into a second Agreement to Provide Additional Capital which provides for the contribution of \$7,000,000, subject to the attainment of certain milestones. If Arrowhead elects not to provide additional capital pursuant to this agreement, Arrowhead would forfeit approximately 7% of its interest in Calando.

On June 13, 2006, Arrowhead and NanoPolaris/Unidym entered into an Agreement to Provide Additional Capital which provides for the contribution of \$4,000,000, subject to the attainment of certain milestones. If Arrowhead elects not to provide additional capital pursuant to this agreement, Arrowhead would forfeit approximately 21.7% of its interest in NanoPolaris/Unidym on a fully diluted basis.

Outsourced Research and Development

Outsourced sponsored research expense for the three month and nine month periods ended June 30, 2006 was \$406,412 and \$890,681, respectively. Outsourced sponsored research expense for the three month and nine month periods ended June 30, 2005 was \$254,761 and \$588,690, respectively.

Sponsored Research Agreement—Duke University

The terms of the sponsored research agreement between Arrowhead and Duke University (“Duke”) are summarized in the following table:

<u>Research Project</u>	<u>Total estimated project cost</u>	<u>Annual Cost</u>	<u>Amount paid as of June 30, 2006</u>	<u>Prepaid Amt as of June 30, 2006</u>
CVD Growth of Well-Aligned Individual Single Walled Carbon Nanotubes (Dr. Jie Liu) Dec. 1, 2005–Nov. 30, 2007 (2 years)	\$ 600,000	\$ 300,000	\$ 231,730	\$ 0

The initial payment of \$108,974 was paid in February 2006 with eight quarterly payments of \$61,378 beginning March 1, 2006.

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Sponsored Research Agreement—California Institute of Technology

The terms of the sponsored research agreement between Arrowhead and the California Institute of Technology (“Caltech”) are summarized in the following table:

<u>Research Project</u>	<u>Total estimated project cost</u>	<u>Annual Cost</u>	<u>Amount paid as of June 30, 2006</u>	<u>Prepaid Amt as of June 30, 2006</u>
Drug Discovery & Diagnostics (Dr. C. Patrick Collier)				
Oct. 1, 2003-Sept. 30, 2008 (5 years)	\$ 1,393,806	\$ 280,292	\$ 736,228	\$ 73,135

During the second quarter of FY 2005, the agreement was amended to allow for quarterly rather than annual funding for these research projects. The agreement calls for funding, as indicated above, to subsidize all direct and indirect costs incurred in the performance of the research, not to exceed total estimated project cost. If this agreement is extended, the dollar value of costs that will be reimbursed may be modified by mutual agreement to cover additional work performed during the extension. The research agreement is terminable by either party on 60-days written notice with an obligation to satisfy outstanding obligations at the time of cancellation.

Sponsored Research Agreement—Stanford University

Arrowhead has exclusively licensed intellectual property from Stanford University (“Stanford”) for a nanotech device designed to control the behavior of stem cells. Arrowhead has agreed to fund additional research involving the device at Stanford in exchange for the right to exclusively license and commercialize the technology.

<u>Research Project</u>	<u>Total estimated project cost</u>	<u>Annual Cost</u>	<u>Amount paid as of June 30, 2006</u>	<u>Prepaid Amt as of June 30, 2006</u>
Microchip-based Biological Signal Delivery (Dr. Nicholas Melosh)				
July 1, 2005 – June 30, 2007 (2 years)	\$ 600,000	\$ 300,000	\$ 390,000	\$ 65,000

Sponsored Research Agreement—Lucile Packard Children’s Hospital

Arrowhead agreed to contribute \$100,000 to Stanford’s Lucile Packard Children’s Hospital to fund a project to identify how new technologies, such as nanotechnology and stem cell technology, can address existing clinical needs. This amount was paid at a rate of \$25,000 per quarter commencing July 1, 2005 through June 30, 2006. As of June 30, 2006, the full \$100,000 has been contributed.

NOTE 7. STOCK OPTIONS

Stock-Based Compensation—Arrowhead has two plans that provide for equity-based compensation. Under the 2000 Stock Option Plan, 1,748,500 shares of Arrowhead’s Common Stock are reserved for issuance upon exercise of non-qualified stock options. The 2004 Equity Incentive Plan reserves 5,000,000 shares 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 expected to provide significant services to Arrowhead. The Company’s stockholders approved the 2004 Equity Incentive Plan on January 20, 2005. Pursuant to this approval, no further grants may be made under the 2000 Stock Option Plan.

Arrowhead accounts for employee stock option grants in accordance with Statement of Financial Accounting Standards (SFAS) No. 123R, Accounting for Stock-Based Compensation.

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The following tables summarize information about stock options:

	<u>Number of Options Outstanding</u>	<u>Weighted Average Exercise Price Per Share</u>
Balance at May 7, 2003	—	—
Granted	150,000	0.20
Canceled	—	—
Exercised	—	—
Balance at September 30, 2003	150,000	0.20
Granted	1,570,000	1.00
Canceled	(25,000)	1.00
Exercised	(156,000)	0.23
Balance at September 30, 2004	1,539,000	1.00
Granted	2,095,000	2.53
Canceled	(170,000)	1.00
Exercised	(25,000)	1.00
Balance at September 30, 2005	3,439,000	1.93
Granted	775,000	3.89
Canceled	—	1.00
Exercised	(4,000)	1.00
Balance at December 31, 2005	4,210,000	2.29
Granted	165,000	4.70
Canceled	—	—
Exercised	—	—
Balance at March 31, 2006	4,375,000	2.38
Granted	925,000	5.74
Canceled	(644,167)	3.78
Exercised	(15,500)	2.16
Balance at June 30, 2006	4,640,333	2.86
Exercisable at June 30, 2006	1,902,553	1.98

<u>Exercise Prices</u>	<u>Number of Options</u>	<u>Weighted Average Remaining Life in Years</u>	<u>Weighted Average Exercise Price</u>
\$1.00 – \$6.36	4,640,333	8.8	\$ 2.86

The Company has applied SFAS 123R on a retrospective basis for FY 2006. Therefore, the loss for the three months of FY 2005, ended June 30, 2005, has been increased from \$2,917,116 to \$2,965,701. The loss for the first nine months of FY 2005 has been increased from \$3,880,146 to \$3,981,518 to reflect amortization of the fair value of options awarded to employees prior to the adoption of SFAS 123R. Arrowhead's accumulated deficit at September 30, 2005 has been adjusted by \$262,106 to reflect the retrospective application of SFAS 123R. For the three month and nine month periods ended June 30, 2006, the stock based compensation expense is \$365,712 and \$997,539, respectively.

The estimated fair value of the options granted by Arrowhead and the value for the accelerated stock options for the three month and nine month periods ended June 30, 2006 is \$2,263,361 and \$3,992,521, respectively.

The aggregate fair value of options granted by Aonex, Calando, or Insert for the nine month period ended June 30, 2006 is \$8,702.

The fair value of options granted during the nine months ended June 30, 2006 was estimated at the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions: dividend yield of 0%, expected volatility of 25% to 50%, risk-free interest rate of 4.94% to 5.25%, and expected life of five years. The weighted-average fair value of options granted by Arrowhead for the nine months ended June 30, 2006 was estimated at \$2.30 and the weighted-average exercise price was estimated at \$4.74.

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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. In addition, option valuation models require the input of highly subjective assumptions, including the expected stock price volatility. 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.

NOTE 8. INCOME TAXES

The Company utilizes SFAS No. 109, "Accounting for Income Taxes," which requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns.

Under this method, deferred income taxes are recognized for the tax consequences in future years of differences between the tax bases of assets and liabilities and their financial reporting amounts at each year-end based on enacted tax laws and statutory tax rates applicable to the periods in which the differences are expected to affect taxable income. Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount expected to be realized. The provision for income taxes represents the tax payable for the period and the change during the period in deferred tax assets and liabilities.

For the three month and nine month periods ended June 30, 2006, the Company had consolidated losses of \$3,974,148 and \$10,217,686, respectively. For the nine month period ended June 30, 2005, the Company had a consolidated loss of \$3,981,518. The losses result in a deferred income tax benefit of approximately \$1,569,788 and \$4,035,986 for the three months and nine months ended June 30, 2006 and \$1,549,127 for the nine months ended June 30, 2005, offset by an increase in the valuation allowance for the same amount for Arrowhead. Management has chosen to take a 100% valuation allowance against the tax benefit until such time as management believes that its projections of future profits as well as expected future tax rates make the realization of these deferred tax assets more-likely-than-not. Significant judgment is required in the evaluation of deferred tax benefits and differences in future results from our estimates could result in material differences in the realization of these assets.

NOTE 9: SEGMENT AND GEOGRAPHIC REPORTING

The Company accounts for segments and geographic product and licensing revenues in accordance with SFAS No. 131, "Disclosure about Segments of an Enterprise and Related Information." The Company's reportable segments are strategic business units that offer different products and services.

Grant and collaboration agreements are not considered to be product or licensing revenue as the Company's plan of operations is to sell products and/or license technology. The grant revenue is a way to fund and to offset development costs. In the quarter ended June 30, 2005, Calando accrued the first commercial license agreement revenue totaling \$150,000 covering the period June 15, 2005 through June 14, 2006. License fees from Calando's commercial license fees recorded as revenue were \$31,250 and \$106,250 for the three month and nine month periods ended June 30, 2006. The customer is located in North America.

NOTE 10. RELATED PARTY TRANSACTIONS

There were no related party transactions in the first nine months of FY 2006 or FY 2005.

NOTE 11. SUBSEQUENT EVENTS

On June 2, 2006, by mutual agreement, Mr. Leon Ekchian stepped down from his position as President and Director of the Company. On August 9, 2006, a Severance Agreement and General Release between the Company and Mr. Ekchian became effective and it provides Mr. Ekchian with a lump sum payment of \$280,000 and extends Mr. Ekchian's vested options to purchase 50,000 shares of the Company's Common Stock until the close of business on December 31, 2006, and immediately vests Mr. Ekchian's unvested options in the amount of 83,333 shares of the Common Stock with an exercise price of \$3.90 per share of Common Stock, which options will be immediately exercisable until the close of business on December 31, 2006, after which time, these options shall expire and shall not be exercisable. The total estimated value of the payments and options is \$379,140 and that amount has been accrued in the operating results of the Company as of June 30, 2006.

On July 25, 2006 Arrowhead announced its majority owned subsidiary, NanoPolaris Inc., changed its name to Unidym, Inc.

On August 3, 2006 the Company announced the beginning of a collaboration with Dr. Andrew Rinzler to further develop flexible electronic devices made at the University of Florida. Arrowhead will have the first option to exclusively license and commercialize the technology. Under the sponsored research agreement with the University of Florida, Arrowhead will provide \$647,000 over a two year period to develop optimized thin film transistors devices and prototypes of thin film transistor arrays.

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

Overview

Arrowhead is a development stage nanotechnology company commercializing products and technologies through majority-owned subsidiaries and partnerships with universities and government labs. Currently, operations conducted by Arrowhead and its subsidiaries consist primarily of technological research and development. It could take a long time to bring products to market, and success is uncertain.

Nanotechnology generally refers to the investigation, design, and manipulation of matter at the atomic, molecular, or macromolecular levels. Due to their size and unique properties, nanoscale materials, devices, and systems are being used in a variety of commercial applications and are expected to have broad impact across many industries.

Arrowhead is a development-stage company and has three strategic components to its business model:

- **Outsourced R&D Program:** Arrowhead identifies patented or patent-pending technologies at universities or government labs and funds additional development of those technologies in exchange for exclusive rights to commercialize the resulting prototypes. Leveraging the resources and infrastructure of these institutions provides Arrowhead with a cost-effective development pipeline. At June 30, 2006, Arrowhead is supporting efforts in drug discovery tools, stem cell technology and nanoelectronics at the California Institute of Technology, Stanford University, and Duke University, respectively. On August 3, 2006, Arrowhead announced a collaboration with the University of Florida to further develop flexible thin film electronic devices.
- **Commercialization Program:** After prototypes have been sufficiently developed in the laboratories, Arrowhead forms or acquires majority-owned subsidiaries to commercialize the technology and provides the subsidiaries with strategic, managerial and operational support. By doing so, each research team is able to maintain focus on its specific technology and each management team can focus on specific markets, increasing the likelihood of successful technological development and commercialization. At June 30, 2006, Arrowhead owns majority interest in subsidiaries commercializing diverse technologies, including anti-cancer drugs, RNAi therapeutics, compound semiconductor materials and nanotube technology.
- **The Patent Toolbox:** Arrowhead has acquired or exclusively licensed patents and patent applications covering a broad range of nanotechnology. The Company actively adds to its intellectual property portfolio.

The Company was founded in May 2003. Since inception, the Company has generated significant losses. Operations have been funded primarily through the sale of common stock. Since inception, the Company's accumulated deficit is approximately \$19.7 million. Revenues have come primarily from grants, development fees and a license agreement as the Company has no products ready for sale or broad commercial licensing. Since inception, the Company has focused on establishing or acquiring operating subsidiaries, sponsoring internal and external research and development, acquiring intellectual property rights, hiring management and technical staff and raising capital. At June 30, 2006, the Company has four majority owned operating Subsidiaries, Aonex Technologies, Inc. ("Aonex"), Calando Pharmaceuticals, Inc. ("Calando"), Insert Therapeutics, Inc. ("Insert"), and NanoPolaris, Inc. which name was changed to Unidym.

Aonex's technology development efforts are directed toward commercializing a method for manufacturing semiconductor nanomaterials.

Insert has developed CycloSert™, a proprietary drug delivery platform technology based on a nano-engineered class of linear cyclodextrin-containing polymers. Insert's first investigational new drug application for its first drug candidate, IT-101, was approved by the U.S. Food and Drug Administration in March 2006. IT-101 is a conjugate of Insert's patented nano-engineered drug delivery polymer and camptothecin, a potent anti-cancer compound. A Phase I study for IT-101 is being conducted at the City of Hope, in Duarte, California.

Calando is designing, developing and commercializing novel RNAi therapeutics to treat diseases and other medical conditions by combining effective RNAi therapeutics with patented and proprietary delivery technologies.

NanoPolaris/Unidym assembled exclusive commercial rights to nanotube materials and processes developed at several universities. NanoPolaris continues to consolidate technologies and intellectual property in this field. On June 13, 2006, NanoPolaris acquired the net assets, including the name, of Unidym, a Los Angeles-based company that develops carbon nanotube electronics. On August 3, 2006, NanoPolaris changed its name to Unidym, Inc.

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The Company had a consolidated loss of \$3,974,148 for the quarter ended June 30, 2006 versus a consolidated loss of \$2,965,701 for the same period of the previous fiscal year. During the second quarter of FY 2005, the company recognized a gain of \$2.3 million applicable to the sale to third parties of a portion of Arrowhead's ownership in Insert Therapeutics, Inc.

The consolidated loss for the nine month period ended June 30, 2006 was \$10,217,686 versus a consolidated loss of \$3,981,518 for the same period of the previous year. The consolidated net loss for the nine month period ended June 30, 2005 would have been \$6,274,318 but the loss was reduced by the gain mentioned above.

The increase in the consolidated loss adjusted for the one time gain occurred primarily in four areas. First, staffing has increased as the Company has grown. Staff has been added at all levels within the company to accommodate the increase in development efforts, the addition of Unidym and the increase in general and administrative responsibilities and the need to comply with Sarbanes Oxley. Second, Insert incurred major expenses during the first nine months of FY 2006 related to preclinical research, to filing the Investigational New Drug Application with the U.S. Food and Drug Administration, to obtaining sufficient IT-101 drug inventories to be able to enter Phase I Clinical Trials and finally to pay for all the advance preparation required to enter the trials. Third, legal expenses increased as the company completed a private placement, recapitalized Calando, acquired the net assets of Unidym, examined or reviewed new potential deals and maintained patents licensed from Caltech. Fourth, facilities cost increased due to moving facilities, expanding existing space and the establishment of new facilities to meet growth of or to house new subsidiaries.

The analysis below details the operating expenses and discusses the increased expenditures within the major categories.

For purposes of comparison, the amounts for the three month and nine month periods ended June 30, 2006 and 2005 are shown in the tables below. Certain prior period amounts have been reclassified to conform with current period presentation.

The amounts for each period have been adjusted to include the adoption of SFAS 123R and to eliminate Nanotechnica from continuing operations.

Salary & Wage Expenses

(in thousands)

	Three Months Ended	% of	Three Months Ended	% of	Increase (Decrease)	
	June 30 2006	expense category	June 30 2005	expense category	\$	%
G&A – compensation-related	\$ 1,052	52%	\$ 433	62%	\$ 619	143%
Stock-based compensation	\$ 366	18%	\$ 59	8%	\$ 307	522%
R&D – compensation-related	\$ 619	30%	\$ 209	30%	\$ 410	196%
Total	\$ 2,037	100%	\$ 701	100%	\$ 1,336	191%

	Nine months Ended	% of	Nine months Ended	% of	Increase (Decrease)	
	June 30 2006	expense category	June 30 2005	expense category	\$	%
G&A – compensation-related	\$ 2,131	44%	\$ 734	41%	\$ 1,397	190%
Stock-based compensation	\$ 997	20%	\$ 230	13%	\$ 767	333%
R&D – compensation-related	\$ 1,738	36%	\$ 823	46%	\$ 915	111%
Total	\$ 4,866	100%	\$ 1,787	100%	\$ 3,079	172%

The increase in G&A related compensation is the result of hiring and subsequent departure of a new President for Arrowhead and the associated severance. Hiring other executive management for Arrowhead and its subsidiaries and additional support staff to service the Company and its Subsidiaries in the areas of Sarbanes-Oxley implementation, human resources and accounts payable. The increase in stock based compensation is related to the issuance of stock options to existing and new employees and expense booked pursuant to the adoption of SFAS 123R which requires expensing of stock-based compensation for all options granted. Finally, the R&D compensation increase is the result of hiring additional technical staff as the Company's Subsidiaries increase the pace of development. The Company expects that Salaries & Wages will continue to grow during FY 2006 as more people are hired to support development and administration of the Company.

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General & Administrative Expenses

(in thousands)

	Three Months Ended	% of	Three Months Ended	% of	Increase (Decrease)	
	June 30 2006	expense category	June 30 2005	expense category	\$	%
Professional/outside services	\$ 594	41%	299	38%	\$ 295	99%
Facilities	\$ 247	17%	173	22%	\$ 74	43%
Patent expense	\$ 134	9%	10	1%	\$ 124	1,240%
Travel	\$ 72	5%	34	4%	\$ 38	112%
Business insurance	\$ 105	8%	47	6%	\$ 58	123%
Depreciation	\$ 86	6%	70	9%	\$ 16	23%
Other	\$ 202	14%	163	20%	\$ 39	24%
Total	\$ 1,440	100%	\$ 796	100%	\$ 644	81%

	Nine months Ended	% of	Nine months Ended	% of	Increase (Decrease)	
	June 30 2006	expense category	June 30 2005	expense category	\$	%
Professional/outside services	\$ 1,325	35%	612	35%	\$ 713	117%
Facilities	\$ 702	18%	429	24%	\$ 273	64%
Patent expense	\$ 568	15%	45	3%	\$ 523	1,162%
Travel	\$ 182	5%	105	6%	\$ 77	73%
Business insurance	\$ 195	5%	99	6%	\$ 96	97%
Depreciation	\$ 251	7%	200	11%	\$ 51	26%
Other	\$ 568	15%	275	15%	\$ 293	107%
Total	\$ 3,791	100%	\$ 1,765	100%	\$ 2,026	115%

The major increases in non-compensation related general and administrative expenses are the result of legal and professional fees associated with subsidiary stock purchases, capital contributions to subsidiaries, the acquisition of the net assets of Unidym and strategic initiatives and Sarbanes-Oxley compliance. Arrowhead has incurred additional expense for new or expanded leases as subsidiaries are established or expanded. Facilities related expenses are expected to increase in FY 2006 with the Company's move to larger corporate offices and from both Insert's and Calando's moves into new laboratory facilities. The increase in patent expense during the nine month period relates primarily to the accrual of \$300,000 of patent expenses owed to Caltech for patent & patent applications that Insert licenses from Caltech and NanoPolaris/Unidym related activities. Insurance increased as a result of increases in limits and coverages. Travel increased as the Company management pursues new initiatives and collaborations with others.

Research and Development Expenses

(in thousands)

	Three Months Ended	% of	Three Months Ended	% of	Increase (Decrease)	
	June 30, 2006	expense category	June 30, 2005	expense category	\$	%
R&D contract labor	\$ 346	32%	\$ 155	11%	\$ 191	123%
Laboratory supplies & services	\$ 326	30%	\$ 787	59%	\$ -461	-59%
Sponsored research	\$ 306	28%	\$ 255	19%	\$ 51	20%
Depreciation-R&D-related	\$ 56	5%	\$ 58	4%	\$ -2	-3%
Other research expenses	\$ 47	5%	\$ 90	7%	\$ -43	-48%
Total	\$ 1,081	100%	\$ 1,345	100%	\$ -264	-20%

	Nine months Ended	% of	Nine months Ended	% of	Increase (Decrease)	
	June 30, 2006	expense category	June 30, 2005	expense category	\$	%
R&D contract labor	\$ 1,687	43%	\$ 525	21%	\$ 1,162	221%
Laboratory supplies & services	\$ 1,027	26%	\$ 1,089	45%	\$ -62	-6%
Sponsored research	\$ 891	23%	\$ 589	24%	\$ 302	51%
Depreciation-R&D-related	\$ 170	4%	\$ 136	6%	\$ 34	25%
Other research expenses	\$ 165	4%	\$ 93	4%	\$ 72	77%
Total	\$ 3,940	100%	\$ 2,432	100%	\$ 1,508	62%

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Insert received approval for its Investigational New Drug (IND) application from the Federal Drug Administration (FDA) for its lead anti-cancer therapeutic, IT-101 on March 14, 2006 and began Phase I clinical trials in the third quarter of calendar 2006. In advance of the clinical trials, Insert was required to pay the cost to manufacture the entire amount of, IT-101 necessary to complete the Phase I clinical trial. It is the company's policy to expense the cost of the supplies when received. Laboratory supplies & services decreased compared to the same period in the prior year as the cost of the supplies necessary for the clinical trials, of approximately \$1,283,000 were expensed in prior quarters. Also, Insert completed the large mammal studies, begun in FY 2005, required as part of the IND process and those expenses are included in earlier quarters. While a purchase of supplies and animal studies of this magnitude is not a normal recurring expense, the continued development of new products in Insert, Calando, Aonex, NanoPolaris/Unidym will result in increased R&D expenses in the future.

The Company continues to sponsor research at Caltech, Duke, Stanford and has entered into a new sponsored research agreement with the University of Florida. The number of research projects can fluctuate from time to time as the Company adds or terminates projects. The increase in sponsored research expense in the three month and nine month periods ended June 30, 2006 compared to the three month and nine month periods ended June 30, 2005 is in large part due to the expense of the Duke and the Stanford projects. Each project has an annual cost of \$300,000 over two years and neither project was in place in FY 2005.

Leveraged Technology and Revenue Strategy

Arrowhead continues to follow its strategy to leverage technology which is being or has been developed at universities. By doing so, Arrowhead benefits from work done at those universities and through majority-owned subsidiaries, which can commercialize the most promising technologies developed from sponsored research and other sources. Although the Company is likely to produce prototypes and develop manufacturing processes, it may not ultimately manufacture products developed. The Company has three primary strategies to potentially generate product sales revenue:

- License the products and processes to a third party for a royalty or other payment. By licensing, the Company would not be required to allocate resources to build a sales or a production infrastructure and could use those resources to develop additional products.
- Retain the rights to the products and processes, but contract with a third party for production. The Company would then market the finished products. This approach would require either the establishment of a sales and distribution network or collaboration with a supplier who has an established sales and distribution network, but would not require investment in production equipment.
- Build production capability in order to produce and market the end products. This last approach would likely require the most capital to build the production, sales and distribution infrastructure.

On a case-by-case basis, the Company will choose the strategy, which in the opinion of management, will generate the highest return for the Company.

The Company seeks and has been awarded grants from private and public entities. While the ultimate goal of the Company is to generate revenue through the sale of products and/or the licensing of technology, the Company does record revenue from grants and from development fees. Revenue from grants and development fees are considered to be reimbursements for efforts performed on behalf of third parties and not part of the Company's primary strategy to generate revenue.

In June 2005, Calando entered into the Company's first commercial licensing deal whereby Calando granted an exclusive worldwide license to Benitec Ltd. (ASX:BLT) for the combination of Calando's polymeric RNA interference ("RNAi") delivery technology with Benitec's RNAi-based therapeutic for the hepatitis C virus ("HCV"). Under this license agreement, Calando received an upfront payment of \$150,000, which was amortized over 12 months. For the quarter ended June 30, 2006, the Company recognized \$37,750 in revenue applicable to this agreement. The Company is actively pursuing other license deals.

For the three month and nine month periods ended June 30, 2006, \$181,250 and \$406,250, respectively, in revenue was generated primarily related to development fees paid to Calando by Benitec. The \$150,000, license fee was recognized ratably over the past 4 quarters a rate of approximately \$31,250 per quarter. During the quarter, Aonex recognized another \$20,000 related to an SBIR grant. Year to date Aonex has recognized \$70,000 in SBIR grant revenue. Grants and development fees continue into FY 2006, but there can be no assurance that subsequent grants will be forthcoming.

The Company does not expect any product sales in FY 2006. Therefore, losses can be expected to increase before any substantial revenue is generated. To partially offset these losses, the Company is pursuing other means of funding such as licenses, government grants, contracts and collaborations with third parties. The award of such grants and contracts depends on numerous factors, many of which are not in the Company's control, and therefore it is difficult to predict if this will be successful.

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Liquidity and Capital Resources

Since inception in May 2003, the Company has generated significant losses. As of June 30, 2006, the Company's accumulated deficit including minority interest was \$23.1 million. As of June 30, 2006, the Company had \$30.6 million in cash and marketable securities compared to \$22.5 million in cash and marketable securities at September 30, 2005. The Company's investment objectives are primarily to preserve capital and liquidity and secondarily to obtain investment income. The Company invests excess cash in certificates of deposit, U.S. government obligations and high grade commercial paper.

The Company's operating activities have required significant amounts of cash. This trend will continue through FY 2006 as the Company's Subsidiaries continue to develop and refine their products and technology. During this period the Company does not expect to generate significant amounts of revenue. It is projected that the Company and its subsidiaries will continue to add staff, property, and equipment during FY 2006. In addition, the Company expects to continue to invest in new sponsored research projects and new business opportunities. At June 30, 2006, the Company had a commitment to provide an additional \$7 million to Calando, and \$4 million to NanoPolaris/Unidym if certain milestones are reached. The Company believes that the cash on hand at June 30, 2006 is sufficient to meet all existing obligations and fund existing operations beyond the end of FY 2007.

Since inception, the Company has funded operations and acquisitions through the issuance of equity. As of June 30, 2006, the Company had raised approximately \$52 million through the sale of Common Stock and the exercise of Warrants. New business opportunities may require additional cash resources. In the future, the Company may seek additional funding through public or private financing, through collaborations and/or through private and U.S. government grants.

Except for copy machines, the Company does not lease any equipment and purchases all of its required capital assets. To date, when leasing facility space, the Company has been successful in having most leasehold improvements paid for by the landlord and included in the lease cost. The Company may not be able to do so in all cases going forward.

Off-Balance Sheet Arrangements

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

Contractual Obligations and Commitments

None.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

We are exposed to changes in interest rates primarily from our investments in certain short-term investments. We invest our excess cash in highly liquid short-term investments that are typically held for the duration of the term of the respective instrument. We do not utilize derivative financial instruments, derivative commodity instruments or other market risk sensitive instruments to manage exposure to interest rate changes. Accordingly, we believe that, while the securities we hold are subject to changes in the financial standing of the issuer of such securities, we are not subject to any material risks arising from changes in interest rates, foreign currency exchange rates, commodity prices, equity prices or other market changes that affect market risk sensitive instruments.

ITEM 4. CONTROLS AND PROCEDURES.

As of the end of the period covered by this Quarterly Report on Form 10-Q, the Chief Executive Officer and the Chief Financial Officer of the Company conducted an evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Rules 13a-14 and 3a-15 under the Securities Exchange Act of 1934, as amended. Based upon that evaluation, the Chief Executive Officer, President, and the Chief Financial Officer concluded that the Company's disclosure controls and procedures are functioning effectively to provide reasonable assurance that that the information required to be disclosed by the Company in reports filed under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time period prescribed by the Securities and Exchange Commission. A controls system, no matter how well designed and operated, cannot provide absolute assurance that the objectives of the controls system are met, and no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected.

No change in the Company's internal controls in financial reporting occurred during the Company's most recent three month period that have materially affected, or is reasonably likely to materially affect, these controls subsequent to the date this evaluation was carried out.

PART II—OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

None.

ITEM 2. RECENT SALES OF UNREGISTERED SECURITIES; USE OF PROCEEDS.

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

None.

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

None.

ITEM 5. OTHER INFORMATION.

On June 2, 2006, by mutual agreement, Mr. Leon Ekchian stepped down from his position as President and Director of the Company. On August 9, 2006, a Severance Agreement and General Release entered into between the Company and Mr. Ekchian became effective and it provides Mr. Ekchian with a lump sum payment of \$280,000 and extends Mr. Ekchian's vested options to purchase 50,000 shares of the Company's Common Stock until the close of business on December 31, 2006, and immediately vests Mr. Ekchian's unvested options in the amount of 83,333 shares of the Common Stock with an exercise price of \$3.90 per share of Common Stock, which options will be immediately exercisable until the close of business on December 31, 2006, after which time, these options shall expire and shall not be exercisable.

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ITEM 6. EXHIBITS.

Exhibit Number	Document Description
3.1	Certificate of Incorporation of InterActive, Inc., a Delaware company, dated February 8, 2001 (1)
3.2	Certificate of Amendment of Certificate of Incorporation of InterActive Group, Inc., dated January 12, 2004 (effecting, among other things a change in the corporation's name to "Arrowhead Research Corporation") (2)
3.3	Certificate of Amendment to Certificate of Incorporation, dated January 25, 2005 (3)
3.4	Bylaws (1)
4.1	Form of Registration Rights Agreement dated January 24, 2006 (4)
4.2	Form of Warrant to Purchase Common Stock issued January 24, 2006 (4)
10.1**	Copy of the Arrowhead Research Corporation (fka InterActive, Inc.) 2000 Stock Option Plan, the Arrowhead Research Corporation Stock Option Agreement (Incentive Stock Option) and the Arrowhead Research Corporation Stock Option Agreement (Nonstatutory Option) (5)
10.2**	Copy of the Arrowhead Research Corporation 2004 Stock Option Plan (6)
10.3**	Copy of the Arrowhead Research Corporation Non-employee Director Compensation Policy (7)
10.4	Common Stock and Warrant Purchase Agreement, dated as of January 11, 2006, among Arrowhead, York, Knott and certain affiliates (4)
10.5	Series A Preferred Stock Purchase Agreement between Arrowhead Research and Calando Pharmaceuticals, Inc. dated June 30, 2006 (8)
10.6	Agreement to Provide Additional Capital between Arrowhead Research and Calando Pharmaceuticals, Inc. (8)
10.7	Common Stock Transfer Agreement among Arrowhead Research, Mark Davis, John Petrovich and John Rossi (8)
10.8	Severance Agreement and General Release between Arrowhead Research Corporation and Leon Ekchian*
31.1	Section 302 Certification of Chief Executive Officer*
31.2	Section 302 Certification of President & Chief Financial Officer *
32.1	Section 1350 Certification by Principal Executive Officer*
32.2	Section 1350 Certification by President & Principal Financial Officer*

* Filed herewith.

** Indicates compensation plan, contract or arrangement.

- (1) Incorporated by reference from the Schedule 14C filed by registrant on December 22, 2000.
- (2) Incorporated by reference from the Schedule 14C filed by registrant on December 22, 2003.
- (3) Incorporated by reference from the Quarterly Report on Form 10-QSB for the quarter ended December 31, 2004, filed by registrant on February 11, 2005.
- (4) Incorporated by reference from the Current Report on Form 8-K, filed by registrant on January 18, 2006.
- (5) Incorporated by reference from the Registration Statement on Form S-8, filed by registrant on October 29, 2004.
- (6) Incorporated by reference from Annex A to the definitive Schedule 14C filed by registrant on December 16, 2005.
- (7) Incorporated by reference from the Annual Report on Form 10-KSB for the year ended September 30, 2005, filed by registrant on December 22, 2005.
- (8) Incorporated by reference from the Current Report on Form 8-K filed by registrant on April 6, 2006.

SEVERANCE AGREEMENT AND GENERAL RELEASE

This Severance Agreement and General Release (this "**Agreement**") is made and entered into by and between Leon Ekchian ("**Mr. Ekchian**"), on the one hand, and Arrowhead Research Corporation (the "**Company**"), on the other hand. This Agreement is made with reference to the following facts:

1. **Severance Payment.** In consideration of the promises and releases set forth herein, the Company will pay Mr. Ekchian \$255,000.00, less all applicable statutory withholdings and deductions; payable in one lump sum by check or wire transfer on the eighth day after Mr. Ekchian executes this Agreement (the "**Effective Date**"), or, if such day is a day on which national banks are closed, the following business day.

2. **Stock Options.** The Company, by vote of its Board of Directors, (i) extends Mr. Ekchian's vested options to purchase 50,000 shares of the Company's Common Stock (the "**Common Stock**") until the close of business on December 31, 2006 (the "**Expiration Date**"), and (ii) immediately vests Mr. Ekchian's unvested options in the amount of 83,333 shares ($700,000/42 * 5$) of the Common Stock with an exercise price of \$3.90 per share of Common Stock, which options will be immediately exercisable as of the Effective Date until the close of business on the Expiration Date, after which time, these options shall expire and shall not be exercisable.

3. **Expenses; Legal Fees.** The Company has reimbursed Mr. Ekchian for all unreimbursed expenses incurred in his capacity as an officer or director of the Company on or prior to June 2, 2006, in accordance with the Company's current policies and procedures. Mr. Ekchian agrees and acknowledges that he has no further unreimbursed expenses incurred in his capacity as an officer or director of the Company. In addition, the Company shall pay Mr. Ekchian a lump sum of \$25,000 for legal fees on the Effective Date.

4. **General Release by Mr. Ekchian.** Mr. Ekchian, on behalf of himself and his heirs, spouses and assigns, hereby releases and gives up any and all charges, controversies, claims, wages, rights, agreements, actions, costs or expenses, causes of action, obligations, damages, losses, promises and liabilities of whatever kind or nature (including, but not limited to, back wages and attorney's fees), in law or equity or otherwise, whether known or unknown, suspected or unsuspected, from the beginning of time to the present, which he may have against the Company and/or any of its respective subsidiaries, parent companies, divisions, affiliated companies and benefit plans, as well any current or future employees, managers, officers, directors, owners, attorneys or other agents of those companies or benefit plans, all of which are referred to collectively herein as the "Releasees."

Without limiting the foregoing, Mr. Ekchian hereby generally releases any and all claims or causes of action he may have against the Releasees including, but not limited to, any and all claims for breach of contract, breach of promise, wrongful discharge, unjust dismissal, retaliation, unfair competition, whistleblowing, breach of fiduciary duty, breach of the implied covenant of good faith and fair dealing, defamation, assault, battery, invasion of privacy, wrongful denial of benefits, intentional and/or negligent infliction of emotional distress, intentional and/or negligent misrepresentation, representations made to induce Mr. Ekchian to accept employment with the Company, fraud, negligence, and any and all other torts; any and all claims for wages, expenses, mileage reimbursement, severance pay, sick leave, vacation pay, life insurance, medical insurance, disability insurance or any other benefit of employment; any and all claims of illegal discrimination or harassment including, but not limited to, those based upon age, sex, pregnancy, race, color, religion, national origin, citizenship, veteran status, sexual orientation, gender, gender orientation, pregnancy, marital status, disability and/or handicap; and any and all claims or causes of action under the Civil Rights Act of 1964, 42 U.S.C. Section 2000e *et seq.* ("Title VII"), as amended by the Civil Rights Act of 1991, 42 U.S.C. Section 1981 *et seq.* (1991); the Americans with Disabilities Act, 42 U.S.C. Section 12101 *et seq.* (1990); Sections 503 and 504 of the Rehabilitation Act of 1973; the Age Discrimination in Employment Act, 29 U.S.C. Section 621 *et seq.*, as amended by the Older Workers Benefit Protection Act and/or any state counterpart; Executive Order 11141; the Employee Retirement Income Security Act of 1974, 29 U.S.C. Section 1001 *et seq.*; Executive Order 11246, as amended; the Sarbanes-Oxley Act of 2002; the Consolidated Omnibus Budget Reconciliation Act of 1985

("COBRA"); Cal-COBRA; the Family and Medical Leave Act; the California Family Rights Act; the California Fair Employment and Housing Act; the Fair Labor Standards Act; the California Labor Code; the California Business & Professions Code; the Federal and California Constitutions; the California Industrial Welfare Commission Wage Orders and any other local, state or Federal statute, regulation or ordinance prohibiting illegal discrimination, harassment or retaliation.

Mr. Ekchian hereby releases all claims described herein through the date he signs this Agreement, including any alleged injuries or damages suffered at any time after the date he signs this Agreement by reason of the continued effects of any alleged discriminatory acts or other conduct which occurred on or before the date of this Agreement.

5. Release of Age Discrimination Claims. Mr. Ekchian expressly releases all claims against the Releasees under the Age Discrimination in Employment Act (ADEA), as amended by the Older Workers Benefit Protection Act, and pursuant to the advice of his counsel, hereby voluntarily waives the 21-day period in which to consider this Agreement.

Following the date that Mr. Ekchian signs this Agreement, he shall have a period of seven (7) days within which to revoke it. Any such revocation must be in writing and delivered to the President of Arrowhead Research Corporation, 201 South Lake Street, Suite 703, Pasadena, California 91101; and fax no. 626-304-3401. If Mr. Ekchian signs this Agreement and then revokes it within the seven (7) day revocation period, it will become unenforceable and its offer of payments to Mr. Ekchian and all other provisions will be null and void.

6. General Release by the Company. Subject to the rights and obligations arising out of this Agreement, the Company, on behalf of itself and its employees, representatives, attorneys, agents, successors and assigns, hereby releases, acquits and forever discharges Mr. Ekchian, and any of his heirs, immediate family members, successors, assigns, attorneys, accountants, and agents from any and all charges, controversies, claims, rights, agreements, actions, costs or expenses, causes of action, obligations, damages, losses, promises and liabilities of whatever kind or nature, in law or equity or otherwise, whether known or unknown, suspected or unsuspected, vested or contingent, from the beginning of time to the present, including but not limited to any claims arising out of, based upon or relating in any way to Mr. Ekchian's employment with the Company or relating to or arising from any alleged act or omission by Mr. Ekchian. Notwithstanding anything herein to the contrary, this provision does not preclude the Company from pursuing action against Mr. Ekchian to the extent, and only if, failure to take any action against Mr. Ekchian would (i) constitute a breach of any of its directors' fiduciary duties to any stockholder, creditor or employee or (ii) be unlawful.

7. Waiver of California Civil Code, Section 1542. The parties agree that the releases set forth in Sections 4, 5 and 6 above are general releases. The parties expressly waive any benefits that California Civil Code, Section 1542 or any other laws, legal decisions and/or legal principles of similar effect might provide to them now or in the future, and agree that the releases described in Sections 4, 5 and 6 above extend to all claims, whether or not claimed or suspected by the parties, subject to the representations and warranties provided by the parties herein. California Civil Code, Section 1542 (to the extent such section is applicable) reads as follows:

"A general release does not extend to claims which the creditor does not know or suspect to exist in his or her favor at the time of executing the release, which if known by him or her must have materially affected his or her settlement with the debtor."

The parties certify that they have read the provisions of California Civil Code, Section 1542 and acknowledge that the effect and import of those provisions have been explained to them by their own counsel. The parties further acknowledge and agree that this waiver of rights under California Civil Code, Section 1542 has been separately bargained for and is an essential and material term of this Agreement and, without such waiver, this Agreement would not have been entered into. The parties understand that the facts with respect to which this Agreement is given may hereafter prove to be different from the facts

now known or believed by them, and hereby accept and assume the risk thereof and agree that this Agreement shall be and shall remain, in all respects, effective and not subject to termination or rescission by reason of any such difference in facts.

8. **Indemnification.** Nothing herein shall in any way limit the Company's obligation to indemnify Mr. Ekchian under the Delaware General Corporation Law, Cal. Labor Code § 2802, and the Company's Bylaws. In the event any Releasee sues Mr. Ekchian for any actions arising on or before the Effective Date of this Agreement, the Company shall indemnify Mr. Ekchian for any expenses incurred as a result thereof, and immediately advance all attorneys' fees therefore; provided, however, the Company will not be responsible for any expenses or fees of Mr. Ekchian to the extent that such lawsuit is the result of Mr. Ekchian's gross negligence, willful misconduct or fraud.

9. **Representations and Warranties.** Each party herein represents and warrants to the other that he/it is aware of no other party having an interest in, nor has he/it assigned, hypothecated or otherwise transferred any interest in the claim or claims which are the subject of this Agreement, and each party hereby agrees to indemnify and hold harmless the other party from any and all liability, claims, demands, obligations, damages, costs, expenses and attorneys' fees as a result of anyone asserting such interest, assignment, hypothecation or transfer. Each signatory additionally warrants that he/it is authorized to enter into and execute this Agreement on behalf of the party for whom he/it is signing.

10. **Return of Property.** Mr. Ekchian has previously delivered to the Company, and is not in possession of any, property, documents or other materials pertaining to his prior employment with the Company. The Company has previously delivered to Mr. Ekchian all of his personal property in its possession.

11. **Covenant Not to Sue.** The parties and their representatives covenant and agree that they will forever refrain and forbear from bringing, commencing, or prosecuting any action, lawsuit, claim or claims or proceedings based on, arising out of, or in connection with any claim, debt or obligation that is released or discharged herein, including, but not limited to, any claims related in any way to Mr. Ekchian's employment with the Company. This provision does not preclude any party from suing based on anything arising from the respective obligations and duties, which survive this Agreement. Notwithstanding anything herein to the contrary, this provision does not preclude the Company from pursuing action against Mr. Ekchian to the extent, and only if, failure to take any action against Mr. Ekchian would (i) constitute a breach of any of its directors' fiduciary duties to any stockholder, creditor or employee or (ii) be unlawful.

12. **Communications.** In response to inquiries directed to the Company's Chief Executive Officer or Chief Financial Officer, the Company will confirm Mr. Ekchian's job title, annual base salary while at the Company, and his dates of employment with the Company. It is the Company's policy to not to comment further.

13. **Non-Disparagement.** Mr. Ekchian has not and will not, either directly or indirectly, make or cause to be made disparaging remarks about the Company or any Releasee, regardless of whether he believes such statements to be true, unless required to give testimony pursuant to court order or valid subpoena, or in connection with a government inquiry, investigation or administrative proceeding. To the Company's knowledge, none of its officers, directors or employees have, either directly or indirectly, made or caused to be made disparaging remarks about Mr. Ekchian, and the Company has informed each of its officers, directors and employees of their obligation not to make disparaging remarks about Mr. Ekchian, either directly or indirectly, regardless of such officer, director or employee's belief such statement is true.

14. **Confidentiality of Company Information.** Mr. Ekchian has and will maintain the confidentiality of all Company, client, financial and other confidential and proprietary information that he obtained or to which he had access during his employment with the Company, and Mr. Ekchian will not use or reveal any such information for any purpose whatsoever, unless required to give testimony

pursuant to court order or valid subpoena, or in connection with a government inquiry, investigation or administrative proceeding.

15. **No Other Actions.** The parties represent and warrant that there are currently no administrative proceedings, lawsuits or judicial proceedings of any kind pending with respect to the subject matter of this dispute where Mr. Ekchian, on the one hand, and the Releasees, on the other hand, are parties, and the parties further represent and warrant that they will not commence or cause or seek to have commenced any such lawsuit, action or proceeding in the future for the claims released herein. Other than those claims released hereby or otherwise disclosed to the Company, Mr. Ekchian further represents and warrants that he has no actual knowledge of any pending claim or proceeding or of any claim or proceeding threatened, whether orally or in writing, of any kind against the Company, and/or its affiliates, subsidiaries and parent companies, or any other company owned in whole or in part by the Company.

16. **General Provisions.**

a. Nothing in this Agreement shall be construed to prohibit the parties hereto from providing truthful information under oath or in any investigative, legal or administrative proceeding.

b. This Agreement constitutes the entire Agreement between the parties hereto pertaining to the subject matter hereof, and supersedes all prior and contemporaneous oral and written agreements and understandings of the parties; there are no warranties, representations or other agreements between the parties except as expressly set forth herein. No supplementation, modification, waiver or termination of this Agreement shall be binding unless executed in writing by the party to be bound thereby, in such party's sole and absolute discretion.

c. This Agreement was entered into solely to effectuate an economic resolution of the matters set forth in this Agreement, and nothing herein shall be construed as an admission by any party of any liability, any such liability being expressly denied.

d. The negotiations preceding the execution of this Agreement, including, without limitation, all oral and written communications are confidential, and neither party hereto may disclose them to any third party, other than immediate family members, financial advisors, attorneys, so long as they are advised of the confidential nature of this information, and any appropriate governmental agency.

e. Each of the parties hereto agrees that he or it will execute and deliver all such documents and instruments as may be necessary and appropriate to effectuate the terms hereof.

f. This Agreement may be executed in counterparts and, as so executed, shall constitute one Agreement binding on all parties. A copy or facsimile of a signature on this Agreement shall have the same force and effect as an original ink signature.

g. This Agreement shall inure to the benefit of and shall be binding upon the respective successors and assigns of each of the parties hereto.

h. Each party shall and will bear its own fees and costs in relation to this dispute, and in connection with the negotiation and execution of this Agreement, except as expressly provided herein. However, if any legal action or other proceeding is brought for the enforcement of this Agreement, or because of an alleged dispute, breach, default or misrepresentation in connection with any of the provisions of this Agreement, the successful or prevailing party shall be entitled to recover reasonable attorneys' fees, fees and other costs incurred in that action or proceeding, in addition to any other relief to which it may be entitled.

i. Each party to this Agreement acknowledges that it has been represented by independent counsel of its own choice throughout all of the negotiations, which preceded and resulted in

the execution of this Agreement. This Agreement shall be construed fairly as to all parties and not in favor of or against any party regardless of which of the parties prepared this Agreement, and the parties hereby waive California Civil Code, Section 1654.

j. The parties agree and acknowledge that if any provision of this Agreement is determined by a final judgment of a court of competent jurisdiction to be illegal or unenforceable, such determination shall not affect the balance of this Agreement, which shall remain in full force and effect as such invalid provision shall be deemed severable.

k. This Agreement shall be construed under the laws of the State of California. The exclusive venue for any dispute arising out of this Agreement shall be a court of competent jurisdiction in Los Angeles County, California.

IN WITNESS WHEREOF, the parties have executed this Agreement on the date set forth below.

Date: August 1, 2006

By: /s/ Leon Ekchian

LEON EKCHIAN

Date: August 1, 2006

ARROWHEAD RESEARCH CORPORATION

By: /s/ R. Bruce Stewart

Its: Chief Executive Officer

SECTION 302 CERTIFICATION

I, R. Bruce Stewart, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Arrowhead Research Corporation;

2. Based on my knowledge, this Quarterly Report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this Quarterly Report;

3. Based on my knowledge, the financial statements, and other financial information included in this Quarterly Report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this Quarterly Report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)), for the registrant and we have:

(a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this Quarterly Report is being prepared;

(b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this Quarterly Report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by this report based on such evaluation; and

(c) disclosed in this Quarterly Report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

(a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 9, 2006

/s/ R. BRUCE STEWART

R. Bruce Stewart,
Chief Executive Officer

SECTION 302 CERTIFICATION

I, Joseph T. Kingsley, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Arrowhead Research Corporation;

2. Based on my knowledge, this Quarterly Report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this Quarterly Report;

3. Based on my knowledge, the financial statements, and other financial information included in this Quarterly Report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this Quarterly Report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)), for the registrant and we have:

(a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this Quarterly Report is being prepared;

(b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this Quarterly Report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by this report based on such evaluation; and

(c) disclosed in this Quarterly Report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

(a) all significant deficiencies in the design or operation of internal controls over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 9, 2006

/s/ JOSEPH T. KINGSLEY

Joseph T. Kingsley
President & Chief Financial Officer

SECTION 906 CERTIFICATION

In connection with the Quarterly Report on Form 10-Q of Arrowhead Research Corporation (the "Company") for the quarter ended June 30, 2006, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, R. Bruce Stewart, the chief executive officer of the Company, hereby certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: August 9, 2006

/s/ R. BRUCE STEWART

R. Bruce Stewart

Chief Executive Officer

A signed original of this written statement required by Section 906 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.

SECTION 906 CERTIFICATION

In connection with the Quarterly Report on Form 10-Q of Arrowhead Research Corporation (the "Company") for the quarter ended June 30, 2006, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Joseph T. Kingsley, the chief financial officer of the Company, hereby certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: August 9, 2006

/s/ JOSEPH T. KINGSLEY

Joseph T. Kingsley

President & Chief Financial Officer

A signed original of this written statement required by Section 906 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.