

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549**

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**FORM 10-Q**

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

For the quarterly period ended March 31, 2006.

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

Commission file number 000-21898

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**ARROWHEAD RESEARCH CORPORATION**

(Name of small business issuer in its charter)

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**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)

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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: 33,809,826 as of May 9, 2006.

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

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PART I—FINANCIAL INFORMATIONITEM 1. FINANCIAL STATEMENTS

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**Arrowhead Research Corporation and Subsidiaries**  
**(A Development Stage Company)**

**Consolidated Balance Sheets**  
**As of March 31, 2006 and September 30, 2005**

|  | <u>March 31,</u><br><u>2006</u> | <u>September 30,</u><br><u>2005</u> |
|--|---------------------------------|-------------------------------------|
|  | <u>(Unaudited)</u>              |                                     |
| <b>ASSETS</b>  |                                 |                                     |
| <b>CURRENT ASSETS</b>  |                                 |                                     |
| Cash and cash equivalents                                      | \$ 16,584,747                   | \$22,467,016                        |
| Marketable securities at fair market value—US Treasury Bills   | 18,709,110                      | 76,880                              |
| Grant receivable, net of allowance for doubtful account of \$0 | 40,000                          | 25,748                              |
| Other receivables  | 2,200                           | 7,700                               |
| Prepaid sponsored research, <i>Note 6.</i>                     | 213,487                         | 10,000                              |
| Other prepaid research   | 234,667                         | 81,666                              |
| Other prepaid expenses   | 329,249                         | 144,985                             |
| <b>TOTAL CURRENT ASSETS</b>                                    | <u>36,113,460</u>               | <u>22,813,995</u>                   |
| <b>PROPERTY AND EQUIPMENT</b>                                  |                                 |                                     |
| Computers, office equipment and furniture                      | 459,002                         | 392,164                             |
| Research equipment   | 991,651                         | 860,759                             |
| Software   | 52,023                          | 52,023                              |
| Leasehold improvement  | 324,690                         | 324,690                             |
|  | <u>1,827,366</u>                | <u>1,629,636</u>                    |
| Less: Accumulated depreciation and amortization                | <u>(829,617)</u>                | <u>(551,514)</u>                    |
| <b>NET PROPERTY AND EQUIPMENT</b>                              | <u>997,749</u>                  | <u>1,078,122</u>                    |
| <b>INTANGIBLE AND OTHER ASSETS</b>                             |                                 |                                     |
| Rent deposit   | 183,429                         | 110,379                             |
| Patents, <i>Note 1.</i>  | 3,323,206                       | 3,276,075                           |
| Goodwill   | 4,467,427                       | 1,762,150                           |
|  | <u>7,974,062</u>                | <u>5,148,604</u>                    |
| <b>TOTAL OTHER ASSETS</b>                                      | <u>7,974,062</u>                | <u>5,148,604</u>                    |
| <b>TOTAL ASSETS</b>  | <u><b>\$ 45,085,271</b></u>     | <u><b>\$29,040,721</b></u>          |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                    |                                 |                                     |
| <b>CURRENT LIABILITIES</b>                                     |                                 |                                     |
| Accounts payable, <i>Note 1.</i>                               | \$ 1,714,639                    | \$ 471,943                          |
| Accrued expenses   | 632,732                         | 264,541                             |
| Payroll liabilities  | 210,615                         | 181,330                             |
| Deferred revenue   | 31,250                          | 106,250                             |
| <b>TOTAL CURRENT LIABILITIES</b>                               | <u>2,589,236</u>                | <u>1,024,064</u>                    |
| Minority interests   | 1,296,410                       | 1,889,190                           |
| Commitment and contingencies, <i>Note 6.</i>                   |                                 |                                     |
| <b>STOCKHOLDERS' EQUITY, <i>Note 4.</i></b>                    |                                 |                                     |
| Common stock   | 33,814                          | 27,997                              |
| Preferred stock  | —                               | —                                   |
| Deferred compensation  | (3,073,750)                     | (1,976,353)                         |
| Additional paid-in capital                                     | 59,962,209                      | 37,554,933                          |
| Accumulated deficit during the development stage               | <u>(15,722,648)</u>             | <u>(9,479,110)</u>                  |
| <b>TOTAL STOCKHOLDERS' EQUITY</b>                              | <u>41,199,625</u>               | <u>26,127,467</u>                   |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>              | <u><b>\$ 45,085,271</b></u>     | <u><b>\$29,040,721</b></u>          |

*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<br>Ended<br>March 31, 2006 | Three Months<br>Ended<br>March 31, 2005 | Six Months<br>Ended<br>March 31, 2006 | Six Months<br>Ended<br>March 31, 2005 | Period from<br>May 7, 2003<br>(Date of inception)<br>to March 31, 2006 |
|---|---|---|---------------------------------------|---------------------------------------|--|
| <b>REVENUE</b>  | <b>\$ 57,500</b>                        | <b>\$ 77,614</b>                        | <b>\$ 310,000</b>                     | <b>\$ 207,104</b>                     | <b>\$ 1,096,989</b>  |
| <b>OPERATING EXPENSES</b>   |   |   |                                       |                                       |  |
| Salaries  | 1,463,539                               | 590,471                                 | 2,829,804                             | 1,086,640                             | 6,258,655  |
| Consulting  | 149,874                                 | 238,419                                 | 268,352                               | 400,027                               | 1,615,634  |
| General and administrative expenses                               | 1,253,056                               | 477,117                                 | 2,351,151                             | 968,631                               | 5,982,699  |
| Research and development  | 1,136,181                               | 439,038                                 | 2,858,575                             | 1,086,942                             | 7,448,681  |
| <b>TOTAL OPERATING EXPENSES</b>                                   | <b>4,002,650</b>                        | <b>1,745,045</b>                        | <b>8,307,882</b>                      | <b>3,542,240</b>                      | <b>21,305,669</b>  |
| <b>OPERATING LOSS</b>   | <b>(3,945,150)</b>                      | <b>(1,667,431)</b>                      | <b>(7,997,882)</b>                    | <b>(3,335,136)</b>                    | <b>(20,208,680)</b>  |
| <b>OTHER INCOME (EXPENSES)</b>                                    |   |   |                                       |                                       |  |
| Gain on sale of stock in subsidiary                               | —                                       | 2,292,800                               | —                                     | 2,292,800                             | 2,292,800  |
| Realized and unrealized gain (loss) in marketable securities      | 133,195                                 | 73                                      | 136,461                               | 74,654                                | 203,109  |
| Interest income   | 181,310                                 | 6,842                                   | 357,827                               | 16,055                                | 540,220  |
| Other income  | —                                       | 2,991                                   | —                                     | 3,221                                 | 3,308  |
| Minority interests  | 584,499                                 | 257,697                                 | 1,380,936                             | 514,383                               | 3,133,657  |
| Patents—amortization  | (60,440)                                | (393)                                   | (120,880)                             | (2,158)                               | (269,160)  |
| <b>TOTAL OTHER INCOME (EXPENSES)</b>                              | <b>838,564</b>                          | <b>2,560,010</b>                        | <b>1,754,344</b>                      | <b>2,898,955</b>                      | <b>5,903,934</b>   |
| Loss from continuing operations                                   | (3,106,586)                             | 892,579                                 | (6,243,538)                           | (436,181)                             | (14,304,746)   |
| Loss from operation of discontinued Nanotechnica, Inc.            |   | (276,649)                               |                                       | (510,304)                             | (1,342,505)  |
| Loss on disposal of Nanotechnica, Inc. (July 2005—September 2005) |   |   |                                       |                                       | (73,797)   |
| Provision for income taxes  | —                                       |   | —                                     |                                       | (1,600)  |
| <b>NET INCOME (LOSS)</b>  | <b>(3,106,586)</b>                      | <b>615,930</b>                          | <b>(6,243,538)</b>                    | <b>(946,485)</b>                      | <b>(15,722,648)</b>  |
| Income (loss) from continuing operations per share, undiluted     | (0.10)                                  | 0.06                                    | (0.21)                                | (0.03)                                |  |
| Income (loss) from continuing operations per share, fully diluted | (0.10)                                  | 0.04                                    | (0.21)                                | (0.03)                                |  |
| Loss from discontinued operations                                 | (0.00)                                  | (0.02)                                  | (0.00)                                | (0.04)                                |  |
| Net income (loss) per share, undiluted                            | (0.10)                                  | 0.04                                    | (0.21)                                | (0.07)                                |  |
| Net income (loss) per share, fully diluted                        | (0.10)                                  | 0.03                                    | (0.21)                                | (0.07)                                |  |
| Weighted average shares outstanding, undiluted                    | 32,151,954                              | 14,310,243                              | 30,056,130                            | 14,036,805                            |  |
| Weighted average shares outstanding, fully diluted                | 32,151,954                              | 23,639,419                              | 30,056,130                            | 14,036,805                            |  |

*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 March 31, 2006**  
**(unaudited)**

**Common Stock**

|  | Shares            | Amount           | Additional<br>Paid-in-<br>Capital | Deferred<br>Compensation | Accumulated<br>Deficit<br>during the<br>Development<br>Stage | Totals              |
|--|-------------------|------------------|-----------------------------------|--------------------------|--|---------------------|
| <b>Initial Issuance of Stock:</b>  |                   |                  |                                   |                          |  |                     |
| 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)            |
| <b>Balance at September 30, 2003</b>   | <b>4,680,000</b>  | <b>4,680</b>     | <b>1,510,320</b>                  | <b>—</b>                 | <b>(95,238)</b>  | <b>1,419,762</b>    |
| 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)         |
| <b>Balance at September 30, 2004</b>   | <b>13,631,546</b> | <b>13,645</b>    | <b>12,496,851</b>                 | <b>(436,854)</b>         | <b>(2,625,261)</b>   | <b>9,448,381</b>    |
| 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   | 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)         |
| <b>Balance at September 30, 2005</b>   | <b>27,984,194</b> | <b>27,997</b>    | <b>37,554,933</b>                 | <b>(1,976,353)</b>       | <b>(9,479,110)</b>   | <b>26,127,467</b>   |
| 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)         |
| <b>Balance at December 31, 2005</b>  | <b>28,003,194</b> | <b>28,016</b>    | <b>39,126,687</b>                 | <b>(3,207,749)</b>       | <b>(12,616,063)</b>  | <b>23,330,891</b>   |
| Common stock issued @ \$3.50 per share   | 5,590,000         | 5,590            | 19,539,410                        | —                        | —  | 19,545,000          |
| Purchase of Calando Pharmaceuticals, Inc. shares   | 208,382           | 208              | 1,077,125                         | —                        | —  | 1,077,333           |
| Issuance of stock options  | —                 | —                | 218,987                           | (218,987)                | —  | —                   |
| Amortization of deferred compensation expense  | —                 | —                | —                                 | 352,986                  | —  | 352,986             |
| Net loss for the three months ended March 31, 2006   | —                 | —                | —                                 | —                        | (3,106,585)  | (3,106,585)         |
| <b>Balance at March 31, 2006</b>   | <b>33,801,576</b> | <b>\$ 33,814</b> | <b>\$ 59,962,209</b>              | <b>\$ (3,073,750)</b>    | <b>\$ (15,722,648)</b>                                       | <b>\$41,199,625</b> |

*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 Cash Flows**  
For the six months ended March 31, 2006 and 2005 and from inception through March 31, 2006

|  | Six Months<br>Ended<br>March 31, 2006 | Six Months<br>Ended<br>March 31, 2005 | Period from<br>May 7, 2003<br>(Date of inception)<br>to March 31, 2006 |
|--|---------------------------------------|---------------------------------------|--|
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>             |                                       |                                       |  |
| Net Loss   | \$ (6,243,538)                        | \$ (946,485)                          | \$ (15,722,648)  |
| Realized and unrealized (gain) loss on investment        | (136,461)                             | (74,654)                              | (203,109)  |
| Stock issued as gift to Caltech                          | —                                     | —                                     | 162,750  |
| Stock issued for professional services                   | —                                     | 50,000                                | 50,000   |
| Compensation expense related to stock option issuance    | 631,763                               | 171,472                               | 1,315,929  |
| Depreciation and amortization                            | 405,400                               | 254,859                               | 1,124,236  |
| Gain on sale of stock in subsidiary                      | —                                     | (2,292,800)                           | (2,292,800)  |
| Minority interests                                       | (1,380,936)                           | (681,759)                             | (3,152,698)  |
| Decrease/increase in:                                    |                                       |                                       |  |
| Receivables  | (8,752)                               | 13,549                                | (42,200)   |
| Prepaid research expense                                 | (356,488)                             | 232,768                               | (448,155)  |
| Other prepaid expenses                                   | (184,264)                             | (30,356)                              | (329,249)  |
| Restricted cash  | —                                     | 50,773                                | —  |
| Deposits   | (73,050)                              | (74,478)                              | (173,471)  |
| Accounts payable   | 403,522                               | (96,237)                              | 675,575  |
| Accrued expenses   | 368,193                               | 8,852                                 | 599,631  |
| Deferred revenue   | (75,000)                              | —                                     | 31,250   |
| Other liabilities  | 29,285                                | (164,984)                             | 213,304  |
| NET CASH PROVIDED (USED) IN OPERATING ACTIVITIES         | (6,620,326)                           | (3,579,480)                           | (18,191,655)   |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>             |                                       |                                       |  |
| Purchase of marketable securities—US Treasury Bills      | (18,575,915)                          | —                                     | (18,575,915)   |
| Purchase of property and equipment                       | (197,730)                             | (471,073)                             | (1,538,071)  |
| Cash paid for interest in Nanotechnica                   | —                                     | —                                     | (4,000,000)  |
| Cash paid for interest in Aonex                          | (1,000,000)                           | —                                     | (5,000,000)  |
| Cash paid for interest in Insert                         | —                                     | (1,000,000)                           | (5,000,000)  |
| Cash paid for interest in Calando                        | (2,000,000)                           | (250,000)                             | (4,000,000)  |
| Cash paid for interest in NanoPolaris                    | —                                     | —                                     | (1,000)  |
| Cash obtained from interest in Nanotechnica              | —                                     | —                                     | 4,000,000  |
| Cash obtained from interest in Aonex                     | 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                             | 250,000                               | 4,000,000  |
| Cash obtained from interest in NanoPolaris               | —                                     | —                                     | 1,000  |
| Proceeds from sale of stock in subsidiary                | —                                     | 2,640,000                             | 2,424,924  |
| Proceeds from sale of investments                        | 80,145                                | 411,554                               | 569,913  |
| Payment for patents                                      | (117,443)                             | —                                     | (215,816)  |
| Restricted cash  | —                                     | —                                     | 50,773   |
| NET CASH USED IN INVESTING ACTIVITIES                    | (18,810,943)                          | 2,580,481                             | (16,903,348)   |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>             |                                       |                                       |  |
| Proceeds from issuance of common stock and warrants, net | 19,549,000                            | 1,756,832                             | 51,679,750   |
| NET CASH PROVIDED BY FINANCING ACTIVITIES                | 19,549,000                            | 1,756,832                             | 51,679,750   |
| NET INCREASE (DECREASE) IN CASH                          | (5,882,269)                           | 757,833                               | 16,584,747   |
| CASH AT BEGINNING OF PERIOD                              | 22,467,016                            | 8,552,667                             | —  |
| CASH AT END OF PERIOD                                    | \$ 16,584,747                         | \$ 9,310,500                          | \$ 16,584,747  |
| Supplementary disclosures:                               |                                       |                                       |  |
| Interest paid  | \$ —                                  | \$ —                                  | \$ —   |
| <b>Income tax paid</b>                                   | <b>\$ 7,900</b>                       | <b>\$ 2,400</b>                       | <b>\$ 11,100</b>   |

**SUPPLEMENT NON CASH TRANSACTIONS**

On March 23, 2005, Arrowhead purchased 7,375,000 shares of Insert Therapeutic, 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 208,382 newly issued shares of Arrowhead Common Stock valued at \$1,077,333 plus \$850,667 in cash. 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.

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

**Arrowhead Research Corporation**  
**Notes to Consolidated Financial Statements**  
**March 31, 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 diversified 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 all industries.

**Description of the Business**

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. Currently, 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.
- **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 present, 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.

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 March 31, 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 six month periods

ended March 31, 2006 are not necessarily indicative of the results that might be expected for the year ending September 30, 2006.

**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”). 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 six months ended March 31, 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 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 March 31, 2006, the Company had uninsured cash deposits totaling \$25,967,863, which includes \$18,709,110 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 March 31, 2006, intellectual property consists of patents and patent applications licensed or purchased totaling \$316,634. 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 March 31, 2006, the patent has 150 months until its expiration. The accumulated amortization of patents totaled \$294,618 at March 31, 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 March 31, 2006 consisted of \$999,000 for Aonex and \$3,468,427 for Calando.

**Revenue Recognition**—Calando signed a license agreement with Benitec on June 20, 2005. The agreement includes license fees, development fees and milestone fees with an initial annual license fee of \$150,000, paid in advance. The license fee revenue is being recognized over 12 months. The Company recognized \$37,500 and \$75,000 in license revenue for the three month and six month periods ended March 31, 2006, respectively. The remainder of \$31,250 is reported as deferred revenue at March 31, 2006. During the six months ended March 31, 2006, Calando received and recognized \$150,000 in development fee revenue from Benitec. For the three month and six month periods ended March 31, 2006, Aonex recorded \$20,000 and \$50,000 in revenue applicable to a Phase I SBIR grant.

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 primarily consist of stock options issued to employees and consultants of the Company. For three-month period ended March 31, 2006 and six-month periods ended March 31, 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 six month periods ended March 31, 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 six month periods ended March 31, 2006 and 2005 respectively include the accounts of Arrowhead and its subsidiaries, Aonex, Calando, Insert and NanoPolaris. Nanotechnica (which a majority of its shareholders voted to dissolve on June 3, 2005) is included in the results for the three month and six month periods ended March 31, 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 March 31, 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. The sale of the Series C Preferred Stock reduced Arrowhead’s ownership in Insert from 74.7% to 68.5% as of March 31, 2005.

As of March 31, 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 in 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 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 82.7% of the outstanding, voting stock of Calando. Arrowhead has direct ownership of 80.1% 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 82.7% to 68.0%.

On March 31, 2006, Arrowhead entered into a second Agreement to Provide Additional Capital with Calando. Arrowhead agreed 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.

On April 4, 2005, Arrowhead founded NanoPolaris as a wholly owned subsidiary of Arrowhead. NanoPolaris was initially capitalized with \$1,000. NanoPolaris will seek to generate revenue by licensing intellectual property to customers who will utilize nanotube technology in their products. NanoPolaris controls commercialization of a set of issued patents and patent applications claiming nanotube compositions of matter and general manufacturing techniques such as chemical vapor deposition synthesis, plasma chemical vapor deposition synthesis, purification, solubilization, separation of certain types of tubes, coating, functionalization and manipulation.

### Nanotechnica, Inc.—Discontinued Operations

In the third quarter of FY 2005, the Company determined that the progress being made by Nanotechnica in commercializing HPLC 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 Losses from Discontinued Operations of 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 March 31, 2006, 33,801,576 shares of common stock were outstanding. At March 31, 2006, 1,785,000 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 March 31, 2006, options to purchase 1,785,000 shares were outstanding under the 2000 Stock Option Plan and options to purchase 2,590,000 shares have been granted under the 2004 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.

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 March 31, 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                 | 9.8   | \$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 (2) | 8,000 sq ft             | \$ 14,413           | December 27, 2004         | 25 Months         |
| New York (3) | 130 sq ft               | \$ 3,350            | September 15, 2005        | 12 Months         |
| Aonex        | 4,000 sq ft             | \$ 6,810            | July 1, 2004              | 24 Months         |
| Calando      | 2,755 sq ft             | \$ 4,821            | May 16, 2005              | 24 Months         |
| Insert       | 7,000 sq ft             | \$ 10,543           | N/A                       | Month to Month    |

- 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.
- On November 21, 2005, Insert signed a lease to take over 4,354 sq ft of this space as soon as new laboratory space is completed. The estimated completion date is July 1, 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.

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

At March 31, 2006, the future minimum commitments by Fiscal Year remaining under leases are as follows:

|                  | <u>Facilities Leases</u> | <u>Equipment Leases</u> |
|------------------|--------------------------|-------------------------|
| FY 2006          | \$ 280,331               | \$ 10,599               |
| FY 2007          | \$ 459,214               | \$ 19,125               |
| FY 2008          | \$ 409,421               | \$ 7,555                |
| FY 2009          | \$ 349,501               | \$ 3,461                |
| FY 2010 & Beyond | \$ 384,545               | —                       |

Facility and equipment rent expense for the three-month and six-month periods ended March 31, 2006 was \$171,063 and 309,678, respectively. Facility and equipment rent expense for the three-month and six-month periods ended March 31, 2005 was \$76,636 and \$155,542 respectively. From inception to date, rent expense has totaled \$761,602.

**NOTE 6: COMMITMENTS AND CONTINGENCIES—SUBSIDIARIES AND SPONSORED RESEARCH**

**Subsidiaries**

As of March 31, 2006, Arrowhead held a majority of the voting stock of the following four subsidiaries (the “Subsidiaries”):

| Subsidiary  | %Ownership | Technology/Product Focus  |
|---|------------|---|
| Aonex Technologies, Inc.<br><i>founded April 20, 2004</i>         | 80.0%      | Semiconductor nanomaterial process with initial emphasis on high efficiency solar cells             |
| Insert Therapeutics, Inc.<br><i>acquired June 4, 2004</i>         | 68.3%      | Nano-engineered drug delivery system, preparing for clinical trials with first anti-cancer compound |
| Calando Pharmaceuticals, Inc.<br><i>founded February 20, 2005</i> | 82.7%*     | Nano-engineered RNAi Therapeutics   |
| NanoPolaris, Inc.<br><i>founded April 4, 2005</i>                 | 100.0%     | Developing strategic opportunities for the commercialization of nanotube-based products.            |

\* Arrowhead has direct ownership of 80.1% of the outstanding, voting stock of Calando and indirectly, through Insert, controls another 2.6% of the outstanding, voting stock.

NanoPolaris is wholly-owned subsidiary of Arrowhead and Arrowhead retains full rights to appoint its Board of Directors. Arrowhead holds a majority interest in each of Aonex, Insert, and Calando 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 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.

**Outsourced Research and Development**

Outsourced sponsored research expense for the three month and six month periods ended March 31, 2006 was \$250,635 and \$584,270, respectively. Outsourced sponsored research expense for the three month and six month periods ended March 31, 2005 was \$168,225 and \$335,189, 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:

| Research Project  | Total estimated<br>project cost | Annual Cost | Amount paid<br>as of<br>Mar. 31, 2006 | Prepaid Amt<br>as of<br>Mar. 31, 2006 |
|---|---------------------------------|-------------|---------------------------------------|---------------------------------------|
| CVD Growth of Well-Aligned Individual Single Walled Carbon Nanotubes<br>(Dr. Jie Liu)<br>Dec. 1, 2005–Nov. 30, 2007 (2 years) | \$ 600,000                      | \$ 300,000  | \$ 170,352                            | \$ 70,352                             |

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

**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:

| Research Project   | Total estimated<br>project cost | Annual Cost | Amount paid<br>as of<br>Mar. 31, 2006 | Prepaid Amt<br>as of<br>Mar. 31, 2006 |
|--|---------------------------------|-------------|---------------------------------------|---------------------------------------|
| Drug Discovery & Diagnostics<br>(Dr. C. Patrick Collier) |                                 |             |                                       |                                       |
| Oct. 1, 2003-Sept. 30, 2008 (5 years)                    | \$ 1,393,806                    | \$ 280,292  | \$ 663,093                            | \$ 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.

| Research Project  | Total estimated<br>project cost | Annual Cost | Amount paid<br>as of<br>Mar. 31, 2006 | Prepaid Amt<br>as of<br>Mar. 31, 2006 |
|---|---------------------------------|-------------|---------------------------------------|---------------------------------------|
| Microchip-based Biological Signal Delivery<br>(Dr. Nicholas Melosh) |                                 |             |                                       |                                       |
| July 1, 2005 – June 30, 2007 (2 years)                              | \$ 600,000                      | \$ 300,000  | \$ 320,000                            | \$ 70,000                             |

**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 March 31, 2006. As of March 31, 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, 1,785,000 shares of Arrowhead’s Common Stock are reserved for issuance upon exercise of non-qualified stock options. The 2004 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. At the 2006 Annual Meeting of Stockholders, an increase from 3,000,000 to 5,000,000 shares in the 2004 Incentive Plan was approved.

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

The following tables summarize information about stock options:

|                               | <u>Number of<br/>Options<br/>Outstanding</u> | <u>Weighted<br/>Average Exercise<br/>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   |
| Exercisable at March 31, 2006 | 1,388,747                                    | 1.70   |

| <u>Exercise Prices</u> | <u>Number of<br/>Options</u> | <u>Weighted Average<br/>Remaining<br/>Life in Years</u> | <u>Weighted Average<br/>Exercise Price</u> |
|------------------------|------------------------------|---|--|
| \$1.00 – \$5.12        | 4,375,000                    | 8.9   | \$ 2.38                                    |

The Company has applied SFAS 123R on a retrospective basis for FY 2006. Therefore, the income for the three months of FY 2005, ended March 31, 2005, has been decreased from \$642,761 to \$615,930. The loss for the first six months of FY 2005 has been increased from \$893,698 to \$946,485 to reflect amortization of the fair value of options awarded to employees prior to the adoption of SFAS No. 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 six month periods ended March 31, 2006, the stock based compensation expense is \$352,986 and \$631,763, respectively.

The estimated fair value of the options granted by Arrowhead for the three month and six month periods ended March 31, 2006 is \$218,987 and \$1,729,160, respectively.

The aggregate fair value of options granted by Aonex, Calando, or Insert for the six month period ended March 31, 2006 is \$16,168.

The fair value of options granted during the six months ended March 31, 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 5.25%, and expected life of five years. The weighted-average fair value of options granted by Arrowhead for the six months ended March 31, 2006 was estimated at \$1.88 and the weighted-average exercise price was estimated at \$4.03.

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 six month periods ended March 31, 2006, the Company had consolidated losses of \$3,106,586 and \$6,243,538, respectively. For the six month period ended March 31, 2005, the Company had a consolidated loss of \$946,485. The losses result in a deferred income tax benefit of approximately \$1,227,000 and \$2,466,000 for the three months and six months ended March 31, 2006 and \$373,861 for the six months ended March 31, 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 \$37,500 and \$75,000 for the three month and six month periods ended March 31, 2006. The customer is located in North America.

**NOTE 10. RELATED PARTY TRANSACTIONS**

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

**NOTE 11. SUBSEQUENT EVENTS**

None.

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

### Overview

Arrowhead is a diversified 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 all 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. Currently, 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.
- **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 present, 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 \$15.7 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. To date, the Company has four majority owned operating Subsidiaries, Aonex Technologies, Inc. ("Aonex"), Calando Pharmaceuticals, Inc. ("Calando"), Insert Therapeutics, Inc. ("Insert"), NanoPolaris, Inc. ("NanoPolaris").

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 will be 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 seeks to license nanotube technology developed at universities in the U.S. and to generate revenue by sublicensing the rights to such intellectual property to industry participants who will utilize nanotube technology in their commercial products.

The Company had a consolidated loss of \$3.1 million for the quarter ended March 31, 2006 versus a consolidated income of \$615,930 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 second quarter of FY 2005 before this one time gain would have been about \$1.7 million.

The consolidated loss for the six month period ended March 31, 2006 was \$6.2 million versus a consolidated loss of \$946,485 for the same period of the previous year. The consolidated net loss for the six month period ended March 31, 2005 would have been \$3.2 million but the loss was reduced by the gain recognized on the sale of a portion of the Arrowhead's ownership in Insert to a third party.

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. We have added staff at all levels within the company to accommodate the increase development efforts, the addition of Calando, the increase in general and administrative responsibilities and the need to comply with Sarbanes Oxley. Second, Insert incurred major expenses during the first six 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 did a private placement, recapitalized Calando, examined or reviewed new potential deals and maintained patents licensed from Caltech. Fourth, facilities cost increased due to expansion of existing space and 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 six month periods ended March 31, 2006 and 2005 are shown in the tables below. 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) |             |
|----------------------------|--------------------|------------------|--------------------|------------------|---------------------|-------------|
|                            | Mar 31 2006        | expense category | Mar 31 2005        | expense category | \$                  | %           |
| G&A – compensation-related | \$ 567             | 39%              | \$ 192             | 33%              | \$ 375              | 195%        |
| Stock-based compensation   | \$ 353             | 24%              | \$ 98              | 16%              | \$ 255              | 260%        |
| R&D – compensation-related | \$ 544             | 37%              | \$ 300             | 51%              | \$ 244              | 81%         |
| <b>Total</b>               | <b>\$ 1,464</b>    | <b>100%</b>      | <b>\$ 590</b>      | <b>100%</b>      | <b>\$ 874</b>       | <b>148%</b> |

  

|                            | Six Months Ended | % of             | Six Months Ended | % of             | Increase (Decrease) |             |
|----------------------------|------------------|------------------|------------------|------------------|---------------------|-------------|
|                            | Mar 31 2006      | expense category | Mar 31 2005      | expense category | \$                  | %           |
| G&A – compensation-related | \$ 1,139         | 40%              | \$ 301           | 28%              | \$ 838              | 278%        |
| Stock-based compensation   | \$ 632           | 22%              | \$ 171           | 16%              | \$ 461              | 270%        |
| R&D – compensation-related | \$ 1,059         | 38%              | \$ 614           | 56%              | \$ 445              | 72%         |
| <b>Total</b>               | <b>\$ 2,830</b>  | <b>100%</b>      | <b>\$ 1,086</b>  | <b>100%</b>      | <b>\$ 1,744</b>     | <b>161%</b> |

The increase in G&A related compensation is the result of hiring of a new President for Arrowhead, a Vice President, Investor Relations, a President for Insert/Calando, 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.

**General & Administrative Expenses***(in thousands)*

|                               | Three Months Ended | % of             | Three Months Ended | % of             | Increase (Decrease) |      |
|-------------------------------|--------------------|------------------|--------------------|------------------|---------------------|------|
|                               | Mar 31 2006        | expense category | Mar 31 2005        | expense category | \$                  | %    |
| Professional/outside services | \$ 575             | 46%              | 199                | 42%              | \$ 376              | 189% |
| Facilities                    | \$ 244             | 20%              | 124                | 26%              | \$ 120              | 97%  |
| Patent expense                | \$ 28              | 2%               | —                  | 0%               | \$ 28               | 100% |
| Travel                        | \$ 46              | 4%               | 17                 | 4%               | \$ 29               | 165% |
| Business insurance            | \$ 30              | 2%               | 25                 | 5%               | \$ 5                | 20%  |
| Depreciation                  | \$ 81              | 6%               | 45                 | 9%               | \$ 36               | 82%  |
| Other                         | \$ 249             | 20%              | 67                 | 14%              | \$ 182              | 272% |
| Total                         | \$ 1,253           | 100%             | \$ 477             | 100%             | \$ 776              | 163% |

|                               | Six Months Ended | % of             | Six Months Ended | % of             | Increase (Decrease) |        |
|-------------------------------|------------------|------------------|------------------|------------------|---------------------|--------|
|                               | Mar 31 2006      | expense category | Mar 31 2005      | expense category | \$                  | %      |
| Professional/outside services | \$ 779           | 33%              | 313              | 32%              | \$ 466              | 149%   |
| Facilities                    | \$ 454           | 19%              | 256              | 26%              | \$ 198              | 77%    |
| Patent expense                | \$ 386           | 16%              | 35               | 4%               | \$ 351              | 1,003% |
| Travel                        | \$ 111           | 5%               | 71               | 7%               | \$ 40               | 56%    |
| Business insurance            | \$ 90            | 4%               | 52               | 5%               | \$ 38               | 73%    |
| Depreciation                  | \$ 165           | 7%               | 130              | 14%              | \$ 35               | 27%    |
| Other                         | \$ 366           | 16%              | 111              | 12%              | \$ 255              | 230%   |
| Total                         | \$ 2,351         | 100%             | \$ 968           | 100%             | \$ 1,383            | 143%   |

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, 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 when Insert moves into new laboratory facilities. The increase in patent expense during the six 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.

**Research and Development Expenses***(in thousands)*

|                                | Three Months Ended | % of             | Three Months Ended | % of             | Increase (Decrease) |        |
|--------------------------------|--------------------|------------------|--------------------|------------------|---------------------|--------|
|                                | Mar 31, 2006       | expense category | Mar 31, 2005       | expense category | \$                  | %      |
| R&D contract labor             | \$ 380             | 34%              | \$ 34              | 8%               | \$ 346              | 1,018% |
| Laboratory supplies & services | \$ 425             | 37%              | \$ 137             | 31%              | \$ 288              | 210%   |
| Sponsored research             | \$ 251             | 22%              | \$ 167             | 38%              | \$ 84               | 50%    |
| Depreciation-R&D-related       | \$ 48              | 4%               | \$ 78              | 18%              | \$ -30              | -38%   |
| Other research expenses        | \$ 32              | 3%               | \$ 23              | 5%               | \$ 9                | 39%    |
| Total                          | \$ 1,136           | 100%             | \$ 439             | 100%             | \$ 697              | 159%   |

|                                | Six Months Ended | % of             | Six Months Ended | % of             | Increase (Decrease) |        |
|--------------------------------|------------------|------------------|------------------|------------------|---------------------|--------|
|                                | Mar 31, 2006     | expense category | Mar 31, 2005     | expense category | \$                  | %      |
| R&D contract labor             | \$ 1,342         | 47%              | \$ 370           | 34%              | \$ 972              | 263%   |
| Laboratory supplies & services | \$ 691           | 24%              | \$ 302           | 28%              | \$ 389              | 129%   |
| Sponsored research             | \$ 584           | 20%              | \$ 334           | 31%              | \$ 250              | 75%    |
| Depreciation-R&D-related       | \$ 113           | 4%               | \$ 78            | 7%               | \$ 35               | 45%    |
| Other research expenses        | \$ 129           | 5%               | \$ 3             | 0%               | \$ 126              | 4,200% |
| Total                          | \$ 2,859         | 100%             | \$ 1,087         | 100%             | \$ 1,772            | 163%   |

Insert is in the preclinical phase of development of its drug delivery system. Insert received approval for its Investigational New Drug (IND) application from the Federal Drug Administration (FDA) on March 14, 2006 expects to begin Phase I clinical trials in the second quarter of calendar 2006. In advance of the clinical trials, Insert was required to pay the cost to manufacture the entire amount of its drug candidate, 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. Therefore, in first three months and six months of FY 2006, approximately \$930,000 and \$1,283,000 of supplies was expensed, respectively. In addition, Insert completed the large mammal studies required as part of the IND process and those expenses were the primary cause of the increase in laboratory services. While a purchase of supplies of this magnitude is not a normal recurring expense, the continued development of new products in Insert, Calando and Aonex will result in increased R&D expenses in the future.

The Company continues to sponsor research at Caltech, Duke and Stanford. 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 six month periods ended March 31, 2006 compared to the three month and six month periods ended December 31, 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 is being amortized over 12 months. Calando could also receive additional license fees in the following years, milestone development payments, and future royalties on revenue from the HCV therapeutic. For the quarter ended March 31, 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 six month periods ended March 31, 2006, \$57,500 and \$310,000, respectively, in revenue was generated primarily related to a development fee paid to Calando by Benitec \$150,000, license fee revenue recognized of \$37,500 per quarter and \$50,000 related to an SBIR grant to Aonex. 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.

### **Liquidity and Capital Resources**

Since inception in May 2003, the Company has generated significant losses. As of March 31, 2006, the Company's accumulated deficit including minority interest was \$18.9 million. As of March 31, 2006, the Company had \$35.3 million in cash and marketable securities compared to \$22.4 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 March 31, 2006, the Company had a commitment to provide an additional \$7 million to Calando, if certain milestones are reached. The Company believes that the cash on hand at March 31, 2006 is sufficient to meet all existing obligations and fund existing operations beyond the end of FY 2006.

Since inception, the Company has funded operations and acquisitions through the issuance of equity. As of March 31, 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.

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**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.**

On January 24, 2006, the Company completed a private placement of 5,590,000 shares of restricted common stock at \$3.50 per share. The company received approximately \$19.6 million in total proceeds from the placement. At the closing, 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 after 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 proceeds are to be used for general working capital needs, funding subsidiary operations, acquisitions and sponsored research at universities and institutions.

The company filed an S-3 covering the shares issued above and the S-3 was approved on March 24, 2006.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES.**

None.

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

The Company held an annual meeting on February 23, 2006. The following matters were submitted to a vote of the stockholders of record as of December 31, 2005 through a solicitation of proxies and the results are shown below:

1. Election of five directors.

|                     | <u>Number of<br/>Shares For</u> | <u>Percent of<br/>Shares<br/>Voting</u> | <u>Number<br/>of Shares<br/>Withheld</u> | <u>Percent of<br/>Shares<br/>Voting</u> |
|---------------------|---------------------------------|---|--|---|
| R. Bruce Stewart    | 23,822,404                      | >99%                                    | 101,634                                  | <1%                                     |
| Edward W. Frykman   | 23,822,404                      | >99%                                    | 101,624                                  | <1%                                     |
| LeRoy R. Rahn       | 23,822,404                      | >99%                                    | 101,634                                  | <1%                                     |
| Charles P. McKenney | 23,822,404                      | >99%                                    | 101,634                                  | <1%                                     |
| Leon Ekchian        | 23,822,404                      | >99%                                    | 101,634                                  | <1%                                     |

2. Approval of the increase in stock options available under the Company's 2004 Equity Incentive Plan.

|                  | <u>Shares</u> | <u>Percent Of<br/>Shares Voting</u> |
|------------------|---------------|-------------------------------------|
| Votes For        | 10,431,545    | >74%                                |
| Votes Against    | 3,393,062     | <25%                                |
| Votes Abstaining | 101,138       | <1%                                 |
| Broker Non-Votes | 9,998,293     |                                     |

3. Approval of the appointment of Rose, Snyder & Jacobs as the independent public auditors of Arrowhead Research Corporation for the fiscal year ended September 30, 2006:

|                  | <u>Shares</u> | <u>Percent Of<br/>Shares Voting</u> |
|------------------|---------------|-------------------------------------|
| Votes For        | 23,842,068    | >99%                                |
| Votes Against    | 19,938        | <1%                                 |
| Votes Abstaining | 62,032        | <1%                                 |

**ITEM 5. OTHER INFORMATION.**

None.

**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 March 31, 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)  |
| 31.1           | Section 302 Certification of Chief Executive Officer*  |
| 31.2           | Section 302 Certification of President *   |
| 31.3           | Section 302 Certification of Chief Financial Officer*  |
| 32.1           | Section 1350 Certification by Principal Executive Officer*   |
| 32.2           | Section 1350 Certification by President *  |
| 32.3           | Section 1350 Certification by 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.

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- (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.



## 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: May 9, 2006

/s/ R. BRUCE STEWART

\_\_\_\_\_  
R. Bruce Stewart, Chief Executive Officer

## SECTION 302 CERTIFICATION

I, Leon Ekchian, 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: May 9, 2006

/s/ LEON EKCHIAN

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Leon Ekchian, President

## 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: May 9, 2006

/s/ JOSEPH T. KINGSLEY

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Joseph T. Kingsley, 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 March 31, 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: May 9, 2006

/s/ R. BRUCE STEWART

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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 March 31, 2006, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Leon Ekchian, the president 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: May 9, 2006

/s/ LEON EKCHIAN

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Leon Ekchian

President

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 March 31, 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: May 9, 2006

/s/ JOSEPH T. KINGSLEY

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Joseph T. Kingsley  
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.