ACELRX PHARMACEUTICALS INC
Form 10-Q
May 16, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2011

or

¨ **TRANSITION REPORTS PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.**

For the transition period from to

Commission File Number: 001-35068

ACELRX PHARMACEUTICALS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**41-2193603**
(State or other jurisdiction of incorporation or organization)	**(IRS Employer Identification No.)**

575 Chesapeake Drive

Redwood City, CA 94063

(650) 216-3500

(Address, including zip code, and telephone number, including area code, of registrant s principal executive offices)

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

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

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

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

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

As of May 1, 2011, the number of outstanding shares of the registrant s common stock was 19,371,750.

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ACELRX PHARMACEUTICALS, INC.

QUARTERLY REPORT ON FORM 10-Q FOR THE QUARTER ENDED MARCH 31, 2011

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

AcelRx Pharmaceuticals, Inc.

(A Development Stage Company)

Condensed Balance Sheets

(In thousands, except share and per share data)

	March 31, 2011 (Unaudited)	December 31, 2010[(1)]
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 33,206	$ 3,055
Short-term investments	3,032	627
Prepaid expenses and other current assets	758	2,097
Total current assets	36,996	5,779
Property and equipment, net	715	800
Restricted cash	205	205
Other assets	42	46
TOTAL ASSETS	$ 37,958	$ 6,830
LIABILITIES, CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS EQUITY (DEFICIT)		
CURRENT LIABILITIES:		
Accounts payable	$ 1,309	$ 543
Accrued liabilities	499	859
Convertible notes		6,805
Long-term debt, current portion	3,994	5,204
Total current liabilities	5,802	13,411
Deferred rent	198	245
Call option liability		596
Convertible preferred stock warrant liability		2,529
Total liabilities	6,000	16,781
Commitments and Contingencies (Note 7)		
Convertible preferred stock, $0.001 par value no shares and 46,736,125 shares authorized as of March 31, 2011 and December 31, 2010; no shares and 7,151,802 shares issued and outstanding as of March 31, 2011 and December 31, 2010		55,941
STOCKHOLDERS EQUITY (DEFICIT):		
Common stock, $0.001 par value 100,000,000 and 71,000,000 shares authorized as of March 31, 2011 and December 31, 2010; 19,371,750 and 674,353 shares issued and outstanding as of March 31, 2011 and December 31, 2010	21	3

Additional paid-in capital	103,704	2,668
Deficit accumulated during the development stage	(71,767)	(68,563)
Total stockholders equity (deficit)	31,958	(65,892)
TOTAL LIABILITIES, CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS EQUITY (DEFICIT)	$ 37,958	$ 6,830

(1) The condensed consolidated balance sheet as of December 31, 2010 has been derived from the audited financial statements as of that date included in the Company s Annual Report on Form 10-K for the year ended December 31, 2010.

See notes to condensed financial statements.

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AcelRx Pharmaceuticals, Inc.

(A Development Stage Company)

Condensed Statements of Operations

(Unaudited)

(In thousands, except share and per share data)

	Three Months Ended March 31, 2011	Three Months Ended March 31, 2010	Period from July 13, 2005 (Inception) Through March 31, 2011
Operating Expenses:			
Research and development	$ 1,946	$ 2,761	$ 55,743
General and administrative	1,589	672	14,083
Total operating expenses	3,535	3,433	69,826
Loss from operations	(3,535)	(3,433)	(69,826)
Interest income	8	2	1,563
Interest expense	(1,359)	(244)	(4,489)
Other income (expense), net	1,682	(6)	985
Net loss	$ (3,204)	$ (3,681)	$ (71,767)
Net loss per share of common stock, basic and diluted	$ (0.30)	$ (5.85)	
Shares used in computing net loss per share of common stock, basic and diluted	10,742,182	629,006	

See notes to condensed financial statements.

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AcelRx Pharmaceuticals, Inc.

(A Development Stage Company)

Condensed Statements of Cash Flows

(Unaudited)

(In thousands)

	Three Months Ended March 31, 2011	Three Months Ended March 31, 2010	Period from July 13, 2005 (Inception) Through March 31, 2011
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net loss	$ (3,204)	$ (3,681)	$ (71,767)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	117	120	1,682
Interest expense related to debt financing	1,235	61	2,443
Stock-based compensation	323	129	2,836
Contributions of shares to charitable organizations			14
Revaluation of convertible preferred stock warrant liability and write off of call option liability	(1,682)	9	(254)
Realized gain on sale of investments			(29)
Loss on disposal of property and equipment			5
Changes in operating assets and liabilities:			
Prepaids and other assets	1,339	(18)	790
Restricted cash			(205)
Accounts payable	765	125	1,308
Accrued liabilities	(224)	(253)	(1,134)
Deferred rent	(44)	(44)	200
Net cash used in operating activities	(1,375)	(3,552)	(64,111)
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchase of property and equipment	(32)	4	(2,401)
Purchase of investments	(3,041)	(443)	(48,341)
Proceeds from sale of investments	636		45,360
Net cash used in investing activities	(2,437)	(439)	(5,382)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from initial public offering, net of costs	35,208		35,208
Proceeds from the issuance of long-term debt			12,621
Payment of long-term debt	(1,245)	(1,144)	(9,169)
Proceeds from issuance of convertible promissory notes			9,000
Proceeds from issuance of common stock upon exercise of options			98
Proceeds from issuance of convertible preferred stock, net of issuance costs		76	54,941
Net cash provided by (used in) financing activities	33,963	(1,068)	102,699
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	30,151	(5,059)	33,206
CASH AND CASH EQUIVALENTS Beginning of period	3,055	7,150	

CASH AND CASH EQUIVALENTS End of period	$	33,206	$	2,191	$	33,206
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:						
Cash paid for interest	$	82	$	183	$	1,822
NONCASH INVESTING AND FINANCE ACTIVITIES:						
Conversion of convertible promissory notes into common stock	$	8,137	$		$	8,137
Issuance of common stock upon cashless exercise of warrants	$	536	$		$	536
Reclassification of warrant liability and call option liability to equity	$	906	$		$	906

See notes to condensed financial statements.

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AcelRx Pharmaceuticals, Inc.

(A Development Stage Company)

Notes to Condensed Financial Statements

(Unaudited)

1. Organization and Summary of Significant Accounting Policies

The Company

AcelRx Pharmaceuticals, Inc., or the Company, is a development stage company that was incorporated in Delaware on July 13, 2005 as SuRx, Inc. In January 2006, the Company changed its name to AcelRx Pharmaceuticals, Inc. The Company s operations are based in Redwood City, California.

The Company is a specialty pharmaceutical company focused on the development and commercialization of innovative therapies for the treatment of acute and breakthrough pain. Since incorporation, primary activities have consisted of establishing facilities, recruiting personnel, conducting research and development of its product candidates, developing intellectual property, and raising capital. To date, the Company has not yet commenced primary operations or generated any revenues and, accordingly, the Company is considered to be in the development stage.

The Company has one business activity, which is the development and commercialization of product candidates for the treatment of pain, and a single reporting and operating unit structure.

The Company has incurred recurring operating losses and negative cash flows from operating activities since inception through March 31, 2011. In addition, the Company had an accumulated deficit of $71.8 million and $68.6 million as of March 31, 2011 and December 31, 2010. Through March 31, 2011, the Company has relied primarily on the proceeds from equity offerings and loan proceeds to finance its operations. Management believes that the Company s current cash and cash equivalents including the net proceeds of $35.2 million from its initial public offering, or IPO, in February 2011, as detailed below, and the interest earned thereon, will be sufficient to fund the Company s current operations through the second quarter of 2012. The Company will need to raise additional funding or otherwise enter into collaborations to complete the third ARX-01 Phase 3 clinical trial required to submit a new drug application, or NDA, with the U.S. Food and Drug Administration, or FDA, for ARX-01. However, there is no assurance that additional funding will be available to the Company on acceptable terms on a timely basis, if at all, or that the Company will achieve profitable operations. If the Company is unable to raise additional capital to fund its operations, it will need to curtail planned activities to reduce costs. Doing so may affect the Company s ability to operate effectively. The accompanying financial statements do not include any adjustments that might result from the outcome of these uncertainties.

Basis of Presentation

The accompanying unaudited condensed financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and the rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, the unaudited condensed financial statements reflect all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation of the financial position, results of operations and cash flows for the periods indicated.

The condensed balance sheet as of December 31, 2010 is derived from the Company s audited financial statements as of December 31, 2010, included in the Company s Annual Report on Form 10-K for the year ended December 31, 2010, filed with the Securities and Exchange Commission on March 30, 2011, but does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

The unaudited condensed financial statements and the accompanying notes should be read in conjunction with the Company s Annual Report on Form 10-K for the year ended December 31, 2010. Operating results for the three months ended March 31, 2011 are not necessarily indicative of the results that may be expected for any other interim period or for the full year ending December 31, 2011. Stockholders are encouraged to review the Company s Annual Report on Form 10-K for a broader discussion of the Company s business and the risks inherent therein.

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AcelRx Pharmaceuticals, Inc.

(A Development Stage Company)

Notes to Condensed Financial Statements (Continued)

(Unaudited)

Reverse Stock Split

In January 2011, the Company s board of directors and stockholders approved an amended and restated certificate of incorporation effecting a 1-for-4 reverse stock split of the Company s issued and outstanding shares of common stock and convertible preferred stock and on January 28, 2011, the Company filed an amended and restated certificate of incorporation effecting the 1-for-4 reverse stock split. The par value of the common and convertible preferred stock was not adjusted as a result of the reverse stock split. All issued and outstanding common stock, options for common stock, convertible preferred stock, warrants for common stock, warrants for convertible preferred stock, and per share amounts contained in the Company s condensed financial statements have been retroactively adjusted to reflect this reverse stock split for all periods presented.

Initial Public Offering

On February 10, 2011, the Company sold 8,000,000 shares of common stock at a price of $5.00 per share in its IPO. The shares began trading on the NASDAQ Global Market on February 11, 2011. The Company received $35.2 million in net proceeds from the IPO, after deducting an estimated $4.8 million in underwriting discounts and commissions and other offering-related expenses payable by the Company. Upon the closing of the offering, all outstanding shares of convertible preferred stock converted into common stock. The convertible preferred stock converted into 8,555,713 shares of common stock. In addition, the principal and accrued interest under the 2010 Convertible Notes, as defined in Note 5 Convertible Notes, converted into 2,034,438 shares of common stock immediately prior to the closing of the Company s IPO and the 2010 Warrants, as defined in Note 6 Warrants, were net exercised for 107,246 shares of Series C convertible preferred stock, which shares were converted to common stock immediately prior to the closing of the Company s IPO. All other outstanding warrants to purchase convertible preferred stock became exercisable for shares of common stock. Concurrently, the Company filed an amended and restated certificate of incorporation increasing the number of authorized shares of common stock to 100,000,000 with a par value of $0.001 per share and decreasing the number of authorized shares of preferred stock to 10,000,000 with a par value of $0.001 per share.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the condensed financial statements and accompanying notes. Such management estimates include the fair value of common stock, stock-based compensation expense, valuation of deferred tax assets and the fair value of convertible preferred stock warrants. The Company bases its estimates on historical experience and also on assumptions that it believes are reasonable, however, actual results could differ from those estimates.

Concentrations of Credit Risk

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist primarily of cash, cash equivalents, short-term investments and restricted cash. The Company is exposed to credit risk in the event of default by the institutions holding the cash, cash equivalents and investments to the extent of the amounts recorded on the balance sheet. Cash, cash equivalents, short-term investments and restricted cash are invested with banks and other financial institutions in the United States and are only invested in high-credit quality instruments. Such deposits may be in excess of insured limits provided on such deposits.

AcelRx Pharmaceuticals, Inc.

(A Development Stage Company)

Notes to Condensed Financial Statements (Continued)

(Unaudited)

Recently Issued Accounting Pronouncements

In January 2010, the Financial Accounting Standards Board, or FASB, issued an amendment to an accounting standard which requires new disclosures for fair value measurements and provides clarification for existing fair value disclosure requirements. The amendment will require an entity to disclose separately the amounts of significant transfers in and out of Levels I and II fair value measurements and to describe the reasons for the transfers; and to disclose information about purchases, sales, issuances and settlements separately in the reconciliation for fair value measurements using significant unobservable inputs, or Level III inputs. This amendment clarifies existing disclosure requirements for the level of disaggregation used for classes of assets and liabilities measured at fair value and require disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements using Level II and Level III inputs. This guidance is effective for interim and annual reporting periods beginning after December 15, 2009, except for certain Level III activity disclosure requirements that are effective for reporting periods beginning after December 15, 2010. The adoption of this amendment during the three months ended March 31, 2011 did not impact the Company s financial position or results of operations.

2. Cash, Cash Equivalents and Short-Term Investments

Cash, cash equivalents and short-term investments consist of the following (in thousands):

	As of March 31, 2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Cash	$ 39	$	$	$ 39
Money market funds	292			292
U.S. government agency obligations	6,861			6,861
Commercial Paper	29,046			29,046
	$ 36,238	$	$	$ 36,238

	As of December 31, 2010			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Cash	$ 103	$	$	$ 103
Money market funds	79			79
U.S. government agency obligations	3,500			3,500
	$ 3,682	$	$	$ 3,682

As of March 31, 2011 and December 31, 2010, the contractual maturity of all investments held was less than one year.

3. Fair Value of Financial Instruments

Fair Value of Financial Instruments

The Company measures and reports its cash equivalents, short-term investments and the liability associated with previously outstanding warrants to purchase convertible preferred stock at fair value. Fair value is defined as the exchange price that would be received for an asset or an exit price paid to transfer a liability in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value must maximize the use of observable inputs and minimize the use of unobservable inputs. The fair value hierarchy defines a three-level valuation hierarchy for disclosure of fair value measurements as follows:

Level I Unadjusted quoted prices in active markets for identical assets or liabilities;

Level II Inputs other than quoted prices included within Level I that are observable, unadjusted quoted prices in markets that are not active, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the related assets or liabilities; and

Level III Unobservable inputs that are supported by little or no market activity for the related assets or liabilities.

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AcelRx Pharmaceuticals, Inc.

(A Development Stage Company)

Notes to Condensed Financial Statements (Continued)

(Unaudited)

The categorization of a financial instrument within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

The Company s financial instruments consist of Level I and Level II assets and Level III liabilities. Level I securities include highly liquid money market funds. If quoted market prices are not available for the specific security, then the Company estimates fair value by using benchmark yields, reported trades, broker dealer quotes and issuer spreads. Such Level II instruments include U.S. government agency and corporate obligations. Level III liabilities measured at fair value on a recurring basis consisted of convertible preferred stock warrant liabilities and call option liabilities. The fair values of the then-outstanding convertible preferred stock warrants were measured using the Black-Scholes option-pricing model. Inputs used to determine estimated fair market value included the estimated fair value of the underlying stock at the valuation measurement date, the remaining contractual term of the warrants, risk-free interest rates, expected dividends and the expected volatility of the underlying stock. The fair value of the call option was determined by evaluating multiple potential outcomes using a market approach and an income approach depending on the scenario and discounting the values back to December 31, 2010 while applying estimated probabilities to each scenario value. Immediately prior to the closing of the Company s IPO, the convertible preferred stock warrants were either converted into warrants to purchase common stock or exercised into shares of convertible preferred stock, which shares where automatically converted into common stock.

The following table sets forth the fair value of the Company s financial assets and liabilities by level within the fair value hierarchy (in thousands):

	As of March 31, 2011			
	Fair Value	**Level I**	**Level II**	**Level III**
Assets				
Money market funds	$ 292	$ 292	$	$
U.S. government agency obligations	6,861		6,861	
Commercial Paper	29,046		29,046	
Total assets measured at fair value	$ 36,199	$ 292	$ 35,907	$

	As of December 31, 2010			
	Fair Value	**Level I**	**Level II**	**Level III**
Assets				
Money market funds	$ 79	$ 79	$	$
U.S. government agency obligations	3,500		3,500	
Total assets measured at fair value	$ 3,579	$ 79	$ 3,500	$
Liabilities				
Convertible preferred stock warrant liability	$ 2,529	$	$	$ 2,529
Call option liability	$ 596			$ 596
Total liabilities measured at fair value	$ 3,125	$	$	$ 3,125

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AcelRx Pharmaceuticals, Inc.

(A Development Stage Company)

Notes to Condensed Financial Statements (Continued)

(Unaudited)

The following table sets forth a summary of the changes in the fair value of the Company s Level III financial liabilities (in thousands):

	Three Months Ended March 31, 2011
Fair value beginning of period	$ 3,125
Exercise of warrants	(536)
Reclassification of warrant liability	(906)
Change in fair value of Level III liabilities	(1,683)
Fair value end of period	$

4. Long-Term Debt

Loan and Security Agreement

In September 2008, the Company entered into a $12.0 million loan and security agreement with Pinnacle Ventures L.L.C., or Pinnacle Ventures. In November 2008, the Company drew down all $12.0 million of the loan facility. The loan is repayable over 36 months, carries an interest rate of 8.5% per annum and is collateralized by the Company s tangible assets and proceeds from intellectual property. An additional $600,000 will be due as a final payment at the end of the loan term in November 2011, representing a 5.0% final payment fee. The final payment is being accreted on an effective interest basis over the term of the loan agreement. As of March 31, 2011 and December 31, 2010, the Company accrued $541,000 and $507,000 relating to this final payment, which is classified as a component of long-term debt in the condensed balance sheet. During the three months ended March 31, 2011, the Company made regular payments on the loan and security agreement of $1.2 million. As of March 31, 2011 and December 31, 2010, the Company had outstanding borrowings under the loan and security agreement of $4.0 million and $5.2 million.

During the three months ended March 31, 2011 and 2010, amortization of the deferred financing cost to interest expense was $4,000 and $4,000. As of March 31, 2011 and December 31, 2010, deferred financing cost on the condensed balance sheets related to this loan and security agreement was $12,000 and $16,000.

5. Convertible Notes

2010 Convertible Notes

On September 14, 2010, the Company sold convertible promissory notes, or 2010 Convertible Notes to certain existing investors for an aggregate purchase price of $8.0 million. The 2010 Convertible Notes bore interest at a rate of 4.0% per annum and had a maturity date of the earliest of (1) September 14, 2011 or (2) an event of default. In connection with the Company s IPO in February 2011, the outstanding principal and accrued interest under the 2010 Convertible Notes automatically converted into 2,034,438 shares of common stock immediately prior to the Company s IPO.

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AcelRx Pharmaceuticals, Inc.

(A Development Stage Company)

Notes to Condensed Financial Statements (Continued)

(Unaudited)

Upon the election of the holders of a majority of the aggregate principal amount payable under the 2010 Convertible Notes outstanding, the Company was required to sell an additional $4.0 million of 2010 Convertible Notes. This additional $4.0 million was determined to be a call option that was recorded at its fair value of $476,000 as a debt discount that would have been amortized to interest expense over the one-year term of the 2010 Convertible Notes. The fair value of the call option was determined by evaluating multiple potential outcomes using a market approach and an income approach depending on the scenario and discounting these values back to the appropriate date while applying estimated probabilities to each scenario value. These scenarios included a potential IPO, merger or sale at different times during 2011 and 2012 as well as remaining private. The fair value of the call option as of December 31, 2010 was $596,000. During the three months ended March 31, 2011, the 2010 Convertible Notes were amended so that the note holders option to invest the second tranche of $4.0 million expired upon the closing of an IPO by the Company. The call option was revalued to its fair value as of the IPO date and was written off upon its expiration with a benefit of $596,000 being recognized through other income (expense) during the three months ended March 31, 2011. In addition, the unamortized debt discount in the amount of $1.1 million at the time of the IPO was recognized as interest expense in connection with the conversion of the notes.

6. Warrants

Series A Warrants

In March 2007, the Company entered into an equipment financing agreement in which the Company issued immediately exercisable and fully vested warrants to purchase 2,500 shares of its Series A convertible preferred stock, or the Series A warrants, with an exercise price of $10.00 per share. These warrants expire in March 2017. The fair value of the Series A warrants on the date of issuance was $1,000, as determined using the Black-Scholes option-pricing model. This fair value was recorded as a convertible preferred stock warrant liability and as a deferred financing cost in other assets. In connection with the Company s IPO in February 2011, the Series A warrants were automatically converted into warrants to purchase 3,425 shares of common stock. Immediately before the conversion to common stock warrants, the Series A warrants were remeasured to fair value with the immaterial change in the fair value of these warrants being recorded as other income (expense), net during the three months ended March 31, 2011. Immediately after the conversion to common stock warrants, the remaining liability of $13,000 was reclassified to additional paid-in capital. The Company revalued the convertible preferred stock warrant liability related to the Series A warrants during each reporting period using the Black-Scholes option-pricing model with the following assumptions:

	Three Months Ended March 31,	
	2011	2010
Expected term (in years)	6.1	7.0
Risk-free interest rate	2.6%	1.9%
Expected volatility	80%	82%
Expected dividend rate	0%	0%

The fair value of the liability related to the Series A warrants was estimated to be $13,000 and $13,000 as of the IPO date in February 2011 and December 31, 2010. The change in the fair value of the Series A warrants during the three months ended March 31, 2011 and 2010 was insignificant. These common stock warrants will no longer be recorded as liabilities and will, therefore, no longer be remeasured as of the end of each reporting period. As of March 31, 2011, the 3,425 common stock warrants had not been exercised and were still outstanding.

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AcelRx Pharmaceuticals, Inc.

(A Development Stage Company)

Notes to Condensed Financial Statements (Continued)

(Unaudited)

Series B and Series C Warrants

In September 2008, the Company entered into a $12.0 million loan and security agreement with Pinnacle Ventures. In November 2008, the Company drew down all $12.0 million of the loan facility. In connection with the loan and security agreement, the Company issued immediately exercisable and fully vested warrants, or Series B warrants, to purchase 56,250 shares of Series B convertible preferred stock with an exercise price of $16.00 per share. Upon the closing of the Series C convertible preferred stock financing during the year ended December 31, 2009, the Series B warrants underlying the loan and security agreement became exercisable for 228,264 shares of Series C convertible preferred stock with an exercise price of $3.94 per share, or Series C warrants. In connection with the Company s IPO in February 2011, the Series C warrants were automatically converted into warrants to purchase 228,264 shares of common stock. Immediately before the conversion to common stock warrants, the Series C warrants were remeasured to fair value with the change in the fair value of these warrants of $323,000 being recorded as a benefit through other income (expense), net during the three months ended March 31, 2011. Immediately after the conversion to common stock warrants, the remaining liability of $894,000 was reclassified to additional paid-in capital. These warrants expire in September 2018. The Company determined the fair value of the Series B warrants and Series C warrants on the dates of issuance to be $162,000, as determined using the Black-Scholes option-pricing model which was recorded as a convertible preferred stock warrant liability and as a deferred financing cost in other assets. The Company revalued the convertible preferred stock warrant liability related to the Series B warrants and Series C warrants during each reporting period using the Black-Scholes option-pricing model with the following assumptions:

	Three Months Ended March 31,	
	2011	**2010**
Expected term (in years)	7.6	8.5
Risk-free interest rate	2.6%	2.2%
Expected volatility	80%	83%
Expected dividend rate	0%	0%

The fair value of the convertible preferred stock warrant liability related to these Series B and Series C warrants was estimated to be $894,000 and $1.2 million as of the IPO date in February 2011 and December 31, 2010. The change in the fair value of the warrants resulted in a charge to other income (expense), net of $9,000 during the three months ended March 31, 2010 and a benefit to other income (expense), net of $323,000 during the three months ended March 31, 2011. These common stock warrants will no longer be recorded as liabilities and will, therefore, no longer be remeasured as of the end of each reporting period. As of March 31, 2011, the 228,264 common stock warrants had not been exercised and were still outstanding.

2010 Warrants

The Company issued warrants in connection with the 2010 Convertible Notes in September 2010, or the 2010 Warrants. The 2010 Warrants were exercisable into (1) shares of convertible preferred stock sold in the Company s next equity financing with proceeds in excess of $15.0 million with an exercise price equal to the price of the convertible preferred stock sold in such equity financing or (2) shares of Series C at a price per share of the Series C (x) if the next equity financing with proceeds in excess of $15.0 million had not occurred prior to September 14, 2011, upon the election of holders of a majority of the aggregate principal amount of the 2010 Convertible Notes or (y) in the event of the IPO, a liquidation, sale of substantially all of the Company s assets, or merger. Each 2010 Warrant was exercisable for a number of shares equal to the quotient obtained by dividing 25% of the principal amount of the 2010 Convertible Note to which such 2010 Warrants related by the applicable per share price indicated above. The 2010 Warrants would have terminated if not exercised immediately prior to an IPO. The 2010 Warrants allowed for cashless exercises.

In order to determine a fair value for the 2010 Warrants on each respective measurement date, the Company evaluated multiple potential outcomes using the intrinsic value or Black-Scholes value depending on the scenario and discounted these values back to the appropriate date while applying estimated probabilities to each scenario value. These scenarios included a potential IPO or potential merger or sale at different times during 2011 and 2012 as well as remaining private with estimated future qualifying equity financings. Accordingly, the Company determined the fair value of the 2010 Warrants to be $1.2 million upon issuance, which was recorded as a convertible preferred stock warrant liability and a debt discount. As of December 31, 2010, the related warrant liability was $1.3 million. In connection with the Company s IPO in February 2011, the 2010 Warrants were net exercised into shares of Series C convertible preferred stock, which shares were automatically converted to 107,246 shares of common stock immediately prior to the Company s IPO. Immediately before the exercise into Series C convertible preferred stock, the 2010 Warrants were remeasured to fair value with the change in the fair value of these warrants of $796,000 being recorded as a benefit through other income (expense), net during the three months ended March 31, 2011. Immediately after the exercise into Series C convertible preferred stock, the remaining liability of $536,000 was reclassified to additional paid-in capital.

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AcelRx Pharmaceuticals, Inc.

(A Development Stage Company)

Notes to Condensed Financial Statements (Continued)

(Unaudited)

7. Commitments and Contingencies

Operating Leases

In January 2007, the Company entered into a non-cancelable lease agreement for office and laboratory facilities in Redwood City, California. The lease term commenced in April 2007 and expires in April 2012. Rental expense from the facility lease is recognized on a straight-line basis from the inception of the lease in January 2007, the early access date, through the end of the lease. Rent expense was $39,000 and $39,000 during the three months ended March 31, 2011 and 2010. Future minimum payments under the lease agreement as of March 31, 2011 are as follows (in thousands):

Year Ending December 31:	
2011 (remainder)	$ 263
2012	97
Total minimum payments	$ 360

During 2007, the landlord provided a tenant improvement allowance of $746,000 to the Company to complete the office and lab facility. The Company has recorded the tenant improvement allowance paid by the landlord as a leasehold improvement asset and a deferred rent liability on the balance sheet. The allowance is amortized as a credit to rent expense over the term of the lease, and the leasehold improvements are amortized as depreciation expense over the period from when the improvements were placed in service until the end of their useful life, which is the end of the lease term. As of March 31, 2011 and December 31, 2010, the Company has an unamortized tenant improvement allowance of $199,000 and $245,000.

Litigation

The Company is not a party to any litigation and does not have contingent reserves established for any litigation liabilities.

8. Stock-Based Compensation

Stock Option and Equity Incentive Plans

2006 Stock Plan

As of December 31, 2010, the Company had one stock-based compensation plan, the 2006 Stock Plan, or the 2006 Plan. In August 2006, the Company established the 2006 Plan in which 342,000 shares of common stock were originally reserved for the issuance of incentive stock options, or ISOs, and nonstatutory stock options, or NSOs, to employees, directors or consultants of the Company. In February 2008, an additional 375,000 shares of common stock were reserved for issuance under the 2006 Plan and, in November 2009, an additional 1,376,059 shares of common stock were reserved for issuance under the 2006 Plan. Pursuant to the 2006 Plan, the exercise price of ISOs and NSOs granted to a stockholder who at the time of grant owns stock representing more than 10% of the voting power of all classes of the stock of the Company could not be less than 110% of the fair value per share of the underlying common stock on the date of grant.

The Company s stock options under the 2006 Plan generally vest over four years at a rate of 25% on the first anniversary and 1/48th per month thereafter. The stock options generally expire ten years from the date of grant. However, in the case of an ISO issued to an optionee who at the time of grant owned stock representing more than 10% of the voting power of all classes of the stock of the Company, the term of the option could be no more than five years. Stock bonus awards and rights to immediately purchase stock were also permitted to be granted under the 2006 Plan, with terms, conditions and restrictions determined by the board of directors. Effective upon the execution and delivery of the underwriting agreement for the Company s IPO, no additional stock options or other stock awards may be granted under the 2006 Plan.

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(A Development Stage Company)

Notes to Condensed Financial Statements (Continued)

(Unaudited)

2011 Equity Incentive Plan

In January 2011, the board of directors adopted, and the Company s stockholders approved, the 2011 Equity Incentive Plan, or 2011 Plan, as a successor to the 2006 Plan. The 2011 Plan became effective immediately upon the execution and delivery of the underwriting agreement for the IPO on February 10, 2011. As of February 10, 2011, no more awards may be granted under the 2006 Plan, although all outstanding stock options and other stock awards previously granted under the 2006 Plan will continue to remain subject to the terms of the 2006 Plan. The 51,693 shares reserved under the 2006 Plan that remained available for future grant at the time of the IPO were transferred to the share reserve of the 2011 Plan. Shares granted under the 2006 Plan that are forfeited will not be added to the shares available for grant under the 2011 Plan.

The initial aggregate number of shares of the Company s common stock that may be issued pursuant to stock awards under the 2011 Plan is 1,875,000 shares, which number was the sum of (i) 51,693 shares remaining available for future grant under the 2006 Plan at the time of the execution and delivery of the underwriting agreement for the Company s IPO, and (ii) an additional 1,823,307 new shares. Then, the number of shares of common stock reserved for issuance under the 2011 Plan will automatically increase on January 1st each year, starting on January 1, 2012 and continuing through January 1, 2020, by 4% of the total number of shares of the Company s common stock outstanding on December 31 of the preceding calendar year, or such lesser number of shares of common stock as determined by the board of directors.

Pursuant to the 2011 Plan, the exercise price of ISOs and NSOs granted to a stockholder who at the time of grant owns stock representing more then 10% of the voting power of all classes of the stock of the Company cannot be less the 110% of the fair value per share of the underlying common stock on the date of grant.

The Company s stock options under the 2011 Plan generally vest over four years at a rate of 25% on the first anniversary and $^{1}/48^{th}$ per month thereafter. The stock options generally expire ten years from the date of the grant. However, in the case of an ISO issued to an optionee who at the time of the grant owned stock representing more than 10% of the voting power of all classes of the stock of the Company, the term of the option cannot be more than five years.

The following table summarizes option activity under the 2006 Plan and the 2011 Plan during the three months ended March 31, 2011:

	Shares Available for Grant	Number of Stock Options Outstanding	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value (in thousands)
Outstanding January 1, 2011	51,693	2,008,797	$ 2.91	8.3	$ 7,171
Additional options authorized	1,823,307				
Options granted	(444,958)	444,958	3.45		
Restricted Stock Units granted	(343,815)				
Options forfeited		(30,758)	2.55		
Outstanding March 31, 2011	1, 086,227	2,422,997	$ 3.02	8.7	$ 1,703
Vested options March 31, 2011		919,313	$ 2.71	7.7	$ 941
Vested and expected to vest March 31, 2011		2,422,997	$ 3.02	8.7	$ 1,703

Exercisable	March 31, 2011	919,313	$	2.71	7.7	$	941